House of Commons

Treasury Committee

Banking Crisis: International Dimensions

Eleventh Report of Session 2008–09

Report, together with formal minutes, oral and written evidence

Ordered by the House of Commons to be printed 14 July 2009

HC 615
Published on 24 July 2009
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue & Customs and associated public bodies.

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Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)
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Mr Andrew Tyrie MP *(Conservative, Chichester)*
Sir Peter Viggers MP (*Conservative, Gosport*)

The following member was also a member of the committee during the inquiry:
Mr George Mudie MP *(Labour, Leeds East)*

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/treascom.

A list of Reports of the Committee in the current Parliament is at the back of this volume.

Committee staff

The current staff of the Committee are Dr John Benger (Clerk), Sîan Woodward (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young, Jay Sheth and Aliya Saied (Committee Specialists), Phil Jones (Senior Committee Assistant), Caroline McElwee (Committee Assistant), Gabrielle Henderson (Committee Support Assistant) and Laura Humble (Media Officer).

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Banking Crisis: International Dimensions

1. Over the last eight months, the Treasury Committee has been engaged in a substantial inquiry into the banking crisis. To date, the Committee has taken evidence on 22 occasions since 3 November 2008, and has produced three Reports.[1] Following on from that inquiry, we wanted to assess briefly some of the wider international repercussions of the crisis.

2. The recent financial and economic crisis has been truly international in nature—real world GDP is forecast to fall by 1.3% in 2009.[2] We publish with this short Report evidence we have received on both the international regulatory framework, and on the international monetary system. A forthcoming report will tackle some of the international regulatory issues faced by the UK. Here we focus on a single aspect of the recent crisis, usually referred to by the term 'global imbalances'. The Turner Review provides the following description of these imbalances:

> Oil exporting countries, Japan, China, and some other east Asian emerging developing nations have accumulated large current account surpluses, while large current account deficits have emerged in the USA, but also in the UK, in Ireland, Spain and some other countries.[3]

3. Throughout our inquiry into the banking crisis, we have heard evidence of the role played by these 'global imbalances' as a key factor in the present difficulties. The Governor of the Bank of England stated that "The ultimate cause of what we have been through in the last two years was the imbalances of the world economy and the inability to cope with the resulting capital flows".[4] In a co-authored paper, Dr Andrew Sentance, an external member of the Monetary Policy Committee of the Bank of England, outlined the extent of these imbalances:

> In 2007, total current account surpluses in non-OECD economies totalled \$894bn, of which the surplus of China alone was \$372bn—over 40% of the total. In the same year, the US current account deficit totalled \$731bn. Spain (\$125bn) and the UK (\$105bn) were other notable deficit countries.[5]

The Turner Review highlighted how these deficits had developed:

> A key driver of those imbalances has been very high savings rates in countries like China; since these high savings exceed domestic investment, China and other countries must accumulate claims on the rest of the world. But since, in addition,

1 Treasury Committee, Fifth Report of Session 2008–09, *Banking Crisis: The impact of the failure of the Icelandic banks*, HC 402; Treasury Committee, Seventh Report of Session 2008–09, *Banking Crisis: dealing with the failure of the UK banks*, HC 416; Treasury Committee, Ninth Report of Session 2008–09, *Banking Crisis: reforming corporate governance and pay in the City*, HC 519

2 International Monetary Fund, *World Economic Outlook*, April 2009, Table A1

3 Financial Services Authority, *The Turner Review*, March 2009, p 11

4 Uncorrected transcript of oral evidence taken before the Treasury Select Committee on 24 June 2009, HC (2008-09) 767-ii, Q 111

5 Bank of England External MPC Unit, Discussion Paper No. 27, *The global credit boom: challenges for macroeconomics and policy*, Michael Hume and Andrew Sentance, June 2009

> China and several other surplus countries are committed to fixed or significantly managed exchange rates, these rising claims take the form of central bank reserves.[6]

The Review then noted that these were "typically invested not in a wide array of equity, property or fixed income assets—but almost exclusively in apparently risk-free or close to risk-free government bonds or government-guaranteed bonds".[7] This then led to "a reduction in real risk-free rates of interest to historically low levels".[8] Professor Willem Buiter of the London School of Economics observed that this reduction in the worldwide real interest rate allowed the "US to continue on this low-interest, high-liquidity asset boom".[9]

4. As the crisis continues, these imbalances may give way to an increase in saving in all countries, a potentially damaging outcome for the global economy. In a recent speech, Paul Tucker, Deputy Governor of the Bank of England, warned of the risks from both Asian and Western economies increasing their savings:

> Risks will, I should be clear, persist from the international environment and, in particular, the pattern of international saving. If the Asian economies were to continue to save at an extraordinary rate but the Western economies increase their saving, as over time we must in order to repair national and sectoral balance sheets, longer-term risk-free rates could again fall in order to bring about the counterpart expansion in investment. And, although it may seem far-fetched right now, that could give an upward impetus to asset prices over the medium-term. We would need to be careful not to mistake any such future developments for a miracle improvement in underlying economic and financial conditions. Indeed, internationally, we need to learn lessons about brewing risks from medium-term imbalances.[10]

Professor Buiter told us that "If you have a universal stimulus to domestic saving, private and public in the West without offsetting policies to reduce the saving investment surplus in the rest of the world, we are going to have a period of global stagnation—demand stagnation".[11] However, he thought that "both a desire and a possibility to tackle really excessively high savings rates" existed in China.[12]

5. In our July 2006 Report on *Globalisation: The Role of the IMF*, we concluded that "A disorderly unwinding of global imbalances poses a real risk to the UK economy" and urged the IMF to take "an active part in providing both independent analysis of, and potentially a solution to, the risks posed by a disorderly unwinding of global imbalances".[13] Progress in

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6 Financial Services Authority, *The Turner Review*, March 2009, p 12

7 *Ibid.*, p 12

8 I*bid*., p 13

9 Q 70

10 Speech by Paul Tucker, Deputy Governor, Financial Stability, Bank of England, at the Association of British Insurers 2009 Biennial Conference, London, 9 June 2009, page 3

11 Q 75

12 Q 75

13 Treasury Committee, Ninth Report of Session 2005–06, *Globalisation: the role of the IMF*, para 9

tackling global imbalances since then has been slow. However, the Governor of the Bank of England told us that now was the time to tackle these problems:

> the reason why I think this is the time to [reform the international monetary system] is that, now that the surplus countries, who very often have tended just to blame the deficit countries for racking up more debt, realise that they have a great deal at stake in the deficit countries not getting into deep trouble and, indeed, you simply cannot rely on the previous set of deficit countries expanding domestic demand, they will need to reign in domestic demand for a period. So this is something where it is not a zero sum game; we are all better off if we work together.[14]

He observed that "It is an enormous task, but the prize is also enormous".[15] There have also been several calls from other quarters for these imbalances to be tackled, such as those from the British Bankers' Association, the Bretton Woods Project, and the TUC.[16]

6. **Persistent current account deficits in the developed world, especially in countries such as the UK and the US have been matched by current account surpluses in countries such as China and Russia. These so-called 'global imbalances' have been repeatedly raised with us as being a key factor in the current crisis. There is an urgent need to address the policy responses to these global imbalances. As a small, open economy, the UK cannot impose a solution on its own. It can, however, act as a catalyst to a wider agreement. As such, it will need a clear idea of what the future international monetary architecture should ideally look like. We therefore recommend that the Treasury provide, as a response to this Report, a paper on potential future designs of the international monetary system. While we note the geo-political expediencies that may hamper implementation of such schemes, we recommend that the Treasury should provide us with a range of options, indicating the potential advantages and disadvantages of each, and any obstacles to implementation.**

14 Uncorrected transcript of oral evidence taken before the Treasury Select Committee on 24 June 2009, HC (2008-09) 767-ii, Q 108

15 *Ibid.*, Q 111

16 Ev 43, 55, 86

Formal minutes

Tuesday 14 July 2009

Members present:

John McFall, in the Chair

Nick Ainger	Ms Sally Keeble
Mr Graham Brady	John Thurso
Mr Colin Breed	Mr Andrew Tyrie
Mr Michael Fallon	Sir Peter Viggers

Draft Report (*Banking Crisis: International Dimensions*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 6 read and agreed to.

Resolved, That the Report be the Eleventh Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Written evidence was ordered to be reported to the House for printing with the Report, together with written evidence reported and ordered to be published on 9 and 16 June.

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[Adjourned till Tuesday 21 July at 9.30 am.

Witnesses

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Oral evidence

Taken before the Treasury Committee

on Tuesday 9 June 2009

Members present:

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Mr Colin Breed
Mr Michael Fallon
Ms Sally Keeble
Mr Andrew Love
Mr George Mudie
Mr Andrew Tyrie
Sir Peter Viggers

Witness: **Mr Peter Chowla,** Policy and Advocacy Office, Bretton Woods Project, gave evidence.

Q1 Chairman: Mr Chowla, welcome to this evidence session on the international dimension of the banking crisis, an issue that has been of concern to us now for almost two years. Could you introduce yourself, please, for the shorthand writer?
Mr Chowla: Thank you for welcoming me. I am very happy to be here. I very much welcome this inquiry by the Committee into the international dimensions. We have been following closely the work of the Committee on the domestic dimensions of the banking crisis, and I am very pleased that this is being taken forward. My name is Peter Chowla; I work for the Bretton Woods Project. We are a think-tank/NGO here in London which focuses on international institutions and their impacts on environmental sustainability and development opportunities for developing countries, so we have focused quite heavily on the World Bank and the IMF in the past but have also looked at the ABIS, Financial Stability Forum.

Q2 Chairman: I was actually just looking for your name and your title.
Mr Chowla: Okay; sorry, go ahead.

Q3 Chairman: So you are Peter Chowla of the Bretton Woods Project.
Mr Chowla: Yes.

Q4 Chairman: Okay. I will ask you a question. We have got 90 minutes at the most. If we can get through all these points it will be good for us. There was a lot of talk at the time on international financial regulation and the need to get it changed and a lot of heat without light. Do you think there is much light now in terms of that momentum for change, or do we run the risk of it receding and nothing very much is going to happen?
Mr Chowla: I think it is hard to tell. If we wait until the end of the month, we will have a lot more information. For members of the Committee who are not aware, the UN is organising a major international conference on the impacts of the financial crisis on developing countries, from 24 to 26 June in New York, where many of the proposals that are now on the table coming from various sources—the G20, as well as UN commissions and experts, as well as UN bodies—are going to be debated by members of the UN in a format which will hopefully produce some results. The early indications are that the appetite for very deep structural change is not there amongst some of the rich countries particularly. Although there has been quite a bit of movement on some of the nitty-gritty details of changing regulation at the margins, in terms of the structural elements of how we might look at international aspects of regulation of our monetary system, the feeling is that so far the rich countries, particularly in Europe and in North America, are not being convinced that this is a need at the present time.

Q5 Chairman: On the issue of low-income and middle-income countries, I note that richer countries have provided just over 5% of additional development finance to compensate low-income countries for the shock they face as a result of this crisis. It seems a pretty small amount. How concerned are you that the low-income and middle-income countries will be left out of this reform process? I think we got a hint of that at the G20, and we felt maybe their voice was not heard there as much as it should have been.
Mr Chowla: There is certainly a feeling that low-income countries are being substantially left out of the process. Within the G20 you have only one or two countries which can be considered low-income, one of which is India, but by all accounts the Government treats itself as an emerging market and has very different concerns from what you might expect from a small, low-income country in South Asia, Africa, or Latin America for that matter. The feeling is definitely that low-income countries are being excluded from some of the discussions. The feeling is also that the middle-income countries, the smaller or medium sized ones, are also being sidelined in some of these discussions, and that is an important reason why the UN conference is being focused on by some of the developing countries, so that they can have a voice in some of the discussions around change in the international architecture and financial regulation.

9 June 2009 Mr Peter Chowla

Q6 Sir Peter Viggers: In your evidence you point out that the International Accounting Standards Board, which is a private body with no public accountability, set up a monitoring board recently. Do you welcome that development? Is it acceptable, do you think, on a longer-term basis, that there should be an international body which has no public accountability?
Mr Chowla: Our position has always been that things that affect people's lives people need to have say over, and citizens need to have say over them through the appropriate mechanisms, and that will often include representation from their governments but it can also include direct representation and accountability to citizens through transparency and participation, through mechanisms such as consultation, et cetera. The problem with the ISB and its new monitoring board is that there is still no direct accountability. These are new developments, and it is unclear how the institutional developments will move forward, but the monitoring board does not have the ability to direct what happens at the ISB; its remit is limited to appointing trustees and to raising issues with the foundation which sets the accounting standards. I can certainly say it is a start to bring public accountability into a private body, but I think in the long run the need is for bodies that are setting fundamentally important financial standards to have clear lines of accountability back to the public, and that would be through governments or other mechanisms of direct accountability that allowed people and their representatives to exercise control over the policies that are going to have an influential effect on their lives.

Q7 Sir Peter Viggers: Would you give such a body powers to compel and would you give it powers to compensate if there is an error?
Mr Chowla: There is a need within the international sphere to have international rules which are enforceable, and that is true, for example, about accounting standards or if you are talking about banking regulation or about insurance standards, all of which are across the financial sector sphere. It is clear that we do not yet have an institution which is legitimate and capable at the international level of undertaking that kind of compulsion or compensation. It would be an ideal case that you can create a system where regulations across an international sphere can be agreed multilaterally, everybody has a stake in their implementation and, by consensus, agrees to them, and those who do not implement properly can be either incentivised to improve their implementation or essentially sanctioned for not implementing properly, which can provide some of the mechanisms of compensation which you have talked about.

Q8 Sir Peter Viggers: Developing countries do not really have a say at the moment, do they?
Mr Chowla: No.

Q9 Sir Peter Viggers: Does this concern you, and how can that be rectified?
Mr Chowla: The legitimacy of current international institutions is heavily weakened by the fact that developing countries do not have the kind of participation that would be necessary. If you look at the institutions we have got, the IMF, for example, had some of the better representation of developing countries, but still the voting power is skewed in such a way that between OECD countries (you can add it up in multiple ways), the rich countries can always fix the agenda in the way that they want. If you look to the other committees, the Standard Setting Committee, the IASCO, which handles securities regulation and the ISB, which is a private sector body, or the IAIA, which is the insurance international body, in most cases developing countries are almost excluded from the decision-making process or only involved in a very formal way in a small portion at the very end. So until they can find a legitimate institution through which to express their desires and to influence the way that decision-making is made so that the impacts of international financial flows on their economies are well reflected into standards that are being proposed, then I think we will find it difficult for them to support any of the bodies that currently exist. We generally believe that a fundamental prerequisite is that you have some governance reform to bring the legitimacy up to current standards, not just on participation of developing countries, but we have also seen in some of the other international institutions the need for greater accountability to citizens who may not find themselves adequately represented by their own countries.

Q10 Sir Peter Viggers: Do the existing institutions that are involved have the appetite to develop the kind of mechanism you would like to see, or does it need some kind of external influence or impetus to get the thing going?
Mr Chowla: From what we have seen so far, they do not have that appetite, and there is a need for external pressure. That can come from forward-thinking governments and it can come from institutions like the UN and the committee of experts that the UN has appointed to think through some of these issues and propose ways forward.

Q11 Mr Mudie: Do you think developing countries would be better off creating a new international regulatory structure rather than demanding alternative structures committed to their needs?
Mr Chowla: This is a fundamental question which is often repeated in international political economies. Is it better to reform what we have or to get something new? I think that is a difficult choice. I think the proposal of new institutions can sometimes take a long time and require a lot of will which is not there. I think in this case, when we are talking about finance regulation, we have the nucleus of a body, which is the Financial Stability Forum, which has now become the Financial Stability Board. I think the nucleus is there to use that. Since this reform that has been proposed by the G20 in April, what is left to be decided? The details have not been spelt out of exactly what a new FSB would look like, what its

structure would look like and what its mechanisms would be. So, I think, because we have a proposal already from the G20 without a lot of the details, we can use that as the basis on which to further identify how to make something like the FSB truly legitimate and representative so that it can reflect the interests of developing countries in the international sphere.

Q12 Mr Mudie: Do you have any confidence that the developed world will allow that to happen in that structure?
Mr Chowla: That is yet to be seen.

Q13 Mr Mudie: I know it is yet to be seen.
Mr Chowla: In the US we have an administration now which is more interested in multilateralism and in its responsibility to promote a sound global economy for everybody. I think we have, in Europe, some leaders who, though perhaps not naturally attuned to more regulatory environments, have also expressed a desire for more multilateralism. I think there is still resistance, not least of which sometimes comes from this country and sometimes from some other leading rich countries as well, but I do not think it is impossible to convince these countries that we can get there—this year perhaps. I think as the financial and economic crisis deepens (and the expectations are that it will in most places), as unemployment soars, I think the pressure will come to bear that we need something more radical and something more fundamental as we look to institutional responses and changes that can address this. If the economic crisis suddenly starts to dissipate, those famous green shoots start sprouting very quickly, we may lose the moment, we may lose the ability to convince the remaining hold-outs.

Q14 Mr Mudie: Have we not lost it, Peter? I looked at yesterday's *Financial Times*: a whole page devoted to our Chancellor being too pessimistic and that the recovery is going to start sooner, plus at the same time reporting that we are falling out with Europe about regulation as a sovereign nation, and it all points to the fact that we are already forgetting the disaster and starting to make sure that nothing much changes.
Mr Chowla: I think that some parties would like to see it move that way. There are interested parties who like the system as it was before because it provides certain advantages and benefits to them, and so they will certainly work hard to make sure that a more fundamental change does not come into play. I am not a soothsayer, I will not try to predict the state of the global economy in six months, but I do not think it impossible, for those who have watched the news to see Latvia not place a bond issue with the international markets and having to seriously consider again devaluing its currency quite heavily, to say that such a thing would not happen to a major emerging market. If, for example, something like what happened to Latvia happened to a Turkey or to a South Africa in the coming months—financial contagion spreads very rapidly around emerging markets—it is not impossible to say that things will get drastically worse, and that will provide some of those incentives and desires for countries to fundamentally rethink.

Q15 Mr Mudie: Why empower the Financial Stability Board instead of pulling the IMF in to do the job?
Mr Chowla: I think we have seen over the last 10 to 15 years, essentially since the Asian financial crisis, calls for the IMF to improve its macro-financial analysis, meaning the links between macroeconomic issues, largely in the public sector and the financial sector, and its implications on the macro sector. For 15 years now those calls have been made and for 15 years the IMF has not responded, has not yet found itself able to do that work, to incorporate that analysis into its own surveillance. I think it comes down to the kind of institutional rigidity that exists at the IMF. I think there is a need to vision, to think about public sector issues, macroeconomic issues, and private sector issues, regulatory and financial issues, and though they link and are interplaying, just as trade links with finance, as development aid at the World Bank links with finance, I think there is a need to vision which can provide a good ability to create a specialised agency that can really delve into the issues related to regulation and financial sector oversight.

Q16 Mr Brady: You highlight the damaging effects of volatile exchange rates. Are there not some benefits, though, of freely floating exchange rates wherein countries need to rebalance their economies?
Mr Chowla: That is true. I think the volatility, though, is of a different order of the kind of benefits that you might get from moving exchange rates. So the kind of adjustments you might need to adjust your economy are not in the order of hourly or daily adjustments, they are in the order of monthly or yearly adjustments, so, as you have now got perhaps a burgeoning current account deficit, you need to make adjustments. Those adjustments in your economic cycle and your economic activity are going to take months and years to pull through, just as when you change interest rate policy it takes 12 to 18 months to pull through the economic cycle and to pull through the economic institutions and to impact on the market, and I think the second by second, hour by hour volatility in exchange rate markets does not necessarily provide that. If you look at some of the volatility in exchange rates for some of the big emerging markets, for example South Korea, which I was looking at this morning, you can see volatility that has shot up and down in the course of days and weeks over the last six months or 12 months since this crisis started, which do not really relate to fundamentals about economic production, sale, trade; nor do they provide the kind of long-term outlook which is necessary for adjustment. So the kind of excess volatility you are getting will not allow adjustment from the business sector, for example, because they cannot plan three years ahead on the

exchange rate, which is the kind of planning cycles you need for productive investment in the real economy.

Q17 Mr Brady: I think we can all accept that there are instances of volatility that do not relate to fundamentals in currency exchange rate movements, but how do you find the appropriate market rate for a currency? How does a currency establish where it should be if you remove its exposure to those market movements?
Mr Chowla: The econometric and macro-financial analysis which produces real equilibrium exchange rates (REERs as they are called) is not perfect, and the IMF, the leading proponent and producer of these kinds of statistics, as well as other international institutions, international agencies, will tell you the same thing, that there is no way you can produce an exact number, and I think the fact that you cannot produce an exact number is tied to the fact that you also cannot produce an exact number through the market. This volatility has the same result. I think the system in place for the first 25 years after the war provides a kind of system that can work; it is workable. It is not perfect, and I think in this sphere that nothing is perfect, but the ability to adjust exchange rates over time, through looking at and analysing your surpluses and deficits in your capital current and trade accounts and by looking at your relative productivity gains and wage level gains, you can analyse and you can see over time if we are continuing building up deficits or surpluses (we have done for two years; maybe now we need to make an adjustment in policy), and I think that kind of regulated system is a possible way out. That is a long way to go from where we are right now, and I understand that transitional arrangements could be very tough, even some countries may not wish to move back to the kind of system we had under the Bretton Woods exchange rate system, and I think accommodation can be made for that. If you read the recently released UN Commission report, it talks about how you can create a system which allows some freedom of choice of which exchange rate system you want, but can build in broader stability in the market for using a global reserve currency system which would allow some better stability and some betting linking of currencies to an international standard.

Q18 Mr Tyrie: Can I come in on that? I have to say, I am rather confused now. Are you arguing for a managed exchange rate system in order to deal with short-term volatility or to deal with the quite different problem of a long-term build-up of global imbalances?
Mr Chowla: I think a managed exchange rate system can help you tackle both at the same time. It will allow you to cut off some of the speculative activity which helps contribute to short-range volatility, and that is not the only thing that creates short-range volatility but which also contributes to it. By tackling that through cutting off some speculative avenues, you can create greater stability in the short run. That also improves business investment and planning in the real economy. You can also then remove the need, for some of the countries that feel the need, to build up self-insurance, because they have a guarantee system that they can plan on and that they can construct their economic models on and which they can also then, hopefully, avoid some of the competitive devaluations, or other kinds of other sudden devaluations, that come with financial crises. So as you reduce the necessity of holding reserves by, I cannot say eliminating financial crises, but drastically reducing the frequency and severity of financial crises, then you can decrease the reserve holdings and bring yourself back to a point where reserve holdings more closely match need from the real economy rather than perceived need in terms of financial risk.

Q19 Mr Tyrie: Do you think it is possible to run a globally managed exchange rate system with free capital markets?
Mr Chowla: It would be incredibly challenging. The necessity for free capital markets has not quite been demonstrated, and I think there are some micro gains. There was a commission that was heavily supported by DFID, called the Growth Commission, which produced a report which studied, over the last 30 years, evidence of countries which had consistently high growth paths—they grew over 5% for more than 10 years at a time—and they studied what kind of policies they followed to enable them to pursue these kind of growth paths. This Growth Commission, which was headed by Noble Laureate Michael Spence at Stamford University, came up with the conclusion that there is no empirical evidence that capital market opening contributes to enhanced growth.

Q20 Mr Tyrie: So you are in favour of the reintroduction of capital controls on a global scale?
Mr Chowla: They need not be global. I think it comes back to giving countries choice and giving countries the policy space to chose what kind of economic and financial linkages they want to have with the world.

Q21 Mr Tyrie: Countries can impose capital controls tomorrow if they choose.
Mr Chowla: They have restrictions.

Q22 Mr Tyrie: We are only talking about global architecture here.
Mr Chowla: No, they have severe restrictions due to existing bilateral investment treaties, free trade agreements, commitments made under the WTO, as well as pressure that comes from the IMF and the World Bank in conditionality attached to lending programmes and policy advice. So the imposition of capital controls, though feasible, is highly incentivised against, and in some cases prohibited by, existing international arrangements under bilateral or investment treaties.

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Q23 Mr Tyrie: You would like the removal of those restrictions on the reintroduction of capital controls to enable a number of countries to return to their imposition?
Mr Chowla: I think it is particularly useful for some developing countries to use capital controls at certain times. They can have counter-cyclical effects; they can buffer the kind of portfolio hot money flows in and out of countries.

Q24 Mr Tyrie: We are not talking about this here. These are very different types of issues: the hot money flows. We are back to this short-term volatility issue. I am trying to get at whether, as part of your long-term architecture to deal with global imbalances, you are in favour of the introduction of capital controls permanently.
Mr Chowla: I think they can be a very useful tool for some countries.

Q25 Mr Tyrie: I am asking whether you want them permanently?
Mr Chowla: I think they permanently need the option so they can use that option when it is made necessary or beneficial by the external environment. It is not to say that you must have capital controls all the time, but it is developing countries that need the ability to use those as and when needed.
Mr Tyrie: I think we will think carefully about your replies.

Q26 Sir Peter Viggers: In your memorandum to us you look at the accumulation of huge foreign currency reserves. You call it a kind of self-insurance, in fact you have just used the expression now, and you trace it back to a loss of confidence in the IMF after the manner in which the IMF dealt with certain crises, especially in the Far East. I suppose two questions arise from this, the first relating to the reserves themselves and the second relating to the restoration of confidence in the mechanisms of the IMF or other international bodies. Dealing first with the foreign currency reserves, do you see that it is likely that countries in the future will wish to have such high foreign currency reserves? As for self-insurance, do you see an ambition for that diminishing or continuing?
Mr Chowla: I think it depends on the resulting institutional changes that we see. If, as some have alluded to, we will have limited institutional changes, then I think we will see a continued desire to hold high levels of reserves. That may be moderated by increasingly advanced regional arrangements for reserve pooling, which we are seeing in Latin America and in Asia, and similar arrangements may be coming into place in other parts of the world that are being discussed. So, as those are taking place, we might see a slight moderation of this desire, but I think, in general, the desire to have self-insurance against highly volatile movements will be there. I think the recent evidence from the financial crisis and lending by the IMF is that, while there is a desire to change some of the conditionality that the IMF uses, that has happened for some subset of countries but not for others, and I think the countries will still face the risk, or still feel the risk that they will be subject to heavy pro-cyclical conditionality from the IMF when it comes to time for them to get a rescue package, and avoid that necessity, when they go to the IMF, they will continue to want to self-insure. That said, I think, clearly, the biggest case that we need to discuss is China. I think for China, my understanding, from my reading of the evidence and opinions, including from some Chinese academics, is that the feeling is strongly that they have reached a point where this is now very counter-productive, and the Chinese are themselves seeing that we should perhaps not continue on this kind of policy in this programme. I think that is why particularly the Chinese have been very interested in institutional changes which might moderate some of the desire or push to hold these kinds of reserves.

Q27 Sir Peter Viggers: Looking at confidence in the institutions, is the IMF the key institution that we should be looking at? If so, what are the essential elements to improve confidence in it?
Mr Chowla: The IMF, I think, is the central one in regard to reserve holdings. There have been other arguments around the WTO and its need to look at the trade implications of managed exchange rates. I will put that aside, since I am not an expert on the WTO, and focus on the IMF. Clearly, at the IMF there are two areas where developing countries have strong concerns, and that is on governance and on conditionality, which I mentioned. So the moves for change in the governance structure of the IMF, as the Committee is probably aware from the 2006 report on the role of the IMF, the outcome was less than radical in terms of changes in government structure. The G20 has agreed to come back to that and bring forward further reform of the governance structure of the IMF. It is not clear how quickly that will happen. On the conditionality side, as I have mentioned, I think the IMF has made progress. So they have a new facility which allows countries who have "strong policies" to get money, conditionality, free. This has already been accessed by Poland, Columbia and Mexico, as the first three countries which have approached this facility. That kind of facility is a good improvement in innovation, but the worry is that the rest of the countries, which are deemed not to have strong policies according to the IMF, still face the same kind of conditionality. So until that conditionality can be streamlined, reduced or eliminated with altogether more facilities like the one that Mexico is accessing, countries, I feel, will still feel the pressure or the desire to build up the reserves to try and avoid facing the kind of imposition of conditionality.

Q28 Nick Ainger: Following on from what you were just saying, in the evidence that you presented to us, your Update 65, you are critical of the IMF. You basically say that they are not practising what they have been preaching about fiscal stimulus, and so on. What is your view of their performance so far in dealing with the current crisis?

Mr Chowla: Their performance is mixed. I think the new managing director of the IMF, Dominique Strauss-Kahn, has brought a change of attitude to the top of the IMF—I think that has been very clear—and he has played quite an active role in making pronouncements about the need for fiscal stimulus, for counter-cyclical policy, for countries to spend to buoy the economy and to create jobs. Unfortunately, I think that has not filtered all the way down into the IMF's strengths and into the IMF's programmes. So, while we have seen the three countries that I have mentioned have access to non-conditional money (Mexico, Poland and Columbia), we have also seen many countries like Hungary, Latvia and Pakistan, facing very strict and austere conditionality from the IMF and repeating, essentially, in Eastern Europe the kinds of things that happened in East Asia in 1997 and 1998, where you had extremely strong pro-cyclical conditions from the IMF, forcing spending cuts, deeper recessions, devaluations of currencies and then more bankruptcies by companies and individuals in debt. So I think we have had a mixed picture and the IMF needs to do more of the kind of programmes that they have been arguing for in a few countries, including now in a few low-income countries like Tanzania and Mozambique. We need to see than now in more countries across the board, including in Eastern Europe and Sub-Saharan Africa, who are facing severe constraints on their financing this year due to the financial crisis.

Q29 Nick Ainger: You say that Dominique Strauss-Kahn (and we met him a few weeks ago) has brought change at the top but that you do not think that further down it is actually having an impact. In many countries, particularly those that are developing, the IMF placed conditions on loans that were basically neo-liberal: there were very strict, fiscal and monetary conditions placed on them. Are you saying that at the top that attitude has changed but that the same people that were applying the policies may be five or 10 years ago are still there and applying those same policies?

Mr Chowla: Yes, I think that is the case. I think from the top they have pushed change only so far, in that you have got the kind of facilities available that I have talked about, the flexible credit line which allows non-conditional money to be provided. We have also had an increase in the amount of money, though it is still very small, that is available conditionality-free under some of the facilities for low-income countries. So they now have a very small portion for which they can get 25% of their quota without any conditions, and those kinds of changes come from the top. They come from pressure at the board level where developing countries have been pushing for and demanding these changes for a long time, and they also come from their top management. I would say the second rung of management is not formally changed in opinion. There are three deputy managing directors. The first deputy managing director is always, by convention, from the United States. I would not proclaim to say that he is a post Keynesian or socialist of any kind, but the additional deputy managing directors also have recently come from Latin America, one of them, and the second deputy managing director generally comes from Japan. I think they have brought different kinds of attitudes, like Strauss-Kahn has, whereas the first deputy managing director maybe has not.

Q30 Nick Ainger: One final point. The G20 announced that the IMF was going to get an additional 750 billion in resources. I notice in your report you refer to the Third World Network. Rather than welcoming this, they actually say, "Additional resources to the IMF would give it the means by which to discipline crisis-hit countries the wrong way, worsening the crisis for them." I think this was in your April update. Have you seen anything from the IMF that would indicate that they are not going to follow that type of policy which is feared by the Third World Network?

Mr Chowla: I think we have seen in recent board discussions, in the cases of Tanzania and Mozambique, that they have proposed fiscal stimulus in low-income countries, which is unheard of in the IMF's history when you are talking about a programme country spending more money. That is generally not the practice from the past. So I think we have seen some small change, but, as I have said, I think the crisis-hit countries, for example in Eastern Europe, are being disciplined the wrong way. They are facing the exact kind of pro-cyclical conditionality that you had in Asia in 1988, and I think we should be very clear. My friends at the Third World Network, who I talk to quite regularly, are quite aware that in countries which have "lived beyond their means", according to the IMF and others, there is a need for adjustment. Everybody recognises that you cannot have deficits of 10% year after year forever; you have to bring things back onto a sustainable footing. It is a question of the timing of adjustment and, just as in this country when banks have gone to the wall, essentially, and been bailed out by the taxpayers, there is a desire for them to rebuild their capital adequacy ratios, but every policy-maker that has talked about this has said, very clearly, we will not force them to do it now; now is not the time. We will get through the crisis, we will restore growth, then we will increase the capital ratios of the banks. That is exactly the kind of policy that developing countries need to follow in terms of their own fiscal position: now we are in a crisis, we need to have more ability to produce counter-cyclical policy; when the crisis is over, when we have restored growth, then is the time to adjust back to a sustainable position. So it is about the timing of adjustment, it is not about the need for adjustment. Everybody recognises that you have to have some sustainable path of fiscal and monetary policy, but I think we are seeing that for the crisis-hit countries, not necessarily for the Tanzanias and Mozambiques, who are facing long-term development challenges, but particularly in Eastern Europe, the IMF is pursuing the same medicine that they always have.

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Q31 Mr Fallon: Your paper says a little bit about transparency but slightly more on the IMF itself than on the record of the Member States, for example, in agreeing to publish surveillance reports. Why is that? Why do you not argue for that?
Mr Chowla: We are in favour of transparency of those surveillance reports as well.

Q32 Mr Fallon: It is not in your paper.
Mr Chowla: It is not in this paper. I can provide you with some other background material which talks about that. I think from our point of view the surveillance issues have largely been resolved. The number of countries that do not publish their Article 4 reports is very small now.

Q33 Mr Fallon: It is one in 10; so that is 18 or 19.
Mr Chowla: It is about right. It has sometimes been 95% on top or sometimes down to 89%. It goes up and down by year.

Q34 Mr Fallon: Why should it not be all?
Mr Chowla: I think it should be all, indeed.

Q35 Mr Fallon: Why do you not call for that?
Mr Chowla: We do call for that.

Q36 Mr Fallon: You do not in the paper.
Mr Chowla: Not in this paper. I can provide you with some other material we provided to the IMF.

Q37 Mr Fallon: Let us be absolutely clear about this. You believe that all countries, whatever the state of their finances, even if they are the ones in the developing world with the most difficulties, should publish in full the staff report and other accompanying analyses?
Mr Chowla: I think, yes, they should publish in full, with the caveat that there is a need to protect data that might create immediate market reactions that are adverse, and that has always been IMF policy. If you are going to talk about some of the very sensitive issues around exchange rates, countries might need to delay publication or prevent publication of that specific piece of data to prevent adverse market reactions.

Q38 Mr Fallon: That is not publication in full, is it?
Mr Chowla: That is following the line of freedom of information policies across the world, including in this country, where sensitive information is allowed to be redacted.

Q39 Mr Fallon: But it depends on the sensitivity, does it not?
Mr Chowla: Yes.

Q40 Mr Fallon: I understand your point about exchange rates, but what about, for example, if the staff report itself is extremely critical of that country's governance? Would you not agree that that should be published in full?
Mr Chowla: Yes.

Q41 Mr Fallon: With all the accompanying analyses?
Mr Chowla: Yes.

Q42 Ms Keeble: You said just now that you expected the economic crisis to deepen, and you also referred to the difficulty of developing countries in financing their budgets. Are you concerned about the debt levels and the possibility for managing debt in developing country economies?
Mr Chowla: This is a particularly large concern right now, and I think it is not yet clear what will happen. The G20 proposals included increasing the amount of money available under lending facilities at the IMF for low-income countries, and I think the worry is that in the time of the financial crisis, where some countries—thankfully not the UK—are cutting their aid budgets (and we have seen that in other countries across Europe), the low-income countries might be pushed into financing that loss of aid through lending, and that will then perhaps return us back to the horrible situation we were in during the 1980s and 1990s where countries ended up with more debt than they could service. The IMF and the World Bank and the G20 have pushed for more flexible consideration of the Debt Sustainability Framework, which is the framework that they use to assess whether a country can manage its debts sustainably. There are worries around that process, because I think there is a feeling that low-income countries who were being hit by the financial crisis should not be pushed into greater debt to deal with its consequences since they have had no part in making the crisis, and the wish amongst those society organisations is generally that levels of grants, not debt-based aid, be provided or increased so that these countries do not find themselves back in the situation they were in the 1980s.

Q43 Ms Keeble: Given the interest in increased regulation of innovative financial products here, including regulation of hedge funds, are you concerned about the activity of those innovations when it comes to looking at developing country debt, particularly around some of the activities of the vulture funds?
Mr Chowla: I think this is concerning, and this is part of the problem that we have seen across the landscape of low levels of regulation and regulatory gaps and regulatory havens, if you will, regulatory arbitrage, where financial institutions move or locate in places where they face low regulation. In terms of vulture funds, so far we know of 54 cases where companies are taking legal action against developing countries which are eligible for debt relief because of this debt problem. I think the recommendations around dealing with this need to be incorporated into the broader discussion around regulatory reform, and I do not think we have seen that happen yet in the UK or in the US, where they are talking about domestic regulatory reform. We have not seen as much of that discussion from the likes of Treasury Secretary Geithner or Lord Turner as we need to see. I am thankful that the UN commission of experts on

financial reform, which has been appointed to study reforms in the international financial system, has devoted half of a chapter to discussing a sovereign debt restructuring mechanism, which is a way to bring bankruptcy court-like procedures to deal with sovereign debts.

Q44 Ms Keeble: You say you think it has not had enough attention yet. Do you think it should be on the agenda for the next G20 meeting, for example?
Mr Chowla: I certainly think it should be.

Q45 Ms Keeble: What do you think should be put forward?
Mr Chowla: The proposals around sovereign debt restructuring are incredibly important. This is something that has been on the table from about 1999, when it was originally proposed by the IMF as well but was never accepted in any format that everybody found acceptable. So I think we need to bring it back and have a serious multilateral discussion about what it could look like and how it should work, but I think that is not enough. That deals with some of the most egregious cases when countries are defaulting, but I think you should work at the beginning to try to prevent this, and so that is about tackling this question of regulatory arbitrage and regulatory competition across sectors through better international regulatory standards, which can bring up the playing field to a level which everybody works on, which can then prevent this kind of activity.

Q46 Ms Keeble: But if we have got the US and the UK looking at specific measures, how can you actually stop the activities of the fund, or prevent them, given that they can circumvent those jurisdictions, or do you think that the US and UK should provide an international lead on this?
Mr Chowla: I think the US and the UK can provide an international lead, and by acting first, or by pushing action further, they can bring everyone else along. The fact that a large portion of sovereign debt contracts are written with London as the jurisdiction provides the opportunity for the UK to take a leading role, because they can change the law on how these debt contracts are interpreted or dealt with when they come to court for cases. So that fact provides the UK with a lot of leverage to take a lead, but I do believe that while the UK can take a lead and can significantly change some of the practices for the better in some cases, to provide a wholesale solution to this problem we need an international approach.

Q47 Ms Keeble: Can you give an idea of the kind of measures you would like to see and, if you could, come back again to the issue about what you would like to see on the G20 agenda?
Mr Chowla: Definitely on the G20 agenda needs to be a sovereign debt restructuring mechanism or a fair and transparent sovereign debt arbitration process, a bankruptcy style approach to sovereign debt, so that all creditors, be they sovereigns or be they the private sector, are subject to jurisprudence around the debt resolution mechanism, just like you would for any kind of bankruptcy. I think that is a fundamentally important thing that needs to be on the agenda. We have kind of danced around this issue about whether you might have an international regulatory authority, and we have talked about FSB reform. As you deal with the FSB's governance and legitimacy problems, I think negotiations need to start now about the role and substantive work of what the FSB would do in terms of regulation of the kinds of actors that work in the vulture fund area.

Q48 Ms Keeble: And a limit on interest.
Mr Chowla: This is something that has also been proposed; this is not on the official agenda. There has been what is called a Charter on Responsible Lending, which has been produced by some of our colleagues at the European Network on Debt and Development, which is a set of standards that should be applied to all lending and includes things like transparency, but also fairness and issues around interest rates and fair interest rates. I also have some colleagues—and I am not expert on this—who feel that regulation around (not here in the UK even) domestic interest rate policy is sometimes lacking in terms of usury interest rates which are being charged on domestic lending, and I think we can look at bringing some of those kind of usury regulatory issues into the agenda at the international level as well.

Q49 Ms Keeble: If the international community is going to look at continued debt relief, provision of debt relief, do you think there is a need to look very carefully at the activities of vulture funds, given that they do actually extract a large amount of that value, do they not?
Mr Chowla: There is a very concerted need to look at the activities of these vulture funds. I think I would also worry, from the sole stand point of a taxpayer, where my tax resources are going to. When we are providing debt relief, that is a kind of aid to developing countries. There are problems with the conditionality attached, but, setting those aside, this is taxpayers' money which is going to provide aid, and if it is being clawed back in the form of private profits for actors in the City or the Cayman Islands, I would be very concerned, and I think the UK and the Department for International Development can take a lead on bringing these issues to the fore at the international discussions at the G20, at the UN and in other places.

Q50 Mr Love: Can I take you back to a discussion earlier on where you were suggesting that there should be a permanent option for countries to introduce capital controls. At the moment most countries only do that *in extremis*, and they still have the right to do it, but there is an international consensus architecture that stops them doing that. What changes do we need to make to that architecture to make it easier for them? I am thinking mainly about smaller countries. Larger countries do not suffer this problem. What do the smaller countries need to allow them to introduce that?

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Mr Chowla: We have seen it is not just smaller countries, I should say. Capital controls are in existence in India and China, some of the biggest emerging markets, and they have used them to great effect, in terms of producing volatility of portfolio flows coming into and out of the country and have used them also for domestic political purposes and other things. So, let us be clear, it is a broad sector. The area where action needs to be taken, if you are going to create the possibilities, is particularly around rolling back some of these commitments under financial services liberalisation and investment liberalisation so that, under bilateral investment treaties or free trade agreements, including through the European Union's economic partnership agreements, which have not yet been concluded but are being worked on with the African and Caribbean countries, these kind of capital liberalisation clauses are included. So you need to somehow roll back some of the existing agreements, and that has been talked about by the UN Commission of experts on financial reform and the kind of places where you can do that and where you need to do that. So I think you have got bilateral investment treaties, regional trade agreements, free trade agreements, economic partnership agreements and GATS (the General Agreement on Trade and Services), an annex of the WTO. That is the one that governs financial services liberalisation where countries have made levels of commitment which vary but some countries have made very high levels of commitments in terms of liberalisation. So those are some of the very structural areas where you need to address this. I think the other areas are, as I mentioned at the World Bank and the IMF, where capital mobility has been a very strong element of their policy advice and sometimes conditionality for the last 20 or 30 years. So you need to deal with that at those levels.

Q51 Mr Love: That is a revolution, if I may say so!
Mr Chowla: Yes.

Q52 Mr Love: You are talking about shifting the whole international consensus that there has been to lever an economic policy?
Mr Chowla: Yes, but I think it is probably not as radical as it seems, because I do not think anybody is arguing for going back to the kind of damaging and distorting capital mobility and currency exchange rules which have been problematic in the past in developing countries where you have had black markets operating, orders of magnitude above what you have in the official markets. I do not think that is what we want. I think what we want to see is the IMF engaging with countries to give them advice on how to introduce smart mechanisms of capital controls, smart mechanisms of financial investment controls, so that you can moderate some of the hot money flows and radical movements in capital around. The example that most people point to is Chile, where they have had for now 10, 15 years, essentially, a deposit that you must put on inward investment, and you put this deposit, and you lose it if you take your investment out—it is a very small half a percentage point kind of thing—but then, if you are in for long-term investment, you get the money back. It is just a deposit that the Government holds. Those kinds of measures are the kinds of things the IMF needs to be advising countries on how to implement, how to do it properly, how to set up the structures to do it, how to enforce it—those are the kinds of things they need to be doing—and, to be fair to the IMF, they have not always advised against capital controls: there have been a few cases where they have advised the implementation of capital controls. I think it is just a matter of improving that advice, increasing its availability to developing countries and broadening it to make sure it is consistent across the IMF.

Q53 Mr Love: Can I take you on to conditionality. I think you are absolutely right about the IMF policies being pursued in Eastern Europe at the moment. It seems to be the old IMF, if I may say so. I think everybody accepts there has to be some form of conditionality. You were suggesting they need a breathing space to introduce the adjustments necessary. Is that the only change in terms of conditionality, or is there an acceptance that tough policies have to be pursued in order to bring people back to a sustainable position?
Mr Chowla: There are a couple of areas to mention. The IMF has, generally, two kinds of conditionality: they have what they call quantitative conditionality, which deals with regulatory macroeconomic indicators—your inflation levels, your budget deficit, your current account deficits—and then they have structural conditionality, where they deal with structural change in your economy requiring privatisation of enterprises or other kinds of measures. I think in the first one, quantitative, what people are asking for is more flexibility and a greater time differentiation of how we implement what are called sustainable policies, however you define those (and there is debate about how you define them), at least giving breathing room for adjustment and time to pursue counter-cyclical policies during a crisis. In the structural area there is a lot of evidence that the IMF's conditionality, however well-meaning it is and whether it is even correct or not (and, again, there is debate about how correct it is), is ineffective. Structural reforms are only pursued if the Government wants to pursue them, and structural reforms they commit to, to the IMF, simply to get a package are not pursued with the kind of vigour that they should be and, at the end of the programme, are often turned back. So there is a question about whether this kind of conditionality is effective at all, and I think it provides the analysis to think perhaps we should be doing away with this kind of conditionality altogether, and the IMF has made some changes in the last six months to this structural conditionality: they have now decided they will no longer have individual requirements. In the past, if you did not meet a single individual requirement, there was a risk your programme would not continue and you would not get the money that you were being lent from the IMF. They have announced a move away from that towards a more structural

holistic approach, to say, "Have you done enough? If not, what more do you need to do?"—rather than a single, a wide-angled approach.

Q54 Mr Love: Is that change in the IMF recognition of the need to bring in the bigger economies who have built up balances? When they go and check with these countries as to why they are so opposed to having the IMF in, is this a critical issue for them?
Mr Chowla: Yes. As I have mentioned to your colleague, this is definitely a critical issue. It is one of the two main issues that they face in terms of the legitimacy. The changes have been driven by developing country demands, by also the managing director and his recognition that this is a problem, and also by the Independent Evaluation Office of the IMF which has done some excellent research in evaluation of recommendations in terms of how to deal with this. So they have made a lot of progress in terms of identifying that this is an area where there are problems, where the effectiveness of the IMF is low and how you can change it. I think further changes need to be made.

Q55 Mr Love: Can I take you on to tax havens and your call for greater transparency. This was reflected at the G20 meeting. Have they got the political will to do it?
Mr Chowla: I think, with all respect, you would know better than I would what the political will of the Government is in tackling this issue.

Q56 Mr Love: They are not saying so publicly, in fact they are being quite helpful publicly about tax havens, but the hope is that the political will will dissipate. Is that likely to happen, do you think?
Mr Chowla: I think the momentum for change and the forces that are demanding change are gaining strength and I think developing countries have recognised that this is an area where they need action. Civil society organisations in developed countries are demanding of their governments that they take action, and I think this is an area where we are likely to see change. The question is whether it will go far enough. The Prime Minister has taken quite strong steps, compared to what anyone could have imagined a year ago, in terms of disciplining overseas territories, commonwealth territories, his demands that they fully meet all the standards that are in existence and that they will be expected to exceed them. The question now becomes: can this Government and other rich governments be in the position to increase the standards to a level that is going to really provide a significant change to developing countries and their ability to raise revenue and not have revenue essentially taken out from under them by the activities of not only corrupt individuals but also foreign investors and other kinds of money laundering activities and drug activities?

Q57 Mr Love: Can I raise two problems with you. The first is that of the small places, the Andorras, the Monacos, the Cayman Islands, where these changes may well wreak economic havoc, admittedly in a very small area but where their whole existence economically may be affected, and, secondly, the much larger Singapores and Switzerlands where they have some clout in the world. How do we deal with those two separate problems?
Mr Chowla: The first problem is fairly straightforward. Most of these small territories that rely on financial centre activity are in the rubric of developing countries, middle-income countries or small island states. Measures need to be put in place to increase the ability of them to have other kinds of economic activity and that can be done through traditional aid programmes or development lending programmes through the various international institutions and bilaterally through DFID and others. That is a fairly straightforward problem. This has happened with trade negotiations over 20 years; you provide aid to adjust to a new economic position. The Singapores and Switzerlands of the world are a different story. I am not an expert in these tax competition matters, but I suspect that even if you produce a level playing field and up the regulatory stakes to a certain level and increased the transparency, and Switzerland and Singapore are brought along to that level, the substantial network effects they have in their banking sectors would continue to play into them being strong financial centres. I would not expect that you would see a lot of movement away from Singapore or Switzerland because they have such established institutions which allow them to have network effects where they interact with each other and with their clients. I suspect that the damage would not be as severe as some might predict because I cannot imagine that the banking industry would move completely away from these kinds of places.

Q58 Chairman: Mr Chowla, can I thank you very much for your evidence. It was very helpful. We have got further evidence from academics next week on the wider issues regarding not only emerging countries but what are termed as the richer, more developed countries, so it is a good introduction for us and we are grateful to you for taking the time to come along.
Mr Chowla: Thank you again. I really do appreciate it and I do welcome this. I look forward to your conclusions.

Tuesday 16 June 2009

Members present

Mr John McFall, in the Chair

Nick Ainger	John Mann
Mr Graham Brady	John Thurso
Mr Colin Breed	Mr Mark Todd
Mr Michael Fallon	Mr Andrew Tyrie
Ms Sally Keeble	Sir Peter Viggers
Mr Andrew Love	

Witnesses: **Professor Willem Buiter**, London School of Economics and Political Science, **Dr Jon Danielsson**, London School of Economics and Political Science, **Professor John Driffill**, Birkbeck College, and **Professor Mark Taylor**, Warwick Business School, gave evidence.

Q59 Chairman: Welcome to this Banking Crisis inquiry. Can I ask you, starting with Professor Buiter, to introduce yourselves for the shorthand writer, please?
Professor Buiter: I am Willem Buiter, Professor of European Political Economy at the London School of Economics.
Dr Danielsson: Jon Danielsson, Reader in Finance, London School of Economics.
Professor Taylor: Mark Taylor, Professor of International Finance, University of Warwick.
Professor Driffill: I am John Driffill, Professor of Economics at Birkbeck, University of London, and Director of the ESRC's research programme on World Economy and Finance.

Q60 Chairman: You are all welcome. We hope to finish this session by 11.30 at the latest, so not everyone needs to jump in to every question; you play to your strengths. Can I start by looking at the issue of what the Governor of the Bank of England called "an unprecedented and synchronised downturn in business and consumer confidence around the world"? Was it synchronised? Or was there a decoupling? What were the reasons for it?
Professor Buiter: It was pretty synchronised, as global cycles go; every country in the world, except North Korea, underwent a downturn. It started in the US, but the UK and then the rest of continental Europe followed soon after, and then the emerging markets chipped in. So it was triggered by the financial crisis that was the common cause, but I think it was primarily a fall in business confidence rather than in consumer confidence.

Q61 Chairman: Perhaps we can talk about the decoupling issue. Will the present crisis provide the stimulus for decoupling to begin? Was there a decoupling?
Professor Driffill: There has been a lot of talk about decoupling. It is a kind of mysterious business because the way in which the world has been changing you would have thought would have led to exactly the opposite phenomenon from taking place; more and more trade and more and more financial and investment linkages between the developed and the undeveloped world, and on the developing world, the emerging markets, and you have seen more coupling, I would have thought, rather than decoupling. The synchronisation has been the exact opposite of decoupling. So it has really affected, to a greater or lesser extent, all of the emerging markets in Asia, Africa and South America.

Q62 Chairman: The *New York Times* described it as: "A true decoupling may not be so much between the United States and the rest of the world as between segments as the global economy cater to the burgeoning nouveau riche of emerging economies, on the one hand, and most other commercial sectors on the other". Would you agree with that?
Professor Buiter: In part, yes. Those countries, regions, that (a) have not had their financial sector destroyed, (b) are not too dependent on external finances and (c) are not dependent on external trade will lead the recovery, and the downturn could indeed be V-shaped. We are seeing that, probably, in China, India and, possibly, in Brazil, but that is about it at the moment. There are many nouveau riche who are not doing too well at all; the Middle East, by its standards, is doing very poor.
Dr Danielsson: I would think that the crisis demonstrates how integrated the world is and how synchronised economies are except for North Korea, Cuba and a couple of other countries. I would tend to disagree with the statement in the *New York Times*.

Q63 Chairman: On to Eastern Europe. I note recently (12 June) that the Latvian Prime Minister said that he had saved the country from bankruptcy, but the cuts he will impose will include reducing old age pensions (and I quote this from the BBC) by 10% and cutting public sector salaries by 20%. However, the Latvian Government have decided against increasing income taxes. What lessons should we learn from the problems that have hit Eastern European countries such as Latvia and Hungary?
Professor Driffill: They have grown very, very rapidly, partly on the back of somewhat speculative investments, and they have relied heavily on external finance, and when that has been pulled out the whole thing has gone pear-shaped very, very quickly.
Professor Buiter: Latvia was a country that was going to go off the cliff for domestic reasons; it had the most unsustainable boom I have ever seen

anywhere—9-10% growth for seven or eight years, and an enormous appreciation of the real exchange rate. The current account deficits were larger than Iceland's—it was unbelievable. Of course, it was enabled and facilitated by the willingness of the rest of the world to throw very cheap capital at it, but the problems of Latvia are primarily found inside Latvia—they were grotesquely mismanaged.
Professor Taylor: I think it is worth noting that the problems in Eastern Europe, to some extent, mirror the crisis that occurred in East Asia in 1997/98, and what is striking is the failure of those Eastern European countries to see that parallel, and the rest of the world also to see that parallel.

Q64 John Mann: Senior people in the Home Office and the police warned of social unrest in Britain (which we have not seen) because of the economic crisis. It is not just Latvia that has seen major social unrest; we have seen riots and near-riots in a number of European countries, all in Eastern Europe, in very recent times. How important is membership of the eurozone to avoiding such crises?
Dr Danielsson: I do not really see membership of the eurozone as being very helpful. You might see riots in countries that are within the euro; we do see Greece suffering bad problems; we do see Ireland suffering bad problems. The countries that have seen these riots are countries which have unsustainable economic growth fuelled by the inflow of hot money without the institutional background to sustain it and without, really, the economy developing to accompany it. In a country like the UK, which is a much more solid economy, I would not expect to see such economic downturns or unrest.
Professor Driffill: Membership of the eurozone would help a country like Latvia but using the euro would obviate the chance of a catastrophic collapse in the exchange rate, which hits very heavily a country that has large external borrowings in foreign currencies. So the Swedish banks have invested heavily in Latvia and Latvia has a lot of external debt in foreign currencies. Then devaluation of the currency becomes very, very expensive, and being a member of the eurozone would cut that out.

Q65 John Mann: It is very easy to analyse currency and exchange rates in those statistics, but there seems to be no ease of monitoring mass movements of people which we appear to have witnessed in different directions in the last two to three years, including, since the economic crisis, people moving in large numbers within the European Union. How much of a factor is that, and is it a positive or a negative factor in terms of labour market flexibility or in terms of creating further instability?
Professor Taylor: Typically it is a positive factor in the sense that within a common currency area you can adjust or you can compensate for the lack of monetary instruments being the same across a country which may be accelerating different phases of the economic cycle, typically, by capital and labour mobilities—classic criteria. So it does not count as much with mobility to the UK, of course, because we are not part of that common currency area.
Professor Buiter: Labour mobility data have always been bad in Europe as anywhere else, because so much migration is illegal or, even when it is legal, it is just not registered. Within the EU there is no longer a need to register but even across the EU border the massive flows have certainly increased the flexibility of the labour market but, also, made for social tensions, and that is true everywhere in Europe; it is true in this country (as seen when British workers objected to Polish gas workers on various large-scale construction sites); it is true in the Netherlands. So migrants, immigrants, are always an easy group to blame for either feeding off the public purse or taking your jobs in a downturn, and those sentiments we hear loudly and clearly now.

Q66 John Mann: I am not interested so much in the question of blame; I am interested in the economic consequences. Let me put a proposition to you: there appears to have been a significant move of East Europeans from this country back to countries such as, particularly, Poland but, also, to the Baltics, in quite huge numbers because they are the most flexible within the labour market here. That appears not to have significantly registered in terms of economic analysis in this country. Yet, those countries do not appear, despite being in a worse recession, to have been negatively impacted by this movement back. Is that because these people are highly skilled and are contributing more? Are they part of the potential salvation or are they an additional burden on those countries? Normal economic analysis would suggest a sudden movement back at times of recession of a huge number of people without work would further worsen an economic downturn.
Dr Danielsson: It will really depend. Many of these countries did also employ substantial amounts of labour from places further east; labour that has been displaced and has gone back to its own countries. Also, many of the people who return to Eastern Europe tend to be fairly low-skilled labour but they have developed skills in this country; they have learnt how to operate in an internationally developed economy and that will enable many of the very same people to survive in the economy back home. So they are, in many respects, better placed than they would have been before, so I would probably think it is a net benefit to those countries to have these people coming back.
Professor Buiter: It will not be a benefit, because in a synchronised downturn you are simply redistributing the misery. Clearly, if Latvia were booming this would be a great time to go back, but it is not so great a time now.

Q67 Chairman: On the issue of economic consequences, there are still economic consequences for Europe. As a Committee we visited Sweden 18 months ago and they learned from the banking crisis of the 1990s and the difficult liquidity problems they had; they were fairly exposed to Latvia and the

Baltic States, and Austria is very exposed to Hungary and elsewhere. The issue at the time for our Committee was the cross-border relationships, and those do not seem to have moved. Is there a possibility of a big problem coming our way which Europe itself has to get to grips with on these issues?
Professor Buiter: You are talking about the exposure to Eastern Europe?

Q68 Chairman: Yes.
Professor Buiter: It is not really big enough, relative to the size of Western Europe, to constitute much of a problem. It certainly is a huge problem for the countries in question. If Austria, Italy and Germany decided to pull the plug on their banks or their subsidiaries in Eastern Europe (they have promised not to do so but a promise is worth just that) then there would be a real disaster for these countries. The total exposure of a country like Austria, for instance, to Central and Eastern Europe is much smaller than the headline 67% of GDP that you hear about, because that figure assumes that the parent stands behind the whole balance sheet of the subsidiary, and if you are lucky you are only exposed for the equity, which has probably gone already, and for any inter-parent/daughter loans you may have. So the actual exposure is much less than the headline numbers. They could bring down a few banks in Austria, but nothing that the Austrian Central Bank and the Austrian authorities could not live with.

Q69 Mr Todd: Can we explore the function of savings in the macro-economy. First, the exceptional level of savings in the Asian economies. What role did that play in providing a platform for some of the excessive credit expansion that led to this crisis? Then I am going to ask what is going to change in the future.
Professor Taylor: I think it played a key role in terms of building up reserves both as a buffer or as an insurance policy in the 1997/98 East Asia crisis and, also, because of the exchange rate policies pursued by some of these East Asian countries.

Q70 Mr Todd: Particularly China?
Professor Taylor: Particularly China. Of course, those savings were held in currency reserve, the currency being the dollar, so it was recycled back to the United States, and then created a financial market awash with liquidity that was simply returned.
Professor Buiter: I do not think it was the savings themselves that were a problem; that just lowered the worldwide real interest rate, which is not something I necessarily frown upon, but the fact that China and the Gulf States decided (and this is not a saving decision but a portfolio allocation decision) to hold this increased wealth in ultra-safe and liquid form. This created a totally artificial demand for Treasuries everywhere, including American Treasuries, and allowed the US to continue on this low-interest, high-liquidity asset boom. So it was more, I think, an unusual portfolio choice than excessive saving, in a way, that was the cause of the problem.

Q71 Mr Todd: So we are agreed on that. What is going to change?
Professor Buiter: They have to change—they have to.

Q72 Mr Todd: Are they changing?
Professor Buiter: Yes, certainly at the margins they are allocating their funds, their wealth, to riskier assets. The Sovereign Wealth Firms are not there to invest in Treasuries; they went into Black Rock, which was not a actually a terribly wise move, which shows that they were willing to consider taking more risk, and they are going to become normal investors, but that is a question of time.

Q73 Mr Todd: Greed.
Professor Driffill: There have been some recent movements, have there not; I think some diversification of portfolios; the Chinese Government exchange reserves have been shifted away from US treasuries to some extent in the last few months. However, whether or not the enormous savings are going to continue is a more difficult question to answer; I do not think we can give a confident response to that. I guess the Chinese Government will want to engineer more domestic spending and a smaller current account surplus in the coming years because if they do not their growth is going to falter very badly because the demand from North America and Europe is not going to be there. To what extent they can do that—

Q74 Mr Todd: Do you think we are better prepared? Obviously, this happened over a very long period of time with the effects that you have set out. Do you think we are better prepared to deal with how the Asian economies choose to allocate their savings and the consequences of that, which I think we agreed were deleterious?
Professor Taylor: The answer is probably no. There have been moves, as John Driffill pointed out, to diversify those reserve holdings, both in terms of assets and, also, in terms of currencies—a move to holding euros. However, it is relatively marginal. Of course, if it were China you would think: "If I switch out of the dollar too quickly that will precipitate a fall in the dollar and devalue my reserves". So it has to be slow, in any case. So I would say we are not desperate yet.

Q75 Mr Todd: Okay. It is a fair assumption now, of necessity, that Western economies will also have to increase their saving rates as well in the next few years. What effect is that going to have? How is that going to impact on the way in which the global economy works?
Professor Buiter: If you have a universal stimulus to domestic saving, private and public in the West without offsetting policies to reduce the saving investment surplus in the rest of the world, we are going to have a period of global stagnation—demand stagnation. I see the Chinese as being rather keen to move to a domestic consumption-driven boom. They have a very rapidly aging population and they can still (and are in the process of trying to

do so) use unfunded social security, which would stimulate domestic consumption demand; also, the government has, for a long time, tried to get its hands on the surpluses of the state corporations and may finally be about to do so. So I think there is both a desire and a possibility to tackle these really excessively high savings rates. A nation that saves between 45 and 50% of its GDP must be doing something wrong. However, there are reasons for that: the one child policy, the absence of unfunded social security, very bad publicly funded health care, increasing live-spans saving to pay for private spending to top up public spending on education—all these things are amenable to policy and the Chinese are aware of this, and they are moving, but the question is can they move fast enough to offset the need for the West, especially the US and the UK, to increase their savings rates? I do not know the answer to that.

Q76 Chairman: The Chinese Central Bank Governor has suggested using Special Drawing Rights as a global reserve currency. What would be needed to achieve such an operationalisation of the SDR and what are the benefits to having SDR as a global reserve currency rather than the euro or the dollar?
Professor Driffill: Someone would have to issue the SDR, like the IMF creating Special Drawing Rights, and then there is the question about how you allocate them and what would happen to the revenue from doing that, because in a sense what has been happening over the last 50 or 60 years is that the US has been providing the world's reserve currency and it has been collecting the seniorage revenue from doing that; it has been printing money on the basis of getting goods and services in exchange. So you print money at no cost and get the value of that in terms of goods and services in exchange. So it would mean a redistribution of the seniorage revenue from creating the global reserve currency away from the United States, and it could be redistributed to emerging markets and developing countries.

Q77 Chairman: Is that just an academic discussion, Professor Buiter?
Professor Buiter: No, I think the problem is that, as John says, somebody has to issue it and that somebody or something has to be credible. Historically, reserve currencies have been provided by the present or past world hegemon—economically, politically, militarily. The IMF is a building with 1500 people in Washington DC; they just cannot do this. I would love to see it because I think it is very desirable that there not be a single fiscal authority such as a country standing behind the issue of the world reserve currency because the risk of it acting irresponsibly is far too great. This is actually an argument in favour of the euro because it does not have a single sovereign standing behind it, it has 16, and before they agree on anything, as you know, it takes a long time. So even the chances of abuse would be lower. I do not see, therefore—nice as it would be—the Special Drawing Rights playing any role as a global reserve currency. It may, at the margin, help provide some aid for deserving developing countries but it is not a solution to the world's currency problem. We are going to move to a multi-polar world; there is a shrinking share of the dollar because America is losing its hegemon status and it has acted systematically irresponsibly, so the two criteria for being an effective issuer of global currency, being a hegemon and being responsible, are not satisfied. It is very hard to shift reserve currencies but it has been happening, and will continue to happen; in the short run the euro will gain and in the long run the yuan and the rupee.

Q78 Mr Breed: Can I ask each of our witnesses to give a brief comment on the UN Panel of experts' suggestion that there needs to be a global fiscal stimulus to tackle what is the global problem?
Professor Driffill: We sort of have a global fiscal stimulus in the sense that everybody who has changed anything has been increasing public spending relative to taxation. So there has been a kind of unco-ordinated, global expansion. It is better to have a global expansion rather than a local one because if one country expands and everybody else does not, as is well known, a lot of the benefits leak abroad, and one country's increase in demand leaks out into the demand for imports, and that stimulates demand elsewhere. It is better if everybody does it at the same time, so that we all benefit from each other's expansion of public spending.
Professor Taylor: I think it is important to think about what the fiscal expansion and what the fiscal stimulus is doing. What makes this recession different from previous recessions in the US and the UK is the very large amount of debt overhang. Usually, recessions are caused by governments applying the brakes too hard because you are in a boom and then you go into recession, whereas here it was really precipitated by a collapse in asset prices, which has led to very large debt overhangs, which means that when there is a fiscal stimulus—when there are tax breaks or increases in spending—the people receiving that extra income may not spend it all; they may just pay down some of their debt, so one would expect the usual fiscal multiplier effect to be much less in those economies. If we contrast that with Japan, Japan went through a similar process in the "lost decade" ten years ago, it was just emerging from that and then was hit by an actual loss in exports markets to the West. That is more of a traditional type of downturn where fiscal stimulus is likely to have more impact in Japan. The fact that the fiscal stimulus may not have a strong impact in those countries where the debt is being repaid by the private sector does not mean it should not take place because then what it does is replace or compensate for private sector demand that otherwise would not be there. So, yes, I would be in favour of a global stimulus but for different reasons for different economies.
Dr Danielsson: The countries in the world that are able to provide that stimulus have been quite impressive in how they have stimulated their economies, and that, of course, has spill-over effects

to the rest of the counties in the world because those countries have not been providing a stimulus. However, if you are referring to this new report from the UN that is coming out next week, I think they are mixing a lot of different things into that proposal; some of them are wise and some of them are less wise. That report is confusing development aid and our responsibility to emerging markets with a global stimulus. I thought that document was more political than economic, at this time.

Professor Buiter: I agree that was definitely a Curate's egg. A global fiscal stimulus, since the world is going through a period of weak demand, would be helpful because, as my colleague pointed out, it internalises, basically, the import leakage it would otherwise have, but it would have to be modulated according to ability to put in place a stimulus, and that depends on the underlying fiscal position and according to the domestic effectiveness of the policy, which depends on the private debt position, as Mark pointed out. I think, at this stage, a further fiscal stimulus is the last thing that is required, except possibly in a very few countries. Germany, clearly, looks a candidate for additional expansion of fiscal action and, possibly, France, but it is hard to think of many other places. Indeed, a number of countries like the US and the UK may have gone well beyond what is fiscally and financially sustainable, and may wish to think of bringing in a measure of intelligently designed fiscal tightening, or at least an explicit commitment to do so in the near future, rather than considering an additional injection. It would help to have a Jubilee—private debt forgiveness. That would take out Mark's problem, but I do not think that is likely.

Q79 Mr Breed: Nor do I. What they did say was that rapid recovery depends on there being no free loaders or free riders. Everybody can put their hands up and say: "Great idea; let's have a global stimulus" and then a few countries will sit back and let the rising debt of other countries provide this stimulus so that they can ride on the back of it. To what extent do you think that is a problem?

Professor Buiter: It has not happened a lot. Everybody that could has really done so. There are a couple of countries, Germany and France I can think of, that could do a little bit more, but nobody has free-ridden; everybody has been desperate to hand out the fiscal cookies. This is a theoretical problem that turns out not to have materialised in practice.

Q80 Nick Ainger: Can we talk about the role and performance of the IMF? We had Peter Chowla, from the Bretton Woods project before us earlier and he was quite critical of the IMF's performance in terms of the differential way that they were applying conditionality to different economies and he put it down to there were some at the top in the IMF that were recognising that their performance had to change in the way that they assisted countries but that perhaps those further down were still operating in the same way that they were operating ten or five years ago. Do you think that these twin roles the IMF has of surveillance and lending are compatible in one organisation? Secondly, particularly, in relation to surveillance, how do you rate their performance and whether they should continue with that role?

Professor Driffill: It would be difficult to see how an international institution like the IMF can lend without carrying out surveillance of who they are lending to and whether it was likely to get the money back. I think they are bound up together. I cannot see how you can separate them. It is a sort of due diligence aspect of global lending. Arguably, the surveillance and the research that the IMF does and the information it produces has been far more valuable than its lending activities because of the heavy conditions attached. The IMF recently seems to be in a position where nobody wanted to borrow from it at all; everyone has been paying back money as fast as they possibly can. They have massively cut down on staff and their budgets have shrunk enormously. Increasingly, their resources for lending have shrunk relative to the size of the problems that they might be asked to lend to support. It is only in the recent crisis that there has been a revival of interest in borrowing from the IMF. Part of this great global expansion of reserves that we have seen over the last few years has arguably been an attempt by emerging markets to make sure that they never ever have to fall into the arms of the IMF again. So, in a sense, the IMF's conditionality has had the beneficial effect of discouraging countries from wanting to borrow from it.

Dr Danielsson: We can add that the IMF is the only organisation we have which is capable of doing the surveillance we need. If you did not have the IMF you would have to create something in its place. They have the expertise and experts for every country in the world; they have extensive databases and monitoring, and they are looking at economies. They are the only organisation we have to do so.

Professor Buiter: The IMF has two different roles: one is to look after basket cases and to lend to them. Generally, these countries come to the IMF when they are broke and facing insolvency, not just temporary fiscal problems or cyclical problems. This complete but very tough conditionality is unavoidable because nobody else will lend to them and these are countries on the edge of systemic breakdown. Then the IMF has this surveillance role, which I view as a way of internalising the externalities of national policy actions at a global level. It is a systemic role. That does not require lending, of course. This raises the question as to why should anybody pay attention? If you are not lending any resources all you are doing is presenting advice. Advice is nice but it is not very compelling unless it is backed by teeth. I agree that the IMF is the only organisation we have on a global scale; we could abolish it and reinvent it but I wonder what the role of surveillance is if it cannot be backed by instruments to exercise pressure to get incentives for the large countries that are not on the edge of insolvency to pay any attention to whatever advice they give.

Q81 Nick Ainger: Coming back to performance, Pieter Bottelier, who worked for the IMF for 28 years and is now a lecturer at Harvard, said that we need to have a way of knowing when things are going wrong; we need to know when bubbles are being created and when they are becoming dangerous. We need a warning system and there is no better institution set up to do that than the IMF. I think you all agree with that idea, but what about its performance in terms of the commodity bubble between mid-2007 and mid-2008? I do not recall much being said by the IMF about that particular bubble. Were they commenting? How effective as a surveillance tool is the IMF? Is it their problem or is it that people do not listen?
Dr Danielsson: The idea of an early warning system for the global economy is an idea that sounds great in theory but does not really work in practice. We have tried to develop these kinds of systems for the past 30 years and, by and large, those early warning systems have failed completely. We seem to be unable to predict any future uncertainty, and unable to figure out if you are in an asset-price bubble or where asset prices are at the appropriate level until it is too late. So on that score the IMF has failed, just like anybody else who has tried to do the same.
Professor Buiter: There is a further problem, at least historically, that beyond the IMF not "calling the boom", so to speak or the imminent collapse, and the fact that people do not listen to it, the IMF is often not allowed to speak. It has been gagged, mainly by Washington, but also by other countries. The fact that it was never able to do a financial sector assessment (FSA) of the US, which it wanted to do—and of the UK for that matter, which it wanted to do—is, I think, testimony to the fact that countries do not want to be told by the IMF that something might be less than blissful. So that has to change if the IMF is going to have a more significant role—it is not even teeth, it is a necessary condition for having teeth.
Professor Taylor: I think there are two problems; one is the inherent difficulty of recognising and forecasting economics, which of course is well known, and the other is, as Professor Buiter pointed out, the problem of regulatory and political capture; that politicians do not like, generally, to be told that there is a boom and that brakes ought to be applied.

Q82 Nick Ainger: Can I ask one more question, which is a hobby horse of mine? Please accept my apologies to the rest of the Committee. There is a concern that the oil price, which has now gone from $35 per barrel to $70 per barrel in the space of a few months, means we are seeing another bubble in commodity prices, particularly in the crude sector. Do you think that there is a risk that if it continues, with rising energy costs as a result of that, we will actually see a delay in the recovery?
Professor Driffill: Low energy costs would undoubtedly help move things along more quickly, but who knows whether $70 is the fundamental equilibrium in the long-term or a medium-term right price for oil or not? It is very, very difficult to see certain factors impinging on the oil market. That bedevils the whole business, really, of spotting bubbles in advance and nipping them in the bud or doing anything about them; there is just huge uncertainty surrounding any of these estimates for estimating the fundamental equilibrium exchange rate, or figuring out whether there is a bubble in commodity prices or oil prices—extremely difficult to do. You get one group of experts who will give you an authoritative explanation for why there is a bubble and another will give you a compelling argument as to why there is not. Identifying bubbles is an absolute nightmare to do, without the benefit of hindsight. Once they have burst, of course, we can all agree, but without the benefit of hindsight it is totally different.
Professor Buiter: If you are going to have a world recovery, oil prices will go a lot higher than this. It is not at all clear that what is going on at the moment is a bubble. There has been very little investment over the last few years in exploration and increasing extractive capacity. Supply has also been shrinking because of exhaustion of previous fields. So I am not surprised that oil prices are rising and I hate to think what is going to happen with commodity prices generally as and when we get a global recovery, which would be a potential automatic dampener of quite major proportions for the West.

Q83 Nick Ainger: Just a final point on that: there was a lot of conjecture around the amount of speculation on the commodity markets; that commodity index funds, university endowment people were pushing money into the commodity markets because equities were not giving the returns that they had hoped for. I asked this question in New York about the actual flows of volume of trading—not the trading of the physical oil but the actual volumes of trading in futures. Do you know of anyone that has done any serious research on this, because nobody seems to be able to answer whether there were, if you like, spikes in the amount of volume of trading?
Professor Buiter: There was quite a bit of research at the end of the last big spike when oil hit $145 a barrel. People looked at whether speculative action in the futures market has any systematic relationship, and it was basically impossible to find any evidence. The reason that this is so hard is that even if you have all the futures market information you can spread bet on the price of oil and that does not show up in anybody's records. This is interesting research generally but not something that I think is going to give you results any time soon.

Q84 Mr Love: I wanted to ask one question going back, actually, to a comment that Professor Buiter made earlier on about a more significant role for the IMF, taking into account all the difficulties there are for the IMF, which we have gone into. What should be the more significant role for the IMF?
Professor Buiter: To me it is not short-term macroeconomic cyclical advice but it is exactly the stuff that it is stopped from doing for the big countries: doing an impartial assessment of macro-prudential institutions—FSA-plus—and publish it. This is the key thing. Do it without interference; not

a document that goes through the Board and is vetted by 27 cardinals; it has to be an independent, professional view, independent of the Board, and out in the public domain. I think that would do more for systemic stability, even if you cannot call bubbles, than anything they have been able to do so far. If they cannot criticise, implicitly or explicitly, the big countries they might as well pack up.

Professor Taylor: I would echo that. One way to think about it would be to think of the IMF as playing a role that is parallel to the role the World Health Organisation plays in health; to be the world finance organisation in that sense.

Q85 Sir Peter Viggers: I would like to ask about the link between macroeconomic and regulatory policy. Worldwide macroeconomic policy allowed conditions to develop where there was wide liquidity and low interest rates, and of course regulatory conditions allowed dangerous exploitation. What do you think the present crisis has taught us about the link between the worldwide financial system and the worldwide real economy?

Professor Buiter: You can have a collapse of most of the world's financial system and only have, by most standards, still a quite modest contraction of the real economy. That is the good news. However, I would have expected that the magnitude of the financial disaster that we have seen would bring down the real economy much further. It is bad enough as it is—I am not minimising the depth of the recession—but most of the Western world's cross-border banking system is only standing because of past, present and anticipated future government financial support. New lending flows are low, capital markets are only just reviving, so it shows you that there must have been a lot of stuff that went on before in the financial system that did not touch on anything real—as well as some bits that really did impact on the real economy. We have to find out which bits are the ones that matter for transmission of policies and other shocks to the real economy and which ones are, really, in some sense, macroeconomically irrelevant—we are not clear on that yet. I suspect that hedge funds are in the "macroeconomically irrelevant" category.

Professor Taylor: Interpreting your question as asking about macroeconomic policy and the shift towards some kind of inflation targeting or perhaps *de facto* inflation targeting in many countries, which apparently for a time did appear very successful and led to low, stable inflation and low interest rates and the role that played in talking about global imbalances being recycled, and need to be recycled and search for higher rates of return led to, if you like, a generation of various forms of financial assets and derivatives which could generate those apparently higher returns. So, in some sense, it did have a role to play there. The key issue is really not about the macro policy so much as it not being coupled with an appropriate macro-financial regulation to try and dampen some of those asset market bubbles that occurred.

Q86 Sir Peter Viggers: Following that point and following the point made by my colleague, Nick Ainger, it is commonly agreed (I am quoting from the High-level Group on Financial Supervision, chaired by Jacques de Larosière) "that monetary authorities cannot avoid the creation of bubbles by targeting asset prices and they should not try to prick bubbles. However, they can and should adequately communicate their concerns on the sustainability of strong increases in asset prices and contribute to a more objective assessment of systemic risks." So who is "they"? Who do you think should lead us in this search for communicating their concerns about the sustainability of strong increases in asset prices? We have referred to the IMF and rather put the IMF on one side as not being the lead body. Bearing in mind that it is international bodies led from the United States and from Europe with no accountability through to the third world, who should we be looking to to give the lead in this to carry us through this search?

Professor Driffill: I read that as a suggestion that the bodies like the Bank of England and the European Central Bank and, also, the regulators—the FSA and others—ought to be making statements of that kind; that there are big downside risks to asset prices and that they should have been speaking up a lot more loudly in the run-up to the present crisis.

Professor Buiter: Open mouth operations are only, I think, useful at the margin, and it is clear that central banks should be doing it. If it is a national problem it should be through the central banks; if it is a global problem it should be through all of them together at the BIS, which represents them, but I think it is much more important from the point of view of global stability that regulatory instruments be allocated or necessarily designed to control credit growth; not target asset price movements directly but simply to tax credit growth that becomes by historical standards, abnormally high through countercyclical capital ratios and other requirements like that. That, I think, is rather more attractive than expressing one's deep concern, which may have some effect but fundamentally is cheap talk.

Q87 Sir Peter Viggers: As to standards, do you share the concern of the Bretton Woods Project which points out that the Financial Accounting Standards Board and its international counterpart the International Accounting Standards Board have no public accountability and that third world countries are not represented in this view? Do you share that concern?

Professor Driffill: It is certainly true that in the formulation of the Basel capital requirements the third world emerging markets were shut out of the negotiations that led up to that, and the Basel itself took no account of their needs.

Dr Danielsson: I would tend to disagree with that, both on the Basel Committee and also on the issue of accounting. I would rather think that accounting norms are rather universal and the same rules will apply in the most developed countries and the least developed countries, and the countries that have the most experience in running an advanced economy

are probably best placed and the most expert to develop these accounting standards. So I would not see this as a serious worry that the less developed countries are not represented on those bodies.

Professor Buiter: I have the opposite problem that I think the accounting standards boards—both the IASB and the FASB—have become too political and too lobby-able; that they made bad mistakes during this recession in response to political pressures emanating, in the first instance, in the United States but then, also, spreading over to Europe to allow banks to basically mess around with mark-to-market and move things between different categories of their balance sheet in order to hide the true state of the balance sheet. I think that has prolonged the uncertainty about the true state of the bank balance sheets. So by all means let us have accounting bodies from developing countries represented on the IASB, but I would not want governments to have, in a sense, day-to-day political influence over the accounting standards. It would be a nightmare; we have far too much of that.

Q88 Mr Fallon: That is, in fact, what has happened and that is what did happen in Europe. Perhaps we could turn to the issue of international financial regulation more generally, Professor Taylor and Professor Driffill. We have seen the counter proposals now being published and the European Union has suggested colleges of supervisors. How close are we to a system of global regulation? Would we miss—should we miss—a degree of regulatory arbitrage if we got there?

Professor Taylor: I think what is missing from the current financial regulatory system is a system of countercyclical charges so that during the boom when banks' capital grows in value they can basically lend more and more, as there is more liquidity in the system, so it becomes fuel for the cycle. In contrast, when there is a collapse and the capital shrinks in value they have to shrink liquidity, shrink lending and it exacerbates the downturn. Clearly, there is a case, I think, for having some kind of countercyclical capital charges and the capital charges vary over the business cycle. That comes back to this point we raised earlier about trying to pursue two targets with one instrument; you cannot pursue asset prices and inflation with just interest rates, so a second instrument would allow us to effectively target both of those. Even at the moment we have had this global shock, the economy is in different phases of the cycle even now. In more normal times the cycle varies enormously across countries and, therefore, that countercyclical regulation should vary across countries. So what I would certainly be in favour of would be some global type of regulation that is applied by the host country in a countercyclical fashion.

Q89 Mr Fallon: Changes to the Basel framework have notoriously taken years to achieve. Do you really see that being put in place reasonably quickly? Everybody now seems to be in favour of it but getting it in place may take some time.

Dr Danielsson: I would think that most of the proposals on a global regulator either within Europe or even across the world, they sort of do miss the point, which is that what this crisis has shown is that we are further away now from having a global regulator today than we were two or three years ago. Two or three years ago we had the idea that you could have the function of a central bank separate from the treasuries and separate from the regulator, and you could somehow get the regulators to co-operate internationally, but then leave serious financial matters for the home country. What the crisis has shown is that one of the most important institutions is the treasury and the least important institution is the regulator. Very few countries are willing to give up that power; very few countries are willing to face the possibility of saying, if a bank in a different country blows up: "I should be paying for that" or "I should contribute to that or provide deposit insurance or provide lending capacity for it". At the end of the day, it comes back to the national treasury, and countries are now much more jealously guarding their control over financial regulation than they were two or three years ago. What we are, I think, more likely to see—and this would be a positive development—is a discussion within a college of regulators, whatever that means. Basically, it is an entity that is designed to share information so that the regulator in this country facing a bank that operates across Europe would have a clearer idea of what the bank is doing everywhere and, therefore, they would spot immediately if that bank is committing fraud or is taking on too much risk, or whatever. So it is the information sharing and the co-ordination that matters, but regulation is staying in the home country and not to global regulators.

Q90 Mr Fallon: That does not get you round the issue of fiscal burden sharing, does it? It still separates the regulation from the fiscal responsibility.

Dr Danielsson: What the crisis has shown is you cannot really separate financial regulation away from fiscal policies. If you use public money to rescue or intervene in financial institutions it becomes a national matter immediately, and we are not going to get away from that.

Q91 Mr Fallon: So you do not see any hope for the ECOFIN proposal that there should be from the college of supervisors some kind of binding mediation that involves some loss of sovereignty?

Dr Danielsson: It depends a little bit on how you define the scope because there have been various proposals and they are often contradictory. There is considerable scope for co-operation. What we have seen in the crisis is that the banks have been able to operate across Europe without any regulator really understanding what they were up to, and that contributed to these banks collapsing afterwards. That is something people want to avoid. So the regulators do need to co-operate more; they do need to share information and they do need to co-ordinate the responses, and we do need to have the

same sort of regulators across all countries. At the end of the day, it is the treasury that pays and they are going to decide.

Professor Driffill: I guess the global regulatory design is to prevent a kind of regulatory race to the bottom; perhaps one saw something of that over the last 20 years, with Britain as one of the winners. It now appears that is a much less attractive type of race to win because Britain led the way and the whole thing blew up in its face. At the moment I do not think it is a very good incentive.

Q92 Mr Fallon: What is the point of all the extra transparency and information sharing between supervisors if, in the end, there is no blight on, say, what is happening?

Professor Buiter: We are not going to get a global regulator; we may not even get an EU regulator in any meaningful sense because, as Jon pointed out here, to have even a college of regulators that means anything you need a college of fiscal burden sharers to accompany it—either that or something rather close. We have just had quite a kerfuffle about Britain objecting to the new-fangled micro-prudential council, the ESRC (not the Economic and Social Research Council but the other one) being able to mandate the use of national fiscal resources to recapitalise the bank along the lines recommended or required by this European regulator. That clearly is a non-starter given the current EU competences, because there is no fiscal Europe. You could do something very similar, simply by mandating recapitalisation; and then a country cannot or does not want to do it fiscally, require it to call on the unsecured creditors of the banks to turn their debt into equity and recapitalise that way. There are ways I think of having a European-wide college of regulators that would have teeth without being able to impose fiscal recapitalisation, that is, without it necessarily meaning mandating the sovereign to do anything on the fiscal side. Could I also say, it is not clear that a single regulator globally would be necessarily the optimal thing: it would be in a "Philosopher King" world but in the real world it is certainly possible that with a single global regulator we would over-regulate. Therefore regulatory arbitrage—it is indeed a race to the bottom and I have written about that myself—could start not from the right position but from a position that has too high a level of regulation and therefore could bring you closer to the optimum. One has to be careful—it is like tax competition: it can be nefarious; but without tax competition among countries, if the tax burden were to be excessive, it may be a second best mitigation of the problem. I think the reality will be, except possibly in Europe if we get a cross-border college of regulators with teeth, that we are going to see a major retrenchment of cross-border banking. London will be the first victim of that, because this is the home of cross-border banking.

Dr Danielsson: I would disagree with that actually. To take up the last point, I think one of the things we will see out of the crisis is the re-emergence of securitisation and London is going to benefit from that. Financing will remain high tech. I would agree with Willem's statement that banking is going to become much more national. One thing that we will see coming out of this is that countries will want banks to be capitalised in the host country; that the branches be capitalised and regulated in the host country. The accusations that have been levied at some of the European banks—like Austrian banks, that they are taking money away from Eastern Europe and taking it back to Austria, Sweden or wherever—that this is something countries object to, and they will safeguard against that. We will see banks be much more autonomous in the various countries: but, at the same time, I would also expect to see the emergence of even more securitisation, more insurance within more high tech finance, and that always benefits the most advanced, which today is London.

Q93 Mr Brady: Can I pursue that point a little further. Professor Buiter, on 23 April in the *Financial Times* you wrote that you cannot have a single European regulator without having a fiscal Europe. Am I understanding you correctly today that you are saying actually there is a halfway house?

Professor Buiter: You need to be able to *mandate*. For certain things you require fiscal resources. For recapitalisation it is not actually necessary. As long as there are unsecured creditors you can through a special resolution regime—with prompt corrective action of the kind that this country now has; the administrator would simply tell the unsecured creditors, "Congratulations, you are now shareholders".

Q94 Mr Brady: So there is a halfway house?

Professor Buiter: Yes.

Q95 Mr Brady: That presumably could apply to countries that are not members of the Eurozone?

Professor Buiter: For this particular action; for not necessarily everywhere. If you want to recapitalise the central bank, for instance—which maybe needs to be done because central banks are taking on very large amounts of credit risk; the ECB always has; even though it is only just beginning to purchase private securities outright, they already have got a lot of rubbish collateralised assets on their balance sheet; and if they were to blow-out in a major way then to meet its price stability objectives they might require recapitalisation; and that requires a fiscal Europe. You cannot tell the unsecured creditors of the ECB to take more equity.

Dr Danielsson: I will disagree with that last statement because the way the ECB is providing liquidity, they are taking a lot rubbish assets on the books, but it is the national treasury that backs it up. If a Spanish bank blows up and defaults on its obligation to the ECB, the ECB will call the Government of Spain and say, "Give us our money back".

Professor Buiter: No, this is not how it works.
Dr Danielsson: It is how it works.
Professor Buiter: It is very simple: if the Eurosystem as a whole makes losses for any reason during the implementation of its monetary policy, including liquidity operations, and credit enhancing operations, then these losses are simply shared according to their capital shares by the members of the Eurosystem. There is no new money coming in from the outside. If a national central bank is asked by its national minister of finance to act as a lender of last resort—this is not monetary, liquidity or a credit operation—and to bail out a domestic institution that loses money, it has to be done indeed against a full indemnity. They cannot even do it without an indemnity. That is different from the monetary operations. You can look at the balance sheet of the Eurosystem. The ECB is a pawn shop and is very small; the Eurosystem is huge. On the Eurosystem's balance sheet you have about €600 billion, which is assets corresponding to monetary operations which are not guaranteed by any fiscal authorities; these are separate from (but on the same balance sheet) as the assets that are indeed effectively guaranteed by national treasuries because they have been acquired as a result not of Eurosystem operations but of the central bank of a country acting as a fiscal agent for a particular national financial rescue operation, separate from the Eurosystem.

Q96 Mr Brady: Professor Buiter, can I just pursue you specifically on one point arising from that. The balance of payments facility of the €25 billion, which category does that fall into or is that something which the United Kingdom might share some liability for, or is that something which would be backed up only by Eurozone?
Professor Buiter: This is the EU facility?

Q97 Mr Brady: Yes.
Professor Buiter: No, they doubled the EU facility from €25 billion to €50 billion. Yes, I think some of it could in principle be used by the UK. Nothing can be used inside the Eurozone, of course; there is no balance of payments. Some of it can be used for EU members if they are not Eurozone members.

Q98 Mr Brady: We would contribute to that?
Professor Buiter: Yes. That is an EU thing; nothing to do with the ECB.

Q99 Mr Brady: Can I ask this end of the table: do you agree with that balance? Is it possible to have a European regulator without having a fiscal Europe?
Professor Driffill: I am thinking about it! It is true; someone has to pick up the bill if institutions are being bailed out. You need some method of allocating the cost across countries. Would you call that a fiscal Europe—I am not sure. It may be very limited to fiscal powers at the European level.
Professor Taylor: I would agree with that.

Q100 Mr Brady: Do any of you then think that the movement towards greater regulatory harmonisation is going to provide a motor towards the creation of a fiscal Europe?
Professor Buiter: Yes.
Dr Danielsson: No!

Q101 Mr Brady: Yes, but that would be within the Eurozone?
Professor Buiter: In the first instance, yes; but since I expect all EU members in due course to become members of the Eurozone, it should not make a difference in the long run.

Q102 Mr Brady: If it is a fiscal Europe does that not make it less likely rather than more likely that the United Kingdom would join?
Dr Danielsson: The way you ask the question is about regulatory harmonisation. Regulatory harmonisation simply means you have the same rules operating across Europe. Those rules can easily mean that everything goes back to the home treasury. They do not by themselves mean any fiscal harmonisation. They could mean that, but in principle they do not.
Professor Taylor: I would agree. The point is about regulatory harmonisation but implemented at the host country level.

Q103 John Thurso: Professor Buiter, you wrote an article that appeared in the *Financial Times* on 26 May which contained the statement, "The damage caused by financial sector excesses is way out of proportion to whatever gains from financial innovation may have accrued to the wider economy in the last couple of decades". Would you agree with the view that financial innovation has actually been a costly diversion away from the true purpose of capital, which is to invest in commerce and industry; and has therefore been unhelpful? First of all, could I ask you: do you concur with that view?
Professor Buiter: Not quite in that form. I would agree with a weaker version of it, that there has been an enormous amount of financial innovation that has been both pointless, and there has been a fair amount that has been actively harmful. It does not mean that there has not been financial innovation that has not been useful even for the so-called real economy. All I would suggest is that financial innovation, like pharmacological drugs (not the legal variety), be re-regulated, rather than 'invented today, sold tomorrow'. That would solve the problem.

Q104 John Thurso: The thrust of your article was that you do not mind if we have too much regulation now because it is easier to wind-back later than it is to, in boom times, add regulation. Do you think that the regulations that are being considered should actually look at, as it were, the end result of what is happening to capital, and regulate in such a way that more of it goes directly into investment in commerce and industry and less of it into speculation?

Professor Buiter: I do not believe that regulators can really foresee all the possible consequences of financial innovation. Much of financial innovation is driven by tax arbitrage and regulatory arbitrage, and so that is almost, by construction, socially unhelpful. A lot of the rest is organising more and more complex ways of betting on asset price movements through derivatives. Sometimes that can be socially helpful. I think interest swaps by and large have been a useful invention. In the case of CDS, it has become a deeply destabilising instrument that should be regulated to within an inch of its life. I think one should look at proposed new instruments and have them tested again in little laboratories before they are let loose on the markets. I am sure that the sub prime mortgages if they had been vetted properly would not have flown, because it was clear that the derivatives based on them only had value on the assumption that house prices would forever rise faster than the interest rate on the mortgage.

Q105 John Thurso: Do you think there is a danger throughout the world with all the different regulators, given the shock and fright that everybody has had, that we will end up, as it were, regulating to solve the last crisis and we will miss whatever is going to come down in the future?
Professor Buiter: That always happens; that is a given. We are going to have over-regulation; we are going to have the wrong regulation; and we will be winning the last war. I am sure we will never have a sub prime disaster again. Hopefully people will try to look at risk generically, rather than at the most recent manifestations of particular kinds of risk when they design regulative frameworks. I think the Financial Stability Board may be a good vehicle for assuring that we do not just re-fight the last war.
Professor Taylor: The thing about regulation is that it is important to distinguish between regulating products and regulating behaviour, in the sense that, we thought the products themselves generated the problems but actually it is in fact the behaviour and what you do with those products. It turns out you can do a lot of damage with a simple mortgage, for example. The point is that what is necessary to regulate is appropriate recognition of the different kinds of risks that prevail in financial markets and how those different kinds of risks ought to be regulated, rather than trying to regulate individual products; because markets are always capable of generating other products that look very much like the one you are trying to regulate. It really needs to get back to incentives and appropriate classification and regulation of risk.

Q106 John Thurso: At the heart of regulation has to be a more conservative approach to how we look at risk; a precautionary principle with regard to risk, which is that if something looks great fun but clearly there is an unknown quantity of risk, it should not be allowed to fly until it has been worked through. We have seen some products which, with hindsight, you think: how could anybody rationally believe that that product was ever going to do anything other than self-implode? Back in the day, when this Committee was in Washington two years ago, we had Hank Paulson and Ben Bernanke telling us not to worry about sub prime; it was going to be a small matter in a couple of states. With the value of hindsight those look like modest under-estimations of the problem.
Professor Taylor: If you were to identify, for example, different kinds of risk institutions face and distinguish between credit risk, liquidity risk and market risk for example, and then apply different kinds of capital charges according to the different kinds of risk, and look at perhaps what kind of maturities were being matched within an institution's portfolio, then you may effectively be able to regulate those more exotic instruments without regulating them directly; that is what I am thinking; looking more at the behaviour and the incentives for holding them than actually trying to regulate the individual product itself.

Q107 John Thurso: Can I perhaps stick with you, Professor Taylor, and move on to something slightly different but part of the same thing which is the so-called shadow banking system, which has seemed to be very much a part of the transmission mechanism, if you like, within the current crisis. What do you think might be the appropriate international action to be able to counter that? Do you think that the shadow banking system is an important part which, by operating in a different way, can add value?
Professor Taylor: I agree, I think it probably does add value. I think it needs to be an increased umbrella in terms of regulation in order to cover that shadow sector, quite simply.
Dr Danielsson: I would think that shadow banking—I would define that as what is outside the regulatory umbrella—is a good and positive thing to have. Take, for example, perhaps the biggest part of the shadow banking system, the hedge funds. Before the crisis the current view was that what would blow up the financial system would be hedge funds. It turned out to be they were completely benign. What the hedge funds have done, by virtue of being unregulated, they are the entities able to buy the distressed assets. When a big bank needs to sell assets to raise capital because of high risk, to have somebody come in and buy that from them is a positive thing to the economy; it is a positive thing to the bank; and it is a positive thing to the taxpayer. We all have benefited quite considerably by the presence of shadow banks and by the presence of hedge funds, in particular, in the crisis. Trying to regulate those entities out of existence or bring them under a regulatory umbrella, which basically means the same thing, would be a huge mistake.

Q108 John Thurso: Some of the hedge funds have blown up pretty spectacularly and an awful lot of investors who relied on them lost a lot of money?

Dr Danielsson: Investors in hedge funds tend to be two types of entities: either wealthy individuals; or institutions that can afford to hire financial advisors. I do not really feel sorry for those entities; and I do not think it is the public role to protect them.

Q109 John Thurso: It is good idea to redistribute some of the wealth?
Professor Buiter: Unlike the banks—when a bank gets into trouble it runs to the Treasury to hold out its hand—the hedge funds just implode. The population of hedge funds has been decimated. They are the raw face of capitalism but they take the downs and they do not bleat until their losses are socialised. I think they are much more honest institutions than the banks, which try to have it both ways.
Professor Taylor: It is of course true that, so-called, sophisticated individuals, sophisticated entities must be clients of hedge funds, but some of those sophisticated institutions are pension funds and when they suffer in fact ordinary people do suffer, so I do have sympathy with some people that actually have lost money in hedge funds. Secondly, the words "hedge fund" cover a multitude of sins and virtues. Some hedge funds have fared very well, reasonably well or in fact have suffered much less of a downturn during the crisis than a standard long-only-type investment policy would have—the global macro hedge funds especially, for example. Thirdly, in terms of saying "I would like to bring that under the regulatory umbrella", there can be differences in regulation; there can be lighter touch regulation certainly; but certainly it does not make sense to me to have a regulatory structure where you be outside of it in a safe haven.

Q110 John Thurso: Do you think there is a need for more transparency in the shadow banking area? We have had evidence—particularly with regard to not so much the classic long/short fund but the short-only and using the short process to actually drive the price—that more transparency would be helpful.
Professor Taylor: I think more transparency, yes, obviously would be important. There has been talk, for example, of having a clearing house which would look at the net positions of hedge funds in various assets. I do not know how feasible that would be to implement. Certainly some more transparency would be welcome, yes.

Q111 Ms Keeble: I wanted to ask about the impact of the banking crisis on developing countries, which has not been discussed much. Perhaps Professor Buiter and Professor Taylor could give me their experience of the IMF and Barclays Global as well. What do you see as the impact of the current crisis being specifically on developing countries; and do you think that separate or extra instruments or mechanisms are needed to resolve those difficulties?
Professor Taylor: I think the answer is in two ways: it impacts on developing countries because of a global downturn in demand and therefore a loss in their export markets; it is also because of a drying-up in capital that hitherto flowed to those economies. Clearly there is an immediate impact on the developing world. In terms of how you develop a regulatory framework—

Q112 Ms Keeble: If you need separate mechanisms or additional ones to the ones that have been discussed so far to actually deal with those kinds of difficulties, particularly perhaps access to capital.
Professor Taylor: Certainly where countries are suffering loss of access to capital through no great fault of their own and they have not been pursuing profligate borrowing, as in some cases in Eastern Europe for example, it would make sense to have some sort of facility in order to alleviate those problems, I agree.
Professor Buiter: The poorer developing countries have really just been at the receiving end of this recession: their terms of trade, commodity prices, have collapsed; and their export markets have been hit; so have remittances, which are very important for many of these countries; there is forced re-migration of people who had gone abroad; and even there are reduced aid flows, because aid is a residual in most government budgets and, despite protestations to the contrary, it tends to be cut during a downturn. As regards capital flows, they did not directly involve the poorer developing countries at all. That was not one of the channels through which they suffered particularly severely. It is really through the trade and remittances side that they have suffered most, and some counter-cyclical facility with the IMF, a beefed-up version of what they already have could be enhanced to allow countries to borrow their way and smooth their way through what for them is just a big commodity cycle.

Q113 Ms Keeble: The recent Global Witness report highlighted the very destructive consequences of some of the international financial systems on developing countries, in particular on quite dysfunctional economies. Do you think that some of the increased financial regulation that is being discussed at the moment would help to tackle that in terms of transparency, tracking of funding and other scrutiny measures?
Professor Buiter: I am not familiar with the Global Witness report so I cannot comment on that.
Professor Driffill: In terms of the effect of this crisis on developing countries, it is noticeable looking at the IMF world economic outlook in April that their forecasts for the real GDP growth in a lot of African countries do not look as bad as you might have thought. They all remain positive. There is quite a substantial dip in a lot of concern about these countries; but they actually have not had a dramatic collapse in growth that there has been in the US and Europe.

Q114 Ms Keeble: They have to achieve 7% year-on-year to be able to tackle some of the commitments that had been made through the international system, do they not, and they are not achieving that?
Professor Driffill: They are starting off from a much lower level.

Q115 Ms Keeble: There has been quite a lot of discussion around tax havens and increased regulation or transparency for this. Do you think that discussion was justified from the point of view of financial stability?

Professor Driffill: I am not sure that tax havens are that important quantitatively from the point of view of global financial stability and so on. They are sort of objectionable to some people. From the point of view of interfering with the flow of finance around the globe, I cannot believe they are that important.

Professor Buiter: Most tax havens are also regulatory havens. A lot of financial activity goes through banks in those lightly regulated territories, many of which are actually Crown Territories. That does not help because there is a lack of transparency as well as a lack of revelation of whatever income is being earned. Tax havens simply as places with low taxes are, I think, fine if that is the way you are going to make a living. Tax havens as providers of anonymity for ill-gotten gains are not a good thing; but I do not think it is a major contributory factor to this financial crisis.

Q116 Ms Keeble: How do you draw the distinction between the two then? Can I point you to the Stickler report—and it is a very interesting discussion about the need for equal rules to be applied both to the developed countries and also the smaller international financial centres—and its conclusion that, for instance, for foreign investors the US is effectively a tax haven. Where do you draw the distinction between natural competition, as it were, and unfair competition?

Professor Buiter: I do not try to make the distinction because I cannot make it. For me a tax haven is something which gives you anonymity; not something that gives you low taxes. To me, anonymity defines a tax haven. Basically it allows you to hide your assets or your income. Tax competition as healthy/unhealthy—the UK is a tax haven for many; the Netherlands is a tax haven if you want to look at tax rates but that is not what I mean here. The fact is as a US citizen you have to pay taxes on your worldwide income no matter where you live. Tax havens, in my sense of jurisdictions that give you anonymity, allow you to hide assets and income, and that I think is criminal and it should be banned; but I think in this particular crisis it was not a major factor.

Q117 Ms Keeble: Do you want to see the transparency dealt with rather than the aligning of the regimes? That is your concern.

Professor Buiter: If you hear how much support there is, even this country, for federalising at the European level any aspect of taxation, the notion that we are going to get a global agreement on tax rates, is extremely implausible. You cannot get global agreement on that; that it is not permissible to allow citizens of other countries to hide assets from their tax authorities; that is a separate issue.

Q118 Ms Keeble: Professor Driffill, I wanted to ask you a bit more about the international systems and in particular issues around debt of developing countries; because there is concern about the increasing debt levels and the fact that some of the previous international mechanisms for dealing with this perhaps have not been adequate, or they might not be adequate for what is coming in the future. Are you concerned about the increasing debt levels; and do you think that new mechanisms are needed to deal with those?

Professor Driffill: Again, the growth in debt of a lot of developing countries does not look as dramatic as the growth in debt of a lot of the highly developed countries. It is true; I think the main problem is the real GDP growth is slowing down. As they are so poor it is a good argument for the rich countries to continue to provide aid or increase it rather than reduce it at the present time. It may be the problem is that there is a retreat from obligations towards looking at dealing with debt in poor countries.

Q119 Ms Keeble: Have you seen the recommendation in the Stickler report about having an international debt restructuring court to deal with some of the issues? What is your comment on those proposals?

Professor Driffill: That sounds like an attempt to make more systematic the kind of things that have been happening in a fairly piecemeal way under these previous initiatives for dealing with debt in poor countries, and to redistribute burdens of high-class borrowing—sort of globally socialising these debts. In terms of redistribution it would be a good thing; but in terms of incentives that is less clear.

Q120 Ms Keeble: Dr Danielsson, I wanted to come back to one point that you made earlier in response to one of the earlier questions that, when we look at the revised structures for international finance, the developed countries should set the rules because they have the experience of running the bigger economies. What do you think then the role is for the developing countries and, in particular, how should their very specific issues, concerns and difficulties be dealt with?

Dr Danielsson: I think I made a point that was slightly narrower. The point I made was about accounting standards. The accounting standards are more or less universal and we do not need different accounting standards in different countries. It is however clear that the same type of regulatory structure that is appropriate to the UK, Europe or the US is not going to be appropriate for countries with a non-existent or financial system at very low development levels. You do need a separate regulatory structure for those countries; but when it comes to designing international financial regulations, of course the Basel regulations were decided by the Basel committee—and it is a committee of the biggest financial centres in the world—to suit their own purpose: how to regulate their own economies. They were never designed or meant to apply to other countries; in fact those countries chose to adopt them; they did that of their

own volition; they were not designed for them. This is an important distinction. They were not designed to set an international standard of anything; but only a standard for member countries. On that, the emerging market countries, led by China and followed by India, they have chosen to implement something called Basel 1A, which is a version of the Basel regulation more appropriate to the development status and a lot of emerging market countries have then adopted a form of that.

Professor Buiter: I agree, there has been a problem that developing countries have either themselves gold-plated their banking and other regulations, or have been pressured into doing so. The Basel regulation is really just for cross-border banks—the Basel 2-type stuff. As I have experienced at the EBRD—to have micro finance banks and banks for lending to small and medium-sized enterprises—to have the Basel 2-type requirements imposed upon them is lunacy. There is a problem that things become standards even if they do not start out that way. It can become difficult to attract capital, certainly from abroad, unless you are up to the AAA standard for regulation, and you just have to get more sensible about that. I think that is a job both for advanced countries and for developing countries in the regulatory field.

Q121 Chairman: Could I thank you very much for your evidence. There have been two issues we have focussed on this morning: the international macroeconomic environment, including the global imbalances; and the international regulatory environment and the global financial regulatory system. On both those points, do any of you have any final comments to make to us as we take this inquiry forward?

Professor Driffill: One of the lessons that strikes me just listening to the conversation this morning is that although there is much emphasis on the need for more and better systematic and global regulation, it seems that much of the crisis was due to a misapprehension of the risks that were being taken. You could argue that it was not a regulatory problem at all—simply that nobody understood the risks. If the banks knew what they were doing they might well have done something different.

Q122 Chairman: The Governor of the Bank of England made that point to us a number of months ago when he said that no regulator in the world caught that problem.

Professor Taylor: I would partially agree and partially disagree with Professor Driffill. I agree that a lot of the crisis was caused by misunderstanding of the appropriate risks; but that went down to regulation as well. A lot of regulation in force did not distinguish between the different kinds of risks that different institutions were facing—the liquidity market, credit risk and the appropriateness of all kinds of forms of regulations to address those, or maturity risks for example. In terms of regulation, I think the point I would stress, which I have mentioned before, is that one should try and regulate behaviour and effect incentives rather than trying to regulate products, which would be ultimately futile. I would draw the Committee's attention to the view that has been put forward concerning the macro-prudential regulation—the idea of dynamic provisioning and altering capital adequacy ratios in a pro-cyclical fashion—as one worthy of investigation.

Dr Danielsson: I would think that regulation did fail but the question is: did we not regulate enough; or do we not really know how to regulate? I would rather go to the second point. We do not really understand how the financial system works. We have plenty of regulations; but the regulations failed because I think we do not really know how to regulate. Therefore, trying to rush into a world where we try to regulate everything that moves, as some people have proposed, would be exactly the wrong way to go about it. The next crisis is not going to come for the next 20 or 30 years. If you implement financial regulations, they tend to stay in place for a very long time—10, 20, 30 or 70 years; they are difficult to eliminate once you have them. If the problem is caused by the fact we do not know how to regulate, I think the appropriate response would be to try to figure out what went wrong and try to decide on appropriate regulatory mechanisms, taking the time we have and have it ready in the next ten years because the next crisis is not coming tomorrow. At the same time, there are things we need to do today to try to mitigate the crisis and they are part of the regulatory sphere we have to address—for example, putting CDSs onto exchanges and issues like that. We need to separate out the future from dealing with the current crisis.

Professor Buiter: First cross-border banking and cross-border financial intermediation generally is under threat, and it is valuable. We should make sure that we save as much of it as we can, subject to adequate controls being exercisable. I think the position of London is really at stake more than any other place. Second, 90% of the regulation of the financial sector for the UK comes from Brussels and we should never forget that. It does not mean you cannot have influence here, but you have to have influence through Brussels and by persuading Brussels to do certain things. Third, the authorities must to find a way of addressing the "too big to fail" problem for banks and other financial institutions. The obvious solution to me is to stop them from becoming too big. The obvious way to do that is to tax size through, say, capital requirement. That alone would make a repeat of similar problems less likely.

Chairman: The issue of too big to fail, our Committee's last report mentioned that. I feel that this could fall off the agenda if there is not the focus kept on it. We look forward to your regular articles to keep us reminded of that, Professor Buiter. Can I thank you all for your attendance this morning—it has been very helpful to us. Thank you.

Written evidence

Memorandum from the Futures and Options Association (FOA)

1. Introduction and Executive Summary

1.1 The Futures and Options Association (FOA) is the principal European industry association for over 170 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, spread betting companies, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).

2. Causes of the Crisis

2.1 The FOA agrees with the findings of the De Larosière Report that the causes of the crisis were:

(a) excessive and unrealistic "stakeholder" pressure on systemically important and other financial institutions to deliver increasingly high returns in a highly competitive global environment—which compelled many institutions to trade in high return, but also high risk, markets/products;

(b) a lethal combination of product complexity and lack of transparency which led to mispricing, "an overestimation of the ability of financial firms as a whole to manage their risk", an underestimation of the capital necessary to support those risks (particularly liquidity risk) and over-reliance on the flawed rating methodologies of credit rating agencies;

(c) the build-up of a "shadow" banking system and off-balance sheet exposures;

(d) weaknesses in corporate governance, including over-emphasis on short-term performance and inadequate recognition being given to (i) the need for a more long-term "through-the-cycle" perspective; and (ii) the impact of remuneration structures on risk culture and appetite;

(e) severe gaps in regulatory coverage (eg hedge funds, credit rating agencies, corporate governance, prudential rules, etc); and

(f) the lack of an adequate regional/global crisis management structure, largely attributable to the fragmented nature of the EU's current supervisory arrangements.

2.2 The Report is particularly frank on the regulatory failures of the EU's supervisors. More particularly, they are accused of failing to "recognise or act upon the collective seriousness of the problem", poor information-sharing, insufficient supervisory and regulatory resources, failing to focus on macro-systemic risks, tending to protect local interests and apply local laws first and reflecting a mutual "lack of trust". This is underpinned by the European Commission in its Communication *Driving European Recovery*, in which it states in Annex 1 that the EU's cross-border supervisory cooperation framework was "ineffective and unresponsive" and that the system "failed to adjust to the complexity, internationalisation and inter-linkages of the financial markets" (page 2).

2.3 There is one further cause of this crisis, in addition to those attributed to a number of systemically important banks and the regulatory authorities—and that is the "drive by the wider authorities—governments, finance ministries and central bankers—to encourage a significant credit boom, particularly for the benefit of consumers who wished to purchase housing" (Hector Sants, Chief Executive, FSA, in a speech given to Reuters on 12 March). This was particularly the case in the US, where it was a key policy of the Clinton administration, ie extending credit to high-risk consumers was better for votes than sustaining exacting systems and controls for managing credit risk, which would deprive many of mortgages.

2.4 The scale of the current crisis clearly calls for globally agreed solutions and mechanisms to ensure regulatory consistency, simplify the compliance process for firms, even out levels of investor protection for customers and counterparties and avoid unacceptable levels of regulatory arbitrage, but it is equally clear that the EU public interest calls for its institutions to take early and expedited action. As it was put by the Commission in its Communication, *The inefficiencies in the present structure need to be resolved as quickly as possible*.

2.5 That said, a high degree of global consensus on "regulatory repair" and a programme for developing common regulatory standards is particularly important in the context of inter-jurisdictional business.

3. Recommendations for "Regulatory Repair"

3.1 The Report's recommendations fall into four core categories:

(a) Improving the EU structure for macro-supervision through the establishment of a new European Systemic Risk Council (ESRC), which would combine the European Central Bank and the European System of Central Banks into a single micro-prudential supervisor.

(b) Developing and enhancing a more pan-EU approach to micro-supervision by:

— establishing a new European System of Financial Supervision (ESFS), which would comprise all existing European member state supervisory authorities and the three Level 3 committees, namely, CESR, CEBS and CEIOPS;

- — converting each of these Level 3 committees into "authorities" with extensive new powers to develop common rules, oversee the establishment of new supervisory colleges for pan-EU banks and other systemically important institutions, coordinate pan-EU crisis management, overhaul the framework for information-sharing, assume responsibility for representing EU interests overseas (in addition to new powers in relation to regulatory supervision);
- — preserving the remit of the national supervisors to carry out day-to-day supervision.

(c) Strengthening the global surveillance system:

- — by providing the Basel Committee and the Financial Stability Forum (now the Financial Stability Board) with more resources, stronger governance structures and enlarged memberships;
- — by increasing the resources and capability of the IMF to develop early-warning mechanisms and follow up identified weaknesses with prompt "action on the ground" (eg establishing an "international risk management" map, extending its financial assessment programmes to all member countries, exercising rights of "intervention" where there are identified "danger zones" and enhancing its capability to resource countries in distress);

(d) Identifying and correcting areas of regulatory weakness, including:

- — developing new and more exacting prudential rules (eg setting higher capital requirements founded on higher quality elements of capital; requiring banks to build up capital "buffers" capable of being drawn down at times of crisis and introducing new rules for liquidity risk, off-balance sheet vehicles and governance);
- — bringing credit rating agencies, "shadow" banks and hedge funds within the scope of EU regulation.

3.2 The FOA is strongly supportive of these proposals for global and EU macro- and micro-supervisory and regulatory repair, but:

- — believes that much greater recognition needs to be afforded to the need for proportionality and balance to ensure that the drive for regulatory repair is fully sensitive to the equally critical need for EU banks and other firms to rebuild their businesses and to sustain EU market, product and service supplier diversity and competitiveness (see paras 4.1 and 4.2); and
- — is concerned over certain aspects of a number of the proposals (see paras 4.3 and 4.4).

4. Items of Specific FOA Concern Relevant to the De Larosière Group Report and the Commission's Communication

4.1 The FOA recognises the urgent need for regulatory repair and understands that this is a high priority for national supervisors, governments and international standard-setters driven by:

(a) governmental and regulatory annoyance over the serious failure on the part of some systemically important institutions to pay adequate regard to their wider systemic responsibilities;

(b) public agitation over the severe impact of the crisis on the economic and social wellbeing of the EU; and

(c) the need to correct significant failures in the regulatory system.

It is, nevertheless, equally important that the regulatory response is balanced, proportionate and appropriately risk-based.

General principles for delivering a better balance to the process of regulatory repair

4.2 For the reasons set out in 4.1, the FOA believes that there is a clear need for higher levels of express commitment to be given by the European Commission to the following criteria, observance of which will deliver a more holistic and balanced approach to regulatory repair, but without undermining either its urgency or intended effectiveness:

(a) Observance of the Principles for Better Regulation should continue to govern the process of regulatory repair and the actions of regulatory authorities.

There are a number of scattered and helpful references to the need for regulatory proportionality in the Report, namely:

- — over-regulation "slows down financial innovation and therefore undermines economic growth in the wider economy" (page 13);
- — "appropriate" regulation should be applied and extended in a "proportionate manner" (para 85);
- — due priority should be given to "private sector solutions" (para 128).

However, neither the Report nor the EU Commission's Communication (aside from a single reference to preparing its proposals on the basis of an "impact assessment") gives anything like adequate assurance of compliance with the Principles—none of which have been challenged by the emergence of the current crisis.

(b) Much stronger emphasis should be given to the avoidance of a "one size fits all" approach. Penalising the many for the mistakes of the few will undermine the economic viability of small and medium-sized firms, firms which are not systemically important and firms which carry on substantially differentiated business from banks or "shadow" banks.

Clearly, the main focus is on the banking sector and, particularly systemically important banks, but different terms are used in different reports (eg "investment bank", "systemically important institutions", "broker-dealers", "regulated firms"), all of which suggest that there is no clear thinking on the business perimeter of repair. The Turner review and the accompanying FSA Discussion Paper recognise the need to avoid a "one size fits all" approach, but also emphasise that there will be regulatory "spill-over", where that is deemed appropriate. Any form of regulatory "spill-over" must be properly risk-based and fully justifiable and its impact on non-systemically important institutions (regardless of their size), small and medium-sized institutions and institutions which are substantially differentiated from banks must be the subject of market impact and business risk assessment.

The FOA notes the EU's Communication observation that "the EU needs to continue its own work to improving the business environment, to support the small and medium-sized enterprises likely to lead the way when recovery comes" (page 10) and its emphasis on the "think small first" principle (page 12). For the reasons set out above, it is critical that this policy is delivered in practice.

(c) A careful distinction must be drawn between the investment banking model and the excess to which elements of that model were taken.

The investment banking model has been highly successful for many years and has benefitted not just the banks and their "stakeholders" but their customers and the economies in which they are based. It is vitally important for EU and UK competitiveness that this is recognised in the debate over the merits of "narrow" against "utility" or "universal" banking models and in setting the policy and perimeter for regulatory repair.

It is noteworthy that Section 3 "Financial Stability" in the Budget Report 2009 states in Box 3.8 that "The government is not persuaded of the case for introducing "Glass-Stegall-type approaches" and the Turner Review and the accompanying FSA Discussion Paper, after focussing on this issue, draws the conclusion that it is important to sustain banking diversity. Unfortunately, this is less clear in the De Larosière Group Report, although Footnote 9 on page 42 gives some support for the universal banking model.

(d) The drive to establish common regulatory standards and enhance cross-border regulatory cooperation and macro-prudential oversight is essential for regulatory repair, but it is also a sound regulatory basis for liberalising markets—post-crisis recovery means delivering on both of these agendas and not just for one of them.

There is widespread consensus that the regulatory response to the crisis should not lead to any cessation in the dialogue to liberalise trade in financial services or generate protectionist regulation—and it is presumed this includes the 2008 EU/US financial and markets dialogue to establish a more open transatlantic marketplace. The current crisis has not undermined any of the values or the identified benefits that (i) drove the 2008 dialogue; (ii) supported the US/EU declaration to prioritise mutual regulatory recognition; or (iii) stood behind the SEC's proposals for extending the basis of exemptive relief to non-US broker-dealers (with comparable rights of access to be extended to non-US exchanges).

Resumption of this dialogue is of critical importance to financial service suppliers, markets and their customers and counterparties in terms of enhancing choice, raising capital, managing non-domestic risks, increasing business flows and reducing transactional costs.

The Budget Report 2009 at para 3.41 observed that "it is vital that national measures aimed at restoring lending and repairing the financial system do not encourage a retreat into domestic financial markets and end up linking deleveraging with deglobalisation".

(e) "Regulatory repair" must not be delivered at the cost of economic and commercial repair.

The progressive tightening of regulation, including new and more onerous prudential rules, is underway, but the imposition of significant additional regulatory cost must be proportionate and appropriately risk-based and, wherever possible, be phased in to take account of the need for firms to utilise capital to meet growing customer demand and repair their businesses and bank balances.

The OFT Consultation Paper on Financial Services Strategy issued on 7th April emphasises in the penultimate indent in para 4.5 that regulation should avoid "placing undue burdens on business—since these are ultimately passed on to consumers in higher prices and/or less choice".

(f) Market and product diversity must be preserved through the cycle of regulatory reform.

While closer oversight and tighter rules governing under-regulated products and markets, particularly OTC markets, are inevitable, a proportionate approach must be adopted if customer needs are still to be met, market liquidity to be sustained and the EU's markets and service providers to continue to be globally competitive. For example, substantially increasing the amount of regulatory capital necessary to cover proprietary trading is likely to have consequences for market liquidity.

Specific concerns regarding the De Larosière Group Report proposals

4.3 With regard to the Report's proposals for the structural repair of EU macro-prudential supervision, the FOA welcomes the decision by the European Commission to implement the De Larosière Group recommendation for establishing a new European Systemic Risk Council (ESRC), but is concerned that the ECB may have been given undue precedence in terms of its role within the new Council. Clearly, the ECB will have significant influence within the Council, but the Report, in the view of the FOA, goes too far in suggesting that "the ECB should be tasked with the role of ensuring adequate macro-prudential supervision within the EU" (which clearly cuts across central bank responsibilities in non-Eurozone states) and that it should hold both the Presidency and the Secretariat of the ESRC. For example, why could there not be a rotating chair amongst the central bank members of the ESRC? The FOA prefers the approach that the ECB should sit "alongside" other central banks in the EU.

Full member state and regulatory representation on the new Council will exacerbate political interference and the existence of member state economic diversity and could impair the development of a consensual approach. This may mean that consideration will have to be given to the use of emergency powers and/or the use of an Executive Committee and/or facilitating a fast-track decision-making process via, for example, limiting some participants to non-voting observer status and/or utilising economically weighted voting. Any mechanism established to identify areas of macro-prudential concern must be capable acting on an expedited basis in relation to those areas of concern sufficient to either prevent or at least mitigate the consequences of a financial crisis.

4.4 With regard to the Report's proposals for structural repair for EU micro-supervision, the FOA strongly supports the proposals for a new European System of Financial Supervision (ESFS) and the recommendations for centralising the development of EU "core rules", etc. (see para 3.1(b)).

4.5 The FOA does, however, have a number of concerns arising in connection with the proposals for micro-supervision, namely:

(a) The extensive powers given to the new "authorities" of general supervisory review and oversight and direct supervisory authority over, for example, credit-rating agencies, clearing houses and, potentially, other pan-EU institutions (possibly exchanges and banks) undermines the Report's recommendation that the member state supervisors should retain responsibility for direct supervision.

(b) On the basis that the FOA is concerned more about substance than form, it is less over whether the development of a more pan-EU regulatory approach should be delivered through the conversion of the Level 3 committees into three pan-EU "authorities" or through the establishment of a single central authority. On the other hand, the FOA is particularly concerned that the new authority/authorities:

— as emphasised in the Report, "fully respect the proportionality and subsidiarity principles of the Treaty;

— observe the Principles for Better Regulation (which should be a specific obligation contained in the charter or charters establishing the new "authority" or "authorities");

— adopt a very disciplined approach towards the exercise of any new rule-making powers by focussing only on essential rule-making and avoiding "nice to haves", particularly at this time of post-crisis commercial and business repair and when firms are radically reducing their cost base;

— deliver on the paramount importance of securing regulatory coherence, efficiency and cost-effectiveness across the EU;

— avoid unnecessary duplication or conflict, particularly with member state supervisors, in the development and application of regulatory rules, practice and supervisory scope.

4.6 The Report's proposals for strengthening the international financial infrastructure is largely supported by the FOA on the basis that the proposals for developing "a strengthened, more coherent and streamlined international financial and regulatory surveillance system" build on the existing international institution framework. In this context, the FOA believes that the EU has the capability of being "a strong and influential partner" in contributing to the global agenda, bearing in mind particularly its unique role and experience in converging the individual interests of its constituent member states with developing a more authoritative EU regional role.

4.7 However, the FOA has real concerns over the recommended approach to high-risk "offshore centres". The FOA understands regulatory concerns over the undue risk that may be generated for firms which locate their assets in and/or undertake business with organisations in under-regulated "offshore centres". Nevertheless, the proposal that business constraints and/or additional capital requirements should be imposed on firms when dealing in such centres needs to be weighed carefully against a number of other factors, namely:

(a) the apparent political motivation that stands behind this regulatory approach, which is evidenced by the fact that (i) the concern over under-regulation is restricted to "offshore centres" and is not extended to, for example, emerging economies; (ii) the EU has a long history of trying to close down business undertaken in such centres and exerting political pressures on those centres; and

(iii) the underlying political objective is bound up with loss of "tax take", which is further exacerbated by the need to recoup the cost of public sector bailouts (and this is further underpinned by the G20 agreement to inter alia take action against non-cooperative jurisdictions, including "tax havens");

(b) firms dealing in these centres are already fully aware of the commercial and reputational risk that may flow from business undertaken in them and, as a result, carry out their own due diligence and take their own steps to mitigate that risk;

(c) any "tit-for-tat" response by respondent governments (which will assume—taking into account the points made in (a) above—that the EU is undermining their legitimate business aspirations) will deny EU firms legitimate market access across the board;

(d) a key attraction of locating international business in the UK is the significant and legitimate business relations, flows and links with offshore centres—an attraction which could be damaged by unduly harsh or politically-driven regulatory action.

5. Areas of Specific Regulatory Weakness

5.1 With regard to the Report's approach to OTC derivatives, the FOA recognises and supports the regulatory priority (i) to intensify oversight of OTC markets; (ii) providing it takes due account of the need for trading confidentiality, to increase market transparency; and (iii) to impose more comprehensive trade reporting requirements. However, it does have some observations on a number of the Report's conclusions with regard to OTC derivatives, namely:

(a) that consideration should be given inter alia to requiring the simplification and standardisation of most OTC derivatives (and this is asserted more forcefully in relation to CDSs where the requirement is that they would "have to be simplified and standardised"), with a view to "restoring trust in the function of these markets";

The FOA would emphasise that standardising products "for standardisation's sake" or in order to render all of them suitable for clearing by a clearing house would take away the key function of the markets by reducing the number of OTC transactions capable of managing the underlying and often complex risks of customers and counterparties.

(b) that at least one well-capitalised EU central clearing house should be enabled to reduce the counterparty risk of over-the-counter credit default swaps (CDSs);

The FOA is strongly supportive of the need for the EU's existing clearing houses to be able to offer CCP clearing services for addressing the credit risk of over-the-counter credit default swaps, but it question's:

(i) the use of regulatory compulsion to force the use by dealers of a CCP; and

(ii) the requirement that an EU clearing house must be used to clear EU-denominated CDSs.

With regard to (i), the use of compulsion is questionable, bearing in mind that the work to develop a CCP for CDSs predated the crisis; there is and always has been widespread support to use a CCP for CDSs, wherever possible; and that its use is encouraged by the availability of regulatory capital breaks.

With regard to (ii), the reasons for compelling the use of a domestic solution is driven by the desire of the EU Commission to avoid placing reliance on overseas licensing and regulatory standards of CCPs and that the ECB is unlikely to meet any liquidity need driven by a failure or problem with an overseas clearing house. The former runs entirely against the current priority to develop close cross-border regulatory cooperation and recognition (and provides evidence of the Report's concerns over the tendency of national supervisors to protect local interests, apply local laws first and mutually distrust each other (see last indent of para 2.2 of this response).

(c) Any such clearing house should be supervised by CESR and by the relevant monetary authorities, notably the ECB, because 80% of the CDS market is denominated in Euros.

The FOA recognises that the ECB will inevitably have significant influence and authority because of the position of the Euro as the EU's largest and globally most influential currency, but:

— reiterates its concern over the expanding role of the ECB outside the Eurozone (see para 3.2);

— questions whether the fact that 80% of the CDS market is denominated in Euros is an adequate reason as to why clearing houses which clear CDSs should be, wholly or in part, supervised by the ECB (whether jointly with CESR or with the national supervisor of the home state of the relevant clearing house).

The FOA is generally concerned that the regulatory intensity to compel, wherever possible, the use of a central counterparty clearing solution for CDSs (and other OTC products) could impair market and product diversity and the ability of (particularly wholesale) counterparties and customers from exercising choice and from being able to manage their underlying risks efficiently (another post-crisis regulatory priority) and could reduce the competitiveness of EU markets and financial service providers.

5.2 With regard to credit rating agencies, the FOA agrees that they should be brought within regulatory scope and that this process should include reviewing their economic models, addressing conflicts of interest inherent in "user pays", developing a new code for rating structured products and encouraging "buy side" market participants to reduce their reliance on ratings.

5.3 The FOA notes that the Commission will be bringing forward a new recommendation in April 2009 to address the capacity of remuneration schemes to exacerbate risk-taking and (possibly) empowering the supervisory authorities to impose capital sanctions on financial institutions whose remuneration policy is found to "remunerate unacceptable risk" (page 5, Annex 1, Communication). In general terms, the FOA:

(a) supports the principle of performance-based remuneration, insofar as it is designed to provide directors, managers and general staff with the opportunity to share in their company's success—a success to which they will have made a significant contribution;

(b) believes that the level and structure of remuneration packages should remain essentially a commercial matter for the employing institutions and should not therefore be the subject of external rules and regulations;

(c) does not subscribe to the imposition of rules which set levels or "caps" on remuneration.

5.4 At the same time, the FOA recognises that, taken to excess, incentivisation can exacerbate conflicts of interest between the employing institutions and its customers and staff; and incentivise risk-taking. It acknowledges therefore that remuneration schemes should be the subject of review by national supervisors as part of their overall risk assessment of individual firms, and regulatory guidance or principles on the kind of criteria that firms should be taking into account when setting their remuneration schemes are justified, namely:

— the amount of effort that is required in order to secure above-average performance;

— rewarding levels of performance that are markedly beyond the kind of good performance that would naturally be expected from a loyal employee;

— factoring in the level of risk and cost of capital that was deployed in order to secure performance;

— calculating bonuses on the basis of long-term performance, ie contingent on future profits (which would encourage greater corporate loyalty), although exceptional performance should be capable of being appropriately rewarded, even if it is short-term;

— eligibility should include not just staff who operate in the "front office" or in trading and sales, but staff who preserve value/reduce cost (and so contribute to performance);

— establishing a closer relationship between bonuses and basic salaries (which would help to ensure that short-term personal aspirations would not outrun longer-term loyalties to firms and their customers).

5.5 The Commission is proposing to review the Market Abuse Directive in Autumn 2009, and may include within this review the results of recent work undertaken by CESR/ERGEG into commodity markets.

The FOA would only urge at this early stage that the proposal review:

(a) pays full regard to the need for legal clarity and predictability sufficient to enable market participants to readily assess the consequences of the actions/omissions;

(b) observes basic legal notions around mental intent, the burden of evidence and the presumption of innocence;

(c) ensures that the line between physical and financial markets is observed to avoid the inappropriate application of financial regulation to physical markets and vice versa; and

(d) pays due attention to the ways in which commodity markets differ from financial markets.

5.6 With regard to general regulatory targets identified in the Commission's Communication, the FOA supports the proposals:

(a) to strengthen the effectiveness of safeguards when financial institutions market, sell or recommend packaged investment products to retail investors;

(b) to ensure responsible lending and borrowing, including a reliable framework on credit intermediation;

(c) to ensure that the voice of European investors is better heard on all financial issues, but any direct funding to facilitate that process should focus on retail consumer interests rather than wholesale customer interests, which are already adequately represented through well-resourced and existing industry and trade bodies; and

(d) to strengthen financial education throughout Europe (but there is an underlying policy question as to the purpose of enhancing consumer awareness of balancing risk with reward if investor protection becomes investor protectionism, such that consumer awareness of risk is neutered through the process of compensation.

6. Timeframe for Delivering "Regulatory Repair"

6.1 In its Communication, the European Commission is proposing to implement the recommendations of the Report:

(a) by presenting a European financial services package in May 2009 for decision by the June Council meeting; and

(b) by introducing the necessary legislation in Autumn with a view to implementation by the end of 2010.

6.2 The FOA recognises that the existing EU supervisory structure needs to be remedied as soon as possible and that this will involve expedited action on the part of the EU's institutions (as acknowledged in para 1.3 in this response). However, the Commission's assurance that it will prepare its proposals on the basis of an impact assessment and the need to pay full regard to the criteria set out in para 2.1 in this response suggest that, even if those assurances are met on on an expedited basis, the timetable is still overly ambitious.

6.3 The Commission will be all too familiar with the continued concerns over conflicts between political and operational timetables. Too little regard in the past has been paid, firstly, to the ability of member state legislatures and regulatory authorities to introduce fast-track legislative / regulatory changes; and, secondly, to the implementation complexities of "on the ground" regulatory changes by firms. These latter often involve significant market-facing and customer-facing "deliverables", particularly in the area of IT and documentation.

This was particularly the case with the implementation of MiFID, where most member states breached the deadlines, in many cases, significantly.

6.4 The FOA would urge the Commission, therefore, to pay full regard to the implementation complexities and issues faced by individual member state governments, the newly established "authorities", national supervisors and financial service providers.

May 2009

Memorandum from the European Trade Union Confederation (ETUC)

Executive Summary

1. The European Trade Union Confederation (ETUC) exists to represent the European trade union movement at EU level. It works with the other European social partners (representing employers) and the European institutions to develop employment, social and macroeconomic policies that reflect the interests of workers throughout Europe.

2. Over the last decade EU policy towards financial markets was driven by attempts to create a single European financial market.

In 1999–2000, this was regarded as a remainder of the incomplete internal market and a complement to EMU. While the goal was welcome in general, the policies which were meant to build an EU-wide regulatory framework in practice turned out as a process of continuous deregulation, both at EU and at the level of member states. Regulatory frameworks, financial supervision authorities as well as scope and quality of regulation vary widely among member states. However the trend towards more liberalisation of financial markets had become a generalised feature of EU and member states' policies, pursuing the goal of becoming as "competitive" as Wall Street and, in analogy to the "Washington Consensus", dubbed by some as the "Brussels Consensus".

At the same time, competition among EU member states to attract financial investors and innovative financial products promising high rates of capital return has led to a persistence of national exceptions that run counter to a truly harmonised set of core rules in the EU, leaving loopholes in European regulation as an obstacle to create a single European financial market.

While the crisis clearly is of a global nature there is also ample room for European policy to go ahead and tackle it so as to prevent the deepest recession in 80 years to turn into an outright L-shaped economic depression. The ETUC and its affiliates as well as the European Parliament early onwards were calling for better regulation of financial markets, demanding from the Commission to initiate adequate legislation, and formulating policy proposals to this respect.

However it took the meltdown of Lehman Brothers Bank as the key turning point in the financial crisis for EU policy to react. Proposals for a revised European Banking Directive, a revised Capital Requirements Directive and a Proposal for a Regulation on Credit Rating Agencies are currently discussed by the Council and the EP. However until very recently the Commission, in particular Internal Market Commissioner McCreevy, actively postponed regulation of hedge funds and private equity.

In October, former IMF and EBRD Managing Director Jacques de Larosière and a high level group of experts were given the mandate to draw up recommendations for future European financial regulation and supervision. The report was published on 25 February. Subsequently, the Commission has announced

proposals for legislation during the spring which should draw on recommendations made by the de Larosière group. The ETUC will actively engage in consultations with the Commission and the newly elected European Parliament to shape future regulation in the interest of working families and their trade unions.

Macro-economic Policy Framework

The de Larosière report is blaming low interest rates and strong macro-economic growth for being the major underlying factor behind the crisis. This is wrong and highly problematic against the background that risk management and prudential control by the supervisory authorities in the US and in some European countries were either simply ignored or else not implemented. Deregulation and huge differentials in income within and between countries have been the main causes for this crisis. With the creation of the single European currency in 1999, at least one part of the global casino was definitely closed. However the absence of a stable monetary system at global level with exchange rates being based on and adjusted to economic fundamentals rather than speculation has been at the core of global economic imbalances.

A swift and co-ordinated reaction of monetary and fiscal measures was able to avoid an almost complete meltdown of global and European financial markets in the last quarter of 2008. Central Banks' provision of liquidity to the defaulting inter-bank lending market, government guarantees for deposits and for new borrowing as well as the recapitalisation of banks with public capital have all been positive and necessary actions. Yet they are far from being sufficient for the crisis is far from being over and the rescue packages in some countries were not in the longer-term interest of workers and taxpayers.

Many banks in the US and the EU are still unstable, near insolvent and most of them need to clean-up their balance sheet. It is of primary importance to acknowledge that the bleeding of the patient must be stopped while transfusion of fresh blood is going on. At the time of writing, the latest IMF estimates of global toxic assets were boosted to $4,000 billion of which approximately $900 billion originate in Europe. This compares to $400 billion that banks and insurance companies in Europe have so far owned in write downs. Other assessments from the New York Stern School of Business calculate the amount of write downs for European banks to $2,000 billion. Global and EU banks and financial institutions will therefore need more rescue packages and better regulation. This has to go hand in hand with more and better designed stimulus packages, co-ordinated at European level to boost demand. Europe can no longer afford free riders waiting to benefit from their partners' efforts. The ETUC Executive Committee on 17–18 March adopted a resolution on anti-crisis policies in that respect.

Government subsidies for private bad banks, or public bad banks to clean up private banks' toxic assets, are a bad way for workers (and taxpayers in general) to transfer money to troubled banks. All subsidies and transfers should be transparent, and public/private bad banks are not. The only sustainable solution for public finances to restore confidence in the financial system without subsidising bankers and their shareholders is to nationalise insolvent banks and to separate toxic assets from the good. As the Swedish example of the early 1990's has shown, nationalisation is the only way for public finances to benefit from any future potential gains once confidence and bank solvency is restored.

Regulatory Measures Proposed by the de Larosière Group

While it seems difficult to imagine a single world-wide regulator, a single regulator at European level is all the more urgently needed. Yet the de Larosière report has abstained from recommending this, putting a preference for European co-ordination of national regulatory authorities. The ECB/ESCB could play this role in macro-prudential supervision for the EU-27, provided that the ECB mandate is extended beyond the price stability goal to include the growth and employment objective. Moreover, the ETUC expects from EU member states and the Commission to play a leading role in reforming the Financial Stability Board and the future G-20 process in the constructing of a new global financial architecture so as to make them transparent and ensure that a crisis on this scale never happens again.

While some of the de Larosière proposals seem to go into the right direction, the devil is in the detail. To take the example of tax havens, it is clearly not sufficient for European member states and dependent jurisdictions not to appear on the OECD's black or grey lists. There are still a significant number of tax heavens within the jurisdiction of the EU, yet the European Council outcome on co-operation procedures between national tax authorities is insufficient. Tax evasion, in particular the post box location of private equity and hedge funds in tax heavens for the sake of their "tax neutrality", must be banned and procedures for the systematic exchange of information between national authorities installed. This should apply both for intra-EU taxation as well as for capital transfers between the EU and offshore regions. Uncooperative jurisdictions should be faced with a system of scaled sanctions, reaching up to limits to the free movement of capital. De Larosière remains unspecific on this point in recommendation 28.

Basel II rules: gradually increasing minimum capital requirements and reducing pro-cyclicality by reforming international accounting rules (in particular fair value and mark-to-market accounting) is welcome, however recommending "stricter rules for off-balance sheet items" falls short of accepting the principles of transparency and accountability. Off-balance sheet "accounting" is a contradiction in itself and must be banned. In addition, reform of international accounting standards must encourage long-term investment over short-termist business models.

Credit Rating Agencies (CRAs): registration and supervision of CRAs through a strengthened Committee of European Securities Regulators (CESR) is a positive step—this should definitively not be left to national authorities. Going further than the de Larosière report, the EU needs to set up an independent, European non-profit organisation CRA, funded by the European budget under the supervision of a European Financial Services Authority (EFSA). An advisory or supervisory board to this EFSA should include members from the EP, ETUC, BE and civil society organisations.

"Parallel Banking" System: de Larosière is too cautious here. Parallel banking without registration and supervision must be banned. Hedge Funds, Private Equity and all hitherto non-registered Over-the-counter (OTC) trade must with no exception fall under the same regulatory framework.

Corporate Governance issues: proposals to align executive compensation, bonuses and stock options to long-term viability and sustainable company growth are welcome but do not go far enough. Full transparency of executive pay and stakeholder participation in defining sustainability objectives of companies, including co-determination and workers participation must also be tackled.

Proposals to set up a European System of Financial Supervision (ESFS) to ensure an integrated coordination of national supervisory authorities in micro-prudential control at European level are welcome. This is proposed to evolve in two stages (2009–10 and 2010–12) but will depend on political decisions about the degree of harmonisation and integration within the EU. The ETUC will have to assess further legislative initiatives from the Commission.

"Global repair": de Larosière suggests a strengthening of the Financial Stability Board (FSB, former Financial Stability Forum) to reform the financial system. This has been criticised in the Trade Union London Declaration to the G-20 Summit (paragraph 20). Alongside the reform of the global financial system mandated to the FSB it is both this opaque institution and the IMF itself that need to be reformed. As the London Declaration states, the FSF is composed of "the same experts who created the current system that has now collapsed so disastrously. Furthermore, the FSF has failed in the past to engage with trade union, civil society or other stakeholders, including the UN and the ILO, and does not have the appropriate governance structure, expertise or resources to enable it to do so in the future."

As to new power for the IMF International Monetary and Finance Committee (IMFC) proposed by de Larosière, ETUC and Global Unions point to the IMF's lack of democratic accountability. Trade unions demand a seat at the table in all decisive global fora—however de Larosière remains silent on the need to rebuild confidence among working families that are hardest hit by the crisis and risk to pay twice for it: once through the risk of unemployment and cuts in living standards, the second time as taxpayers who will have to pay for huge amounts of financial institutions debt in the future. The ETUC demands the support of basic principles of democracy and transparency in all global from the Commission and the Council.

Macroeconomic surveillance and crisis prevention: de Larosière recommends the development of a financial stability early warning system, accompanied by an international risk map and credit register. While it remains unclear how to prevent political manipulation of the mapping of "danger zones" (changes in the composition and voting rights power within the IMF has been announced but not implemented yet), a transparent international credit register has been demanded by trade unions for a long time.

EU representation in IMF and other international fora: this is welcome and long overdue, provided that the European social model is represented and not the free market anglo-saxon variety of it.

The European debate so far falls short of providing an answer to crucial macro-economic and structural problems that reach beyond the ad-hoc crisis management and current stabilisation measures. The model of unleashed neo-liberal financialisation has failed. For it to be over and finished once and forever, global imbalances must be tackled in the first place. Secondly, this also means that the financial sector will need to shrink significantly and its profits and economic weight be put in proportion to serve the real economy at sustainable growth rates. Market expectations of double-digit profit rates are no longer acceptable in this context. Yet some of the regulatory measures put on the table seem to be based on the illusion that a period of repair of the financial system paid by job losses, massive unemployment and higher taxes on workers would be followed by business as usual. For the ETUC, this is clearly not an option.

Hedge Fund Regulation

Hedge fund activities are not limited to one specific segment of the financial markets. Instead, they can be active in numerous parts of the financial market, they can be short selling equities, arbitraging bonds, speculating on commodities, organising "carry trade" between currencies and so on. What really defines a hedge fund are the following characteristics:

- Operations on international capital markets without being subject to much restrictions. A majority of hedge funds are based off-shore, exploiting both the loopholes on regulation and the lack of prudential oversight as well as the limited or zero tax obligations of such havens.
- Extremely high leverage. Unregulated hedge funds combine with a regulated banking system to produce leverage rates which challenge principles of sound management. In fact, high leverage is key to explaining the industries' profit base: Small differences in prices are blown up by using massive leverage techniques in order to produce high returns.

— Opacity is another key characteristic of hedge funds. Information on hedge funds' ownership, means of finance, business models and investment strategies are not open to the public, nor national regulators.

— A drive for extremely high returns. Excessive leverage is combined with speculative investment strategies in order to generate excessive profitability. Hedge funds also claim that their return performance is independent and uncorrelated from average market returns and that they try to deliver high and positive returns even in cases when markets and financial assets are going down. However, given that opacity is also present in the valuation and the accountancy practices of hedge funds, the question should be raised whether the "books are not being cooked" when official rates of returns of hedge funds are reported. For example, it is striking to notice that returns boom and become three times as high as usual in December when bonuses for hedge fund managers are being calculated. Also, Madof and Bayou testify to the fact that hedge funds are able to abuse the funds they have been entrusted with by setting up a "pyramid" game, registering huge profits on paper and paying out manager bonuses for years while in reality the profits are not there.

In any discussion on regulation of financial markets or tax policy on production factors that are internationally mobile, one recurrent claim is that Europe can not act in isolation from the rest of the world because of the risk of diverting capital flows. This claim is mainly inspired by concerns over the competitive position of some financial centres inside Europe.

The ETUC does not support this claim. It leads to a logic of non-action. Waiting for the rest of the world to take action will simply lead to non-action, not only from Europe but also from the rest of the world. Instead, the other logic that needs to be followed is as following : The European Union is a big player in the world economy and offers a vast market for financial actors including hedge funds. Even if registered abroad, their profits depend on their having access to European financial markets.This implies that Europe, provided it acts as one and in the same direction, can assert leverage over global financial players. Moreover, if Europe does act on this, other world powers will follow and be more inclined to take action from their side as well. Furthermore, below are more policy proposals to make European level regulation bite, even in cases where hedge funds remain off shore.

Systemic risks: The ETUC does not agree with those who claim hedge funds pose little systematic risk and refer to the fact that the failures of LTCM and Amaranth' were absorbed by the financial system without any long term market disruption. Such claims are a far cry from reality. In particular the failure of LCTM, confronted with near bankruptcy and a ratio of 200$ in debts for each dollar of own capital, threatened to unleash a wave of fire selling of LCTM assets. This led liquidity on many markets to almost totally disappear. In the end, a meltdown of the global financial system was avoided at the last moment by the Federal Reserve pressing major banks to bail out LCTM.

In today's *sub prime* financial crisis, the systemic risk of hedge funds using high leverage and borrowing from banks has again become perfectly clear. Banks, in the aftermath of the LCTM failure, are very closely following up what is happening with the hedge funds' asset balance sheet and losses in hedge funds' assets are immediately translated into "margin calls". Funds are called backed in in times of crisis in asset prices. This, together with "Value-At- Risk" models of banks sending out selling signals, has created a situation in which hedge funds were forced to sell assets massively whereas no counter parties were there to buy these assets. As a result, prices of different assets on financial markets (equity, ABS) have simply collapsed, ruining the entire banking system.

Here, there is a parallel to be drawn with the typical Keynesian argument of "fallacy of composition". If one firm cuts wages, it improves cost competitiveness, if all firms do so it kills aggregate demand and all firms. From an individual bank/hedge fund perspective, margin calls and stringent collateral requirements when lending to hedge funds make sense. However, from the point of view from the entire sector, this practice transmits the instability of the high leverage of hedge funds throughout the whole financial system.

An additional and particular systemic risk is indeed through the technique of "short selling" in which hedge funds sell equity they do not own but have lent from other actors like pension funds. This technique has contributed to stock market volatility and has exacerbated the problems with the sub prime financial crisis. Again, the "ripple" effects are not to be underestimated. On several occasions, the equity portfolio made available by pension funds has simply been lost, creating financial difficulties for them, since the hedge fund which the portfolio was lent to has gone bankrupt.

In general, it is worrying that hedge funds are increasingly managing the money of pension funds and individuals, who are attracted by reports of high returns but whose risk profile makes such investment unsuitable.

European regulation. European regulation for hedge funds active in the single market should comprise the following:

— Hedge funds need to be registered with the competent national authorities.

— One key rule the ETUC considers to be of extreme importance is that all financial institutions, including hedge funds, are subject to capital requirements and prudential oversight. "Regime

shopping" and avoiding prudential oversight by repackaging business in the form of a hedge fund or a structured investment vehicle should no longer be possible in the European financial marketplace.

— Another key part of prudential oversight is the implementation of "stress tests": On regular occasions, regulators are to make an inventory of hedge funds' positions with the aim of obtaining an overall view and an assessment of total risks involved.

— Independent rating agencies should also provide information to the public on the situation and the risk management strategy of a hedge fund. This assessment of the risk management strategy can then be used to diversify the capital requirements on hedge funds in function of their risk management.

— Limits to the access of hedge funds to the European retail market in view to protect small investors and capital owners.

— Re-hypothecation, being a strategy to pump up credit and leverage, should be addressed and regulated.

— Short selling without the hedge fund ownership of these shares, given its amplifying downwards effect on the stock exchange, is to be prohibited.

Hedge funds, given their extreme leverage, are highly dependant from more regular financial players such as banks for lending and brokerage services. Moreover, this is a very concentrated business. Worldwide, not more than 15–20 credit institutions, would be confronted wit tighter rules when lending to hedge funds.[1] So, through banking regulations, hedge funds can be regulated in an indirect but nevertheless important way.

Practically, the ETUC proposes to toughen up the Basle II capital requirements for banking lending to hedge funds. At the moment, credit lending to hedge funds brings with it a capital requirement three times as much as usual. This could be increased to a factor of five. Moreover, these factors for capital requirement from the Basle II framework could be modulated to reflect policy preferences, with lending to hedge funds specialising in speculation on commodities and oil and hedge funds in offshore tax havens being hit by a capital requirement ten times' as high.

Higher capital requirements could also be formulated for lending to hedge funds:

— with high illiquid positions;

— who refuse to give information on their total portfolio investments;

— which do not apply "lock up" provisions for their investors; and

— and who do not have additional credit lines in times' of crisis at their disposal.

Another channel of indirect regulation runs through the access to the European (retail) market. Hedge funds based outside Europe, in particular based in offshore tax havens, are not to have access to the European market at all.

Private Equity

Capital and asset stripping

The dangerous logic of pursuing excessive profits by taking on excessive risk and lending is also at the core of the business model of private equity. Moreover, private equity funds do not only put themselves at risk, they are directly imposing this excessively risky business model onto "real world" companies. The effect is that imposing unrealistically high short term profitability standards on "real world" businesses leads to a management style and decisions that undermine the long term competitiveness of these companies. For example, the first thing that happens when private equity enters a firm is to slash research and development budgets as well as to cut investment in training of the workforce. Long term innovation and human capital are sacrificed for short term profits. On top of this, private equity organises asset and capital stripping, replacing safety capital buffers with costly loans and leaving companies extremely vulnerable to the slightest downturn: Minor losses than annihilate the company's capital and push it into bankruptcy.

European regulation of private equity. The ETUC seeks to establish European level regulation of private equity funds in order to prevent private equity funds from engaging in the speculative practices described above and to refocus private equity:

— To avoid extreme risk taking and excessive debt, capital requirements like those already applying to banks and insurance companies need to be introduced in private equity and related businesses as well.

— To ensure the viability of businesses, actions against capital depletion need to be taken.

— To limit private equity's monopolistic hold on companies' workers, the European directive 2001/23/EC needs to be amended so as to ensure that employees are also informed and consulted whenever control of the undertaking of the business is transferred by private equity investors.

[1] Voth, Hans—Joachim. *Transparenz und Fairness auf einem einheitlichen Europ—ischen Kapitalmarkt*. Hans Bckler Stiftung, Juli 2007, available at www.boeckler.de

— Directive 2003/41//Ec also need to be reformed in order to ensure workers with savings engaged in pension schemes and pension funds are informed through their staff representatives about the way their pensions are invested in private equity and hedge funds.

— Directive 77/91/EEC on capital requirements needs to be reviewed with the aim of ensuring a reasonable level of leverage.

Other Measures

Finally, the ETUC reminds the Committee of the other areas of reform which are extremely urgent in the financial market place. These concern, in a non-exhaustive way:

— A European Credit Rating Agency to provide the public good of independent assessment of financial products and creditworthiness and also to break the vested interests of Wall Street agencies serving Wall Street Banks and advising against public finance.

— Limiting bonus payment systems, stock options and golden parachutes, being systems promoting excessive and short term risk taking.

— Addressing the pro-cyclicality in the financial market system.

— Guiding liquidity created by central banks through a system of asset based reserve requirements.

— Attacking off-shore centres and tax havens undermining the government revenue side.

April 2009

Letter and Memorandum from the Joint Administrators of Landsbanki Guernsey Limited

We write in our capacity as Joint Administrators of Landsbanki Guernsey Limited (in Administration) ("LGL") in connection with the above, and, in particular, in order to draw to the attention of the Treasury Select Committee (the "Treasury Committee") our serious concerns regarding the treatment of LGL's depositors and the inadequacy of the existing arrangements both for protecting such depositors and for representing their interests.

We welcome the Treasury Committee's recognition of the severe distress of those suffering due to the Icelandic banking failure, and in particular those who placed their savings in offshore financial centres. The Treasury Committee concludes in this regard, "we can only recommend that the UK authorities work with the Isle of Man and Guernsey authorities to resolve these issues." Regrettably, we strongly believe that the UK authorities are ill-placed to represent the interests of LGL's depositors and others in a similar position, because the UK Government and taxpayer are (under Icelandic insolvency rules introduced following the collapse of the Icelandic banks) in a diametrically opposed position in the insolvency of the Icelandic banks, in which they are a priority creditor, while LGL (and thus its depositors) are not. This therefore means that LGL and its depositors are effectively reliant on the States of Guernsey to represent their interests on a political level. The absence of proper political representation by the UK Government, which is constitutionally responsible for the international representation of the Crown Dependencies (including Guernsey) and has expressly stated that HM Treasury will represent the Crown Dependencies in discussions with the Icelandic Government, only serves to exacerbate the adverse effects of the situation for LGL and its depositors.

Our concerns are of wider significance to the Treasury Committee's further consideration of the existing system of passporting and depositor protection in the context of offshore financial centres, and we respectfully suggest that they are matters that should be subject to intensive and urgent scrutiny.

We accordingly attach a short memorandum outlining our concerns, and also updating the Treasury Committee on a number of relevant developments since its last call for evidence in relation to the banking crisis. We also attach for your information our letter to HM Treasury in this regard.

If we can be of any further assistance, please do not hesitate to contact us on the details given above.

Memorandum submitted by the Joint Administrators of Landsbanki Guernsey Limited

1. This memorandum is submitted by the Joint Administrators of Landsbanki Guernsey Limited (in Administration) ("LGL").[2]

Executive Summary

2. LGL was a subsidiary of Landsbanki Islands hf ("LIHF") operating in Guernsey. LGL's depositors do not have the benefit of any depositor protection scheme and thus will only recover their savings through the administration process if the Joint Administrators are able to recover LGL's assets. LGL's assets include substantial inter-bank deposits with Heritable Bank plc ("Heritable") and LIHF.

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[2] LGL is in Administration and the affairs, business and property of the Bank are being managed by the Joint Administrators, Mr Rick Garrard and Mr Lee Manning of Deloitte LLP.

3. The current regulatory arrangements and the actions of, *inter alios*, the UK and Icelandic authorities have adversely affected the recoverability of those inter-bank deposits, with direct consequences for those who saved with LGL.

4. LGL and its depositors are reliant upon the UK Government to represent their interests at a Governmental level in negotiations with the Icelandic authorities and banks, and other international organisations. However, the UK Government is itself a priority creditor in the insolvency of LIHF and thus in a position diametrically opposed to that of LGL in this regard. As such, we believe that the UK Government's ability properly and effectively to represent LGL's interests has been undermined. This is of immediate concern to LGL's depositors, and also raises fundamental questions about regulation and deposit protection in, and the representation of the interests of, offshore financial centres such as Guernsey.

5. We respectfully ask the Treasury Select Committee (the "Treasury Committee") to give this matter urgent and intensive consideration as part of its current inquiry.

Background

LGL

6. LGL is a Guernsey-registered limited company (now in administration) that carried on business as a bank and was regulated as such by the Guernsey Financial Services Commission (the "GFSC"). LGL was placed in Administration on 7 October 2008.

7. The regulatory arrangements in place in Guernsey at the time LGL was placed into Administration, in contrast to those in place in the United Kingdom, provide no depositor protection. As such, recovery of deposits by depositors in LGL will be limited to their entitlement under the administration to those assets of LGL that the Joint Administrators are able to recover.

8. LGL's assets include substantial inter-bank deposits with Heritable and LIHF. LGL's deposit with LIHF has a book value of approximately £14.5 million. LIHF also provided parent company guarantees in respect of LGL. LGL's deposit with Heritable has a book value of approximately £34.5 million.

Heritable

9. On 7 October 2008, the FSA concluded that Heritable was failing to meet its threshold conditions under the Financial Services and Markets Act 2000 (the "FSMA"). The FSA therefore exercised its power under the FSMA so as to prevent Heritable from accepting any deposits into any new or existing deposit accounts and found Heritable to be in default for the purposes of the Financial Services Compensation Scheme (the "FSCS"). On the same day, the FSA applied to the Court of Session in Scotland for an Administration Order in respect of Heritable, which was granted.

10. On 8 October 2008, Her Majesty's Treasury transferred the retail deposits of Heritable to ING under Statutory Instrument 2008/2666. This transfer was made without compensation to the remaining creditors of Heritable (including LGL).

11. The former directors of Heritable have signed declarations (which have been filed at Companies House) in relation to the impact of the transfer of the retail deposits on the Statement of Affairs as prepared at 30 September:

> ". . . [the Statement of Affairs] is based upon the company in its current state of administration where the deposit base has been removed by the authorities and does not reflect the true value of the company as a going concern where I believe the management accounts of 30 of September give a fair reflection of the company's status as a going concern. . . . According to the latest Management Figures presented to me dated 30 September there was no reason to expect the value of assets to be lower than the value of liabilities. Under reasonable assumptions at that point I cannot confirm other than the value of the ongoing business should have remained positive."

12. Similar actions were taken by the FSA and HM Treasury in relation to Kaupthing Bank's UK subsidiary, Kaupthing Singer & Friedlander ("KSF"). Those actions, and in particular the transfer of the retail deposits KSF to a third party without compensation, are now the subject of a judicial review challenge in the High Court, for which permission was granted by the High Court on 13 March 2009. We understand that the Resolution Committee of LIHF is, in that light, considering the possibility of it's bringing a claim for judicial review of the actions of the UK authorities in respect of Heritable.

LIHF

13. Under the Emergency Laws passed by the Icelandic Government (including Law no 125/2008 and changes to the Act on Financial Undertakings, number 161/2002) ("the Emergency Laws") on 6 October 2008, the Icelandic Government split LIHF into "New" and "Old" banks, with domestic deposits being transferred to the New Bank and non-domestic deposits being left in the Old Bank (which is now being administered (and effectively wound up) by a Resolution Committee appointed for that purpose by the Icelandic Financial Supervisory Authority).

14. Under the Emergency Laws, non-domestic deposits that were covered by the Icelandic deposit insurance scheme were granted a priority over the other creditors of the Old Bank. Deposits by subsidiaries, such as LGL, are expressly not covered by the Icelandic deposit insurance scheme (and thus do not have priority in the Old Bank's administration), whereas deposits from overseas branches of LIHF (such as IceSave in the UK) are covered by this scheme. This fact was only made clear during the LIHF open creditors meeting held in Reykjavik on 20 February 2009.

15. The UK Government, having fully compensated all depositors in the UK branch of Icesave, is now "standing in the shoes" of these depositors in respect of payments from LIHF and is thus itself a priority creditor in LIHF's administration.

16. The Resolution Committee of LIHF expects that such priority creditors will receive a payment of approximately 90 pence in the pound, while the other creditors (including LGL, and thus its depositors) will receive nothing. This will directly result in the depositors in LGL losing approximately 12 pence in the pound of their savings. However, creditors will suffer substantial further losses from the non-fulfilment of LIHF's parent company guarantee in respect of LGL.

17. By contrast, under the apparent insolvency regime that applied prior to the Emergency Laws being passed (including at the time when LGL deposited funds with LIHF), all creditors would have been treated pari passu, with the result that:

(a) LGL would likely have recovered approximately 35 pence in the pound in respect of its £14.5 million deposit (ie c £5.1 million) with creditors potentially recovering further amounts under the parent company guarantee; and

(b) the UK Government would similarly have recovered approximately 35 pence in the pound as opposed to the approximately 90 pence in the pound it now appears likely to receive.

Depositor Protection in Offshore Financial Centres

18. Depositors in UK-based branches and subsidiaries of Icelandic banks have been fully compensated, as, in effect, have domestic depositors in Iceland. By contrast, LGL's depositors have received no compensation. That differential treatment of LGL's depositors as compared with others in a comparable position is, in our view, unfair. Furthermore, the priority given to the UK Government over other creditors including LGL means that LGL's depositors are in effect subsidising the UK Government's decision to provide full compensation to other depositors.[3]

19. We have raised our concern that the current treatment of LGL's depositors does not meet the "fair, equitable and non-discriminatory" standard required under the terms of the IMF stand by facility to Iceland with both the IMF Mission to Iceland and the Chairman of the Coordination Committee in Iceland. However, we note that this treatment is due to the Emergency Laws passed and is therefore not directly the fault of the UK Government.

The Absence of Proper Representation for the Interests of LGL'S Depositors

20. By reason of the above, the position of the UK Government is, as regards the recovery of assets in LIHF's administration, diametrically opposed to that of LGL and LGL's depositors. In these circumstances, we do not believe that the UK Government will be able to effectively represent the interests of LGL and its depositors in negotiations with the Icelandic Government, LIHF and other relevant parties. The current arrangements leave LGL and those who placed their savings with it not only without any UK regulatory protection but without effective representation by the UK Government of their interests in relation to the recovery by LGL of funds from LIHF.

21. The Justice Select Committee (the "Justice Committee") expressed concern at the potential for such a conflict of interests to arise in its First Report of Session 2008–09 regarding Crown Dependencies (the "Report"), noting in particular "the potential divergence between the interests and concerns of UK-based depositors in Icelandic banks in the Crown Dependencies and those of the UK taxpayer." That potential divergence of interests has now crystallised into an actual conflict, following the announcement on 20 February 2009 of the priority arrangements in the LIHF administration, which placed the UK Government in the position of a priority creditor while leaving LGL (and thus all of its depositors) unlikely to recover any money from LIHF.

22. We have raised these concerns with the Justice Committee.

April 2009

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[3] We understand that the Dutch Government is in essentially the same position as the UK Government in this regard.

Memorandum from the British Bankers' Association

2. Potential reforms to the international financial regulatory system, particularly with regard to:

2.1 Potential areas of improvement in European financial regulation (including the de Larosière Report, "Passporting" and deposit protection)

De Larosière Report

1. The BBA agrees that there are a number of significant changes that need to be taken both in Europe and internationally to provide high quality macroeconomic analysis; to build structures to improve financial stability; to revise regulatory frameworks; to address gaps in regulation; and to improve cooperation and coordination amongst supervisors. Although many of these issues need to be addressed on an international basis, or in coordination with authorities around the world, the BBA recognises the need to bring about a coherent solution for the EU.

2. In brief, the BBA considers that the EU should seek to achieve:-

— A coordinated macroeconomic perspective of the issues that can cause systemic problems both from within and from outside the region.

— A coordinated EU and Member State response to issues highlighted by the macro work.

— A coordinated mechanism for regulators that addresses the risks to large financial institutions.

— A high quality mechanism to bring about equivalent implementation of regulatory agreements that focuses on achieving an equality of outcomes for the various EU countries.

— A fast track mechanism for resolving regulatory disputes.

— Clear, coherent and understandable mechanisms for crisis management.

— Targeting and resolving areas where there are either regulatory gaps or regulatory failures.

— An emphasis on high quality risk management and risk control, particularly focussed on all systemic institutions.

3. However, it is of vital importance that the long term competitiveness of the EU within the global marketplace not be forgotten. Many of the issues rightly raised in the de Larosière report are for the international authorities. We therefore look forward to the EU not only providing thought leadership in the international standard setting process, but also engaging to bring about coordinated changes. Failure to implement, or to implement in advance, internationally agreed standards will only have the result in finance moving to other jurisdiction. That would not be in the interest of the industry, the EU, or long term global financial stability.

4. The BBA endorses many of the proposals in the de Larosière Report and would particularly like to emphasise the following areas[4]:

I. The European Systemic Risk Council—we agree that this is an appropriate and effective way forward to provide the macro view and risk warning system essential for the EU. For it to be fully effective, however, it requires representatives from the Central Banks in each of the EU countries and regulators from, at the very least, the countries with major financial centres as members for all of its meetings. Secondly, the ESRC has to be seen to be genuinely representative of the EU and not just the Eurozone. This means that the chairman should be drawn from outside the Eurozone. We agree however that the ECB should be responsible for providing the secretariat to the body and for facilitating its work. Thirdly, the ESRC needs to report on a regular basis to Ecofin and possibly also to the European Parliament. Its recommendations and directions should be set in that context rather than by direct instruction to the European System of Financial Supervision and through them, national supervisors. Lastly, to make it a fully effective body it must have the ability to gather market intelligence and to draw on the data collected by central banks and supervisors to ensure it understands industry practice and industry concerns. An integral part of this new structure therefore, should be an industry advisory committee sharing its knowledge and assessments with the ESRC.

II. The European System of Financial Supervision—the BBA is supportive of the proposition that the operation of the existing Level 3 Committees, with their focus on a more consistent set of rules, definitions and interpretations, should be improved in concert with the upgrading of the quality of supervision generally. Key to the future are properly functioning colleges of regulators for the largest financial institutions. The BBA has undertaken some extensive work on colleges of regulators and particularly how to make them work effectively (our thoughts are detailed below).

[4] The BBA's full response to the European Commission consultation on the recommendations of the de Larosière Report is available at: http://www.bba.org.uk/bba/jsp/polopoly.jsp?d = 155&a = 15906

III. The Future of the Broad Based Bank—we are pleased to see that the continuation of broad based banks is assumed and that attention is paid to more effective regulation and risk controls in this context. We favour much of that which is proposed including the fundamental review of capital rules; measures to combat pro-cyclicality; improvements in risk assessments and a review of the credit rating agency model. In these aspects and more, however, changes proposed by the EU need to be considered in two ways. First is the international context. Many of these issues are already on the agenda for the international standards settlers and thus EU changes need to be coordinated within the global context. There are already unfortunate and worrying examples of this not happening, for example with regard to the regulation of credit rating agencies and proposals on resecuritisation. Second, there are clear costs associated with many of these changes and impact assessments therefore need to be undertaken.

5. We note the recognition that made that many of the changes should take effect once the economies are through the recession. Nevertheless we underline the importance of timing and coordinating with fiscal changes is vital to avoid a combined impact that would risk turning a recovery into a second recessionary dip.

Passporting

6. In considering changes to the prudential capital regime, there is a need to give careful consideration about the potential effect of disrupting home/host regulator arrangements if we are to avoid turning back the tide of trade liberalisation in financial services. While we can see the case for reviewing the means by which host states can satisfy themselves that they can ensure that their national interests are protected, we believe that the UK has more to lose than to gain if our policy response results in a further repatriation of capital and liquidity to home markets because of the cost of doing business here. While the interconnectivity of the global markets may in part explain the broad impact of the current crisis, it has also delivered economic benefits for consumers across the globe in recent decades and we must ensure that our actions are compatible with returning the banking system to financial health within a more secure regulatory environment set at an international level with open markets and open competition remaining as a prime objective.

7. Given the holistic nature of the EU/EEA passporting regime, it is hard to envisage how the branch basis passporting regime for banking firms could change without there also being an impact on the cross-border (ie non-physical) passporting regime as well. Similarly, due to the integrated nature of the EU financial services regime more generally, it is difficult to see how changes to the passporting regime for banks could be effected in isolation without there also being an impact on the passporting regime for other firms (such as insurers, insurance intermediaries and MiFID-only firms). The ramifications of any proposed changes must therefore be carefully considered, including the risk that the unravelling of passporting rights could pose to the City's position as the leading European financial centre.

Deposit Protection

8. Recent market turmoil and resulting bank failures have highlighted the need for enhancements to Deposit Guarantee Schemes (DGS) across Europe. We recognise that DGS play an important role in consumer protection and in under-pinning consumer confidence which in turn supports financial stability.

9. We welcome the recent changes to the DGS Directive which raises the minimum compensation level to €50,000 and significantly reduces the payout timeline for compensation.

10. Recent events have shown however that there are limitations to the impact DGS can have on maintaining consumer confidence and financial stability in certain circumstances. We therefore support the recent DGS amending directive's recognition of the role that continuity of banking services can play in this area.

11. Further DGS reforms at EU level must be based on a clear vision of how consumers can best be served in future and take full account of related developments in prudential supervision and crisis resolution arrangements.

12. We expect that continuity of banking services and access to monies will gain increasing recognition at European level as the preferred basis for depositor protection in the event of a distressed bank as this provides most benefits for consumers and is more likely to maintain financial stability.

13. The FSA's current proposals for the imposition of an industry-wide Single Customer View on the UK banking industry is at odds with this perspective as it is premised on FSCS contingency planning on a basis which would, in the main, not be used in practice. Very serious thought therefore needs to be given to whether DGS arrangements should be premised on maintaining continuity of service or faster payout. The two models differ enormously and proceeding on the basis of both has highly significant cost and planning implications.

14. In addition, we do not believe that the harmonisation of certain elements of DGS at European level and/or support for the creation of a centralised European fund is necessary to delivery improved deposit protection outcomes. For example, we see the harmonisation of funding mechanisms as an irrelevance since the key issue is access to sufficient liquidity to deliver prompt payout in the event of a bank failure. At an EU level, harmonisation of "outputs", ie levels of depositor protection and payout timeliness etc, are what matters most and not harmonisation of "inputs" such as the way in which schemes are funded.

15. We remain strongly opposed to the introduction of pre-funding in the UK which looks increasingly unnecessary given recent action by the UK authorities and access to the National Loans Fund. We therefore support the retention of national discretion in this area at EU level.

16. We believe that prudential supervision and insolvency law would need to be closely aligned across member states before a central fund could even be considered as a feasible option.

2.2 Global cross-border financial regulation and the creation of colleges of supervisors

17. We continue to believe that global, cross-border, financial regulation is necessary for financial institutions which operate internationally. In our view, there are two aspects to consider in this context: (i) the supervision of globally active financial institutions through colleges of supervisors and (ii) the continued evolution of the global regulatory framework.

Colleges of Supervisors

18. We are firm supporters of colleges of supervisors for the supervision of internationally active financial institutions. When discussing colleges, however, it is important to recall that the term has dual meanings. In the EU, the Capital Requirements Directive provides a framework for the supervisors of a cross-border group to cooperate and coordinate specific supervisory tasks. At the international level, the Financial Stability Forum is in the process of establishing supervisory colleges for the 30 largest financial institutions to strengthen the surveillance of major cross-border firms and to provide a forum for comprehensive discussion of institutions' activities and the risks they face.

19. Given the common supervisory framework within the EU, there is obviously much greater scope for EU colleges to harmonise supervisory practices and for national supervisors to delegate their tasks voluntarily to supervisors better placed to undertake them. However, most internationally active banks which operate within the EU also operate in third countries. In our view it is therefore vitally important to find a mechanism to properly engage third country supervisors in colleges. Recent guidance from the Committee of European Banking Supervisors which makes clear that "Non-EEA supervisory authorities may participate in the College at the invitation of the consolidating supervisor where appropriate, subject to their having confidentiality requirements that are equivalent, in the opinion of all competent authorities, to those established by the CRD". This is a good first step, but for colleges to work as efficiently as possible it is essential that third country supervisors be accommodated within EU colleges. At the request of the G20, the Financial Stability Forum (now Board) is developing protocols for the establishment and operation of supervisory colleges at the international level. We welcome this and expect it to promote convergent practice between colleges.

20. Below we set out our views on how colleges should function. In short, we believe colleges should be flexible tools used to coordinate and harmonise the implementation of decisions taken by national supervisors. This will not only allow more efficient and effective supervision but it will also permit supervisors to take a holistic view of the risks faced by firms and further the risks they pose to the financial system. In our view, it is no coincidence that the colleges which have operated most successfully during the current crisis are the longest established where there is a history of cooperative working and trust between the supervisors involved.

I. Formal agreements: It is important that written memoranda of understanding are in place to govern how the college will operate in practice. They should cover, at a minimum:

- How the college will function.
- How it will be organised.
- A description of the structure of the bank which outlines which supervisor is responsible for which elements.
- How cooperation and coordination procedures between supervisors (and with the bank) will work in day to day practice (as well as in emergency situations).
- A list of issues and activities which will and will not be within its scope of consideration (for instance, the college would not be permitted to reach an agreement which imposed a cost to a national taxpayer or would trigger a government to intervene).
- How often colleges should meet.

II. Structure: To be successful it is essential that the right structure is found for colleges. This must balance the differing needs of home and host supervisors and the needs of the bank. A host supervisor with a subsidiary or branch which is immaterial to the group but material to the stability of its jurisdiction must be permitted to fully participate in the college as an equal partner.

However, as it is important to avoid the college becoming unwieldy, we suggest that in many instances a multi-level arrangement will be most appropriate. In practice this will mean a two tier structure which will increase the harmonisation of regulatory approaches whilst at the same time acknowledging the different roles of supervisors. We foresee the division being:

— A "core college" as the principal forum for banks to discuss their strategy with their key regulators, namely their home regulator and the regulators from jurisdictions in which the bank has significant or systemically important subsidiaries and branches.

— A "general forum" to provide an environment for all the authorities within whose jurisdiction the bank has a presence to exchange information on a group wide basis and allow for high level discussion of the overall supervision policy for the group on a less frequent basis, as well as an opportunity for general downloads by banks to all supervisors—in one meeting rather than many—on eg past year's performance, strategy, future plans etc.

In both instances discussion should focus on the group at the consolidated level and the home supervisor should take the lead role. This structure should allow all the supervisors involved with the bank to fully understand its structure, its business model and its risk issues.

III. Participants: To address concerns about the level of seniority of supervisors attending colleges, regulators should commit to sending personnel with the authority to commit their national authorities to the course agreed. Participation by the person who has the most influence on the direct and practical supervision of the subsidiaries and branches of the bank in their jurisdiction would be very welcome.

We suggest that one way to improve the efficiency of colleges may be to have a formal secretariat, provided by the lead supervisor. Such an arrangement would mitigate banks' concerns about being able to rely on decisions made within a college.

I. Where a firm has significant operations outside of the EU, the relevant supervisors should be invited to participate in the college.

IV. Agenda setting: It is important for the objectives of each meeting of the college to be defined and for the agenda to be arranged in a manner so as to allow as efficient a discussion as possible. As both banks and supervisors must invest significant resources in preparing for a college, it is important that issues which might best be discussed on a bilateral basis are taken forward at that level and escalated to the college if, and when, necessary.

V. Communication: Communication between supervisors and the bank should be the responsibility of the home supervisor. They should take the lead in communicating the outcomes of the college to host supervisors and other interested authorities. Host supervisors should then communicate the measures to be applied to subsidiaries in their jurisdiction.

VI. Information sharing: The exchange of information is the key to the success of colleges and to the efficient and effective supervision of cross-border banks. Information should be exchanged within the context of the written arrangements which are in place for the operation of the college but should at a minimum be two-way and proportional to the needs of the supervisors involved. The home supervisor has an important role to play at the centre of the college, collating and disseminating information as necessary. Obviously, when sensitive data is exchanged this should be done by secure channels.

VII. Delegation: Delegation of tasks and mutual cooperation are implicit to the principle of colleges. Supervisors should consider whether to formally delegate tasks to each other (such as the delegation of branches' liquidity management to the home supervisor) and make arrangements for informal delegation to facilitate the most efficient operation of the college. As a first step, we suggest that delegation should focus on effective allocation of tasks to those best placed to undertake them and the sharing of the resulting information. In time, as supervisors have more understanding of and confidence in the capabilities of their colleagues, there will be further opportunities for delegation and corresponding increases in the efficiency of the college from the supervisors' perspective.

Global Regulatory Architecture

21. We firmly support the process put in place by first the G7, through the Financial Stability Forum, and more recently by the G20 to enhance the global regulatory architecture. Financial institutions are global and it follows that financial stability will be strengthened if the regulatory and supervisory frameworks under which they operate are internationally agreed and are of consistently high quality across jurisdictions. Therefore, whilst we welcome the G20 nations' commitment to ensure that their domestic regulatory systems are strong, we place considerable importance on ensuring that the standards applied by national regulators which are agreed through the international standard setters such as the Basel Committee, International

Accounting Standards Board and International Organisation Securities Commissions are robust and appropriately framed. In our view, the G20 Action Plan does this. The changes it proposes to the regulatory frameworks are based on a robust analysis of the causes of the crisis and therefore an understanding of the changes which need to be made to rectify current shortcomings to ensure future financial stability. However, as recognised by Lord Turner in his recent review, regulatory changes by themselves are the not the sole response required. There is also a clear need to address global imbalances; to reconsider the framing and operation of monetary policy (which allowed asset bubbles to build); and to reconsider broader socio-economic policies such as, in a UK context, housing policy.

22. We welcome the fact that the recent de Larosière Report and Turner Review both recognise the importance of a global framework. It is important, however, that the European Union and the UK do not try to forerun international agreements.

The Role of the Financial Stability Board

23. To ensure that the global regulatory framework is both consistent and effective, the BBA has advocated a more central role for the Financial Stability Forum going forward. We therefore welcome and support the G20's decision to expand the Financial Stability Forum's membership, broaden its mandate and reconstitute it as the Financial Stability Board. In our view, the model set out in the G20 communiqué has the potential to strengthen the Financial Stability Forum's effectiveness as a mechanism for national authorities, standard setting bodies and international financial institutions to identify vulnerabilities in the financial system and to enable them to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.

The Committee will also accept further evidence on offshore financial centres in relation to the above topics

24. We support the work being led by the G20 and FSF to promote integrity in financial markets and agree that discussion of the treatment of uncooperative jurisdictions which pose risks of illicit financial activity should be considered as part of the reform of the international financial system. To be effective, however, it is essential that agreements must be reached on this issue at the global level. In our view, as a first step, serious consideration needs to be given to the development of principles by which the cooperation of jurisdictions can be assessed. We agree that there could then be a role for the IMF and FSF to play in monitoring the compliance of offshore financial centres with international regulatory standards.

April 2009

Memorandum from the Guernsey Financial Services Commission

1. This submission by the Guernsey Financial Services Commission ("the Commission") focuses particularly on point 2.2 of the terms of reference of the Committee's enquiry, namely "Potential reforms to the international financial regulatory system, particularly with regard to…global cross-border financial regulation and the creation of colleges of supervisors."

Summary of Key Points

2. The Commission emphasised, both in its written submission in January 2009, and in the oral evidence provided by Mr Neville, the Commission's Director General, during his appearance before the Committee on 3 February 2009, that regulators must, in order to be able to regulate effectively within the context of a global financial market (and more widely to promote global financial stability), be able to rely on effective communication with and information exchange from other regulators.

3. The Commission is a responsible regulator which has been held by a number of authoritative, independent assessors to meet international standards of bank regulation.

4. Regulation of the financial services sector is only effective if regulators acknowledge a responsibility in respect of entities whose activities and involvements extend beyond their own jurisdictions.

5. Shortcomings in the current system of cross-border financial regulation have been identified by, among others, the Chairman of the FSA, Lord Turner, in the Turner Review of March 2009. With the recent declaration by the G20 group of nations on strengthening the financial system, there is now real momentum towards reform of cross-border regulation, and we urge national regulators and governments to seize this opportunity. Much valuable work has already been done in this area, to which the Commission has contributed.

Introduction: Banking and Regulation in Guernsey

6. On 28 February 2009 47 licensed banks from 17 jurisdictions were based in Guernsey. Deposits totalled £142 billion of which approximately £5.1 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.

7. 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 procedures, record keeping and systems of control. The Commission supervises banks by using a combination of off-site monitoring and on-site inspections.

8. Guernsey's long standing commitment to meeting international regulatory standards has been confirmed by a series of independent reviews, including those carried out by the UK Government (through the Home Office Review of Financial Regulation in the Crown Dependencies: "the Edwards Report"), the Financial Action Task Force, the Financial Stability Forum, the International Monetary Fund, and the Organisation for Economic Co-operation and Development. All the reviews have concluded that Guernsey is well regulated and achieves a high level of compliance with international standards. The IMF is due to undertake its next assessment in late 2009. The Commission confidently expects to receive a further endorsement of its regime.

Global Cross-border Financial Regulation

9. Both economic activity and financial services are global in nature. Effective cross-border regulatory co-operation is therefore essential in order to support global financial services and global financial stability.

10. International regulatory bodies are working together to enhance and strengthen global financial regulation, including by achieving greater cross-border co-operation and more efficient and prompt information sharing. For example, the Financial Stability Forum, now re-established as the Financial Stability Board, is to support the establishment of supervisory colleges (groups of regulators interested in the same bank or financial services group) and support contingency planning for cross-border crisis management.

11. Much work has been done and continues to be done by regulators in different jurisdictions to enhance cooperation and information exchange between regulators, and the Commission is active in this area. Bodies looking at the issue of enhanced cooperation include the Basel Committee who have formed the Cross Border Banking Resolution Group (CBBRG), a working group in which the Commission participates, and whose function is to compare national policies, legal frameworks and the allocation of responsibilities for banks with significant cross-border operations.

12. The Commission has led the drafting of a Code of Practice for supervisory communications and information exchange for discussion and agreement by the Offshore Group of Banking Supervisors ("OGBS"). In addition, it is hoped that this will serve as a means of updating the existing home/host supervisor protocols of regulatory bodies within the OGBS and of developing host/host cooperation and information exchange. We consider strong host/host relationships to be a crucial element in achieving global financial stability. In light of this, the Commission hopes that the Basel Committee will consider the Code of Practice with a view to enhancing cooperation and information exchange between supervisory bodies.

Areas for Possible Improvement

13. The Commission believes that it is clear that cross border regulation needs urgently to be improved with regard to the facilitation of effective communication and information flow, as set out in the Commission's January 2009 submission and as stated by Mr Neville at the 3 February 2009 hearing before the Committee. The Committee's Fifth Report of Session 2008–09 noted "with concern the suggestion that the paucity of information provided by the Financial Services Authority may have impeded the ability of the regulators in the Crown Dependencies to safeguard their own financial systems" [paragraph 93].

14. Mr Neville in his oral evidence pointed to the key difficulty in this area when he said "we understand that the FSA believes that it could not and should not have passed us more information than it did…". He used this to highlight the danger of protectionism by individual regulators, and highlighted the need to remove the barriers—"legal, political and attitudinal"—to cross border cooperation. As Mr Neville further stated, any regulator can only regulate to the extent of the information provided to it.

15. These concerns (both as regards the general position and more specifically relating to the poor cooperation and information exchange with the Commission in relation to a Guernsey subsidiary of the Landsbanki Group) have been expressed in correspondence with the FSA. This correspondence has been placed in the public domain, with the consent of the Commission, via the Committee's website. In that correspondence, the Commission set out in some detail its concerns at what it sees as the lack of cooperation and information flow provided by the FSA, a fellow host supervisor of the Landsbanki group, in relation to the position of Heritable Bank Plc, the sister bank of Landsbanki Guernsey Limited. The Committee, is

referred in particular to the letter to the FSA of 23 February 2009. As set out in that letter to Mr Hector Sants, Chief Executive of the FSA, Mr Neville comments "my principal concern is that the FSA considered that it was entitled to act solely in pursuit of a domestic agenda at a time when what was needed was a co-ordinated interpretation of the steps required for effective "crisis management for global groups."" Further, in the same letter, Mr Neville pointed to the fact that the FSA's own Business Plan for 2009–11 states that consideration needs to be given to whether there is scope for better co-ordination and cooperation between regulators in normal times and during periods of crisis. The correspondence with the FSA is ongoing.

16. Another important issue identified by the Commission is the priority given to the views of home supervisors, as set out below.

17. The banking supervisor which takes the lead in relation to any given cross-border financial institution has, up to now, generally been the home supervisor. The extent to which host supervisors' views are taken into account by that home supervisor has generally been determined by the size of the entity within the host supervisor's jurisdiction. The limitations of relying exclusively on the home supervisor for relevant information and of the absence of ongoing, critical, relevant information by a relevant host supervisor was illustrated during the collapse of the Landsbanki Group. It is therefore crucial that host supervisors should communicate fully and openly with their fellow host supervisors.

Colleges of Supervisors

18. The Financial Stability Board has as part of its new remit to identify the most systemically important cross-border firms and to set guidelines for and support supervisory colleges for such firms.

19. A college of supervisors is a mechanism to co-ordinate the practical supervision of a cross-border group, to enhance cooperation between regulatory/supervisory bodies and should serve to reduce regulatory duplication and inconsistency.

20. Participation in colleges of supervisors benefits all regulatory/supervisory bodies because they establish the important face to face contact in non stressed periods which can be invaluable in crisis situations. Hence, participation should be as wide as possible.

21. The OGBS is exploring whether a new protocol could be developed whereby a host supervisor could ask to join a college even if, in size terms, it does not regulate a systemically important or material entity within its jurisdiction. Participation by all host supervisors in Colleges of Supervisors would mean that host supervisors would be able to obtain information on the scale and direction of inter group exposures which have proved to be critical to the ongoing supervision of their licensed banks.

April 2009

Memorandum from the Association of Independent Financial Advisers

Executive Summary

1. The events and economic turmoil of the past 18 months have led to much discussion around the regulatory system, and how it can be reformed to ensure that the current situation is never repeated. What is clear is that there needs to be an overhaul of financial regulation both at national and at European level. We need a system which has increased accountability, increased transparency, delivers in a cost-effective way and which ultimately works better for firms and the clients they serve.

2. AIFA welcomes the recent reviews including De Larosiere Report and the Tripartite Review, and consider many of the suggestions worthy of further study. However, it should always be remembered that changing structures costs money and doesn't necessarily lead to better outcomes. The cost implications of these proposals therefore need to be examined in much closer detail.

3. We welcome and support the notion of separating out prudential supervision of firms from business conduct and consumer protection. We are therefore keen to investigate further what the "twin peaks" approach could mean for the industry, consumers and our members.

4. We also welcome calls for the Bank of England to take over macro-prudential and financial stability regulation as the most sure-fire way to ensure the financial system is not again allowed to become dangerously over-leveraged.

5. This leaves interesting questions around the form that the regulation of conduct of business should take. We are currently researching the viability of different options with our members and consumers, and will be happy to share our findings with the Committee once they are available.

Introduction

6. The Association of Independent Financial Advisers (AIFA) is the representative body for the IFA profession. There are approximately 16,000 adviser firms that employ 128,000 people, and turnover is estimated at £6.5 billion (including £4.5 billion from life policies, £1 billion from fund management and £1 billion from mortgages and general insurance). Around 20% of the UK population regularly use an IFA, with c45% consulting one from time to time.

7. AIFA represent over 85% of all IFAs, who, in turn account for around 70% of all financial services transactions in the UK (measured by value). As such, IFAs represent a leading force in the maintenance of a competitive and dynamic retail financial services market.

Potential Areas of Improvement in European Financial Regulation

8. This global financial crisis; the complex interaction of market failures, global financial and monetary imbalances, inappropriate regulation, weak supervision and poor macro-prudential oversight, have resulted in a wide reaching review of the current regulatory system.

9. Global, European and UK commentators have all provided their views of the future regulatory landscape, all of which would have a significant impact on the UK's regulatory structure. It would be simplistic to believe that today's problems could be addressed with more regulation, and certainly this is a concern for AIFA and its members. Nevertheless it remains that good regulation, not excessive regulation, is a necessary condition for the preservation of financial stability.

10. AIFA believes that the world's monetary authorities and its regulatory and supervisory financial authorities can, and must do more to reduce the chances of crisis events happening again. We encourage and support all discussions around regulatory structures as there is little doubt the current system is not "fit for purpose".

11. Good financial regulation should concentrate on the major sources of weaknesses; dealing with financial bubbles, strengthening regulatory oversight on institutions that have proven to be poorly regulated, adapting regulatory and accounting practices that have aggravated pro-cyclicality, promoting correct incentives to good governance and transparency, ensuring international consistency in standards and rules as well as much stronger coordination between regulators and supervisors. Over-regulation, however, should be avoided. It slows down financial innovation and thereby undermines economic growth in the wider economy.

12. This is not to say that all crises can be prevented in the future. What could and should be prevented is the kind of systemic and inter-connected vulnerabilities we have seen and which have carried such contagious effects. The global financial system as we know it was forged by deregulation underpinned by a naïve view of the self-correcting and self-policing nature of markets. The task now is to get it running again with better brakes and steering. It is appropriate to see significant changes over the coming years to the existing regulatory landscape. However successfully achieving a positive improvement will require solid political leadership.

13. Appropriate implementation of existing regulation, and better supervision, can sometimes be more effective than new regulatory structures, which in themselves do not lead to better outcomes for firms or consumers. This can only be achieved by setting clear regulatory objectives, which are consistent and focussed on protecting the consumer, not from his or her poor decisions but from unscrupulous market participants.

14. We also need to be particularly aware of how the costs of implementing new regulation, or amending existing regulation, are passed onto the consumer. While there is clearly a need to greatly increase consumer protection through better regulation, there is also a need to ensure the costs involved are not disproportionately borne by the consumer to the point that they are discouraged from engaging with financial services institutions.

15. We are especially keen to investigate further what the "twin peaks" approach could mean for the industry, consumers and our members. There has been much talk of separating out prudential regulation of firms from consumer protection and this interesting notion certainly has much merit.

16. We particularly welcome calls for the Bank of England "to be re-banked" and take over macro-prudential and financial stability regulation from FSA. This proposal appears to be the most sure-fire way to ensure the financial system is not again allowed to become dangerously over-leveraged. It is our view that the Bank needs to be given greater expertise and discretion, and the power to make judgments about the sustainability of debt.

17. From an IFA perspective, the impact of regulatory changes at EU level could potentially be huge, especially for the smaller firms who have already been adversely affected by the costs of implementing MiFID and the IMD. If one was to examine the level of risk these small firms pose to the wider economy, when compared to the risk posed by the largest cross-border institutions, it seems illogical that they should all be regulated in the same way. There therefore needs to be different regulatory structures for the different types of businesses.

18. We will shortly be asking our members for their views on the future of financial regulation, in particular the future of conduct of business regulation, and would be more than happy to share this feedback with the Committee as soon as it is available.

April 2009

Memorandum from the London Investment Banking Association

1. LIBA is the principal trade association in the United Kingdom for firms which are active in the investment banking and securities industry. Its objective is to ensure that London continues to be an attractive location for the conduct of investment banking business.

Executive Summary of Main Points

2. We comment only on the second part of the inquiry's Terms of Reference: Potential reforms to the international financial regulatory system. Our main points are as follows:

(a) The principle of a European Systemic Risk Council, thoroughly integrated with global systemic risk arrangements, is a good one, but it needs to be better balanced to ensure a full and rounded assessment of risk.

(b) The Commission and de Larosière are right to stress the need for urgent improvements to the quality of EU regulation and supervision, and coordination between national authorities. These improvements need to be made before any move is made to centralise powers at EU level.

(c) The proposed establishment of an EU authority to fulfil certain tasks needs to be carefully considered to ensure that it contributes to the quality of regulation and coordination. In particular, any decisions about it need to be based on more precision about how it would operate, and on what basis it would assume powers from national authorities.

(d) Defining characteristics of any EU authority need to be set so that the quality of its work can be assured.

(e) The implications of financial turmoil for risk management in the single market will need to be carefully considered, and any limitation of passporting rights kept to a minimum.

(f) The London Summit set out the right basis for global coordination of standard-setting and supervisory cooperation. Regional and national policy-making needs to be in line with and not front-run the global consensus.

(g) Colleges are the right mechanism to build international coordination of supervision. To be efficient and effective, it will be important for EU arrangements on supervisory cooperation arrangements to mesh well with global colleges.

Potential Areas of Improvement in European Financial Regulation: The de Larosière Report

3. Current initiatives to improve EU financial regulation and supervisory cooperation are part of a continuing process that has been going on for many years. Although many of the current initiatives have been prompted by the financial turmoil, they are not qualitatively different from the continuing drive over many years to improve and streamline EU rules and supervision, aspects of which include: the mid-2000s Financial Services Action Plan (FSAP) to modernise financial services single market legislation; the parallel development of the CRD to introduce the Basel 2 improvements to the prudential framework; the early 2000s introduction of the Lamfalussy process to improve the technical quality of EU legislation and to provide a formal structure for regulatory and supervisory convergence and cooperation; and a series of reviews and recommendations for improvements to those cooperation arrangements, culminating in the 2007 and 2008 ECOFIN action plans that arose from the review of the Lamfalussy process. However, unlike the FSAP which sought to produce deep liquid capital markets for the benefit of corporate Europe, there is no clearly defined similar vision covering current regulatory and supervisory initiatives.

4. In addition to a range of specific policy proposals that broadly align with work that is already in progress or planned at global level under the aegis of the Financial Stability Forum / Financial Stability Board (see below), the European Commission's Communication "Driving European Recovery" and the de Larosière report make a range of proposals for structural changes to arrangements for supervisory and financial stability cooperation within the EEA.

5. The Commission Communication and de Larosière report propose to establish a new European Systemic Risk Council (ESRC) to provide a formal structure to gather information about and assess potential financial stability risks, and to initiate a reaction from responsible authorities. de Larosière highlights the need for the ESRC to interact effectively with global systemic risk analysis arrangements coordinated through the IMF and FSB, as agreed by the London Summit. This is indeed a vital link, since an analysis of systemic risk based on the EU alone is unlikely to be comprehensive, and ignoring the

interaction with the rest of the world could lead to false and misleading conclusions. There also needs to be an appropriate and effective mechanism for translating the ESRC's assessments into, at national supervisory level, either action or a valid explanation of why action is not appropriate.

6. The Commission Communication and de Larosière report propose that the ESRC be largely a central banking body. To be fully effective—in gathering information, analysing the interaction between different markets, and giving effect to its decisions— participation in the ESRC needs full participation by supervisors as well as central banks, both eurozone and non-eurozone, and to involve also the authorities overseeing securities markets and insurance, as well as banking.

7. The de Larosière Report proposes to reinforce the existing Lamfalussy arrangements with a European System of Financial Supervisors (ESFS), introduced in stages.

8. Stage 1 of the ESFS, which fits well with work in progress under the ECOFIN road maps, involves a series of urgently needed improvements to existing arrangements for EU regulatory and supervisory cooperation. These improvements of EU supervision and supervisory cooperation arrangements need to be undertaken carefully, and to take account of developments in other jurisdictions as the London Summit action plan is developed.

9. Amongst the critical steps that need to be taken, some of which (in particular aspects of (b), (c), and (d) are referred to in the Commission's and de Larosière's proposals, are:

(a) Global and EU agreement of defined public policy outcomes that regulation aims to achieve. The EU should avoid pre empting Global agreements.

(b) Ensuring that regulatory staff have the right skill sets and detailed knowledge and understanding of different markets. This is important for all markets, including retail, wholesale and corporate markets, but particularly for effective regulation and supervision of wholesale markets. The ability to trust the quality of supervisors across all EU jurisdictions is a sine qua non if the single market is to reach its full potential.

(c) Ensuring that colleges established under EU arrangements (see below) are consistent with, and interact smoothly and seamlessly with international colleges, on the basis of globally agreed guidelines, working flexibly to enable key supervisors to discuss strategy, and all relevant authorities to exchange information and coordinate supervision, accommodating third country and EU supervisory authorities as appropriate, and ensuring that the confidentiality of information provided through global college arrangements is respected in interactions between EU supervisors.

(d) Full and consistent implementation by Member States of the harmonised core rules set out in EU legislation.

(e) Analysis of what degree of convergence is appropriate in different supervisory tasks, and how far supervisory flexibility is valid or necessary, recognising that the optimal level of integration may need to differ in different areas.

(f) Resolution of fiscal support issues in a way that ensures alignment between regulatory and supervisory decision-making and responsibility for fiscal support and the lender of last resort function: without resolution of the fiscal issue, it is hard to envisage successful centralisation of supervisory powers.

10. The de Larosière Report then proposes a Stage 2, to be commenced in 2011, under which new EU agencies with enhanced powers would take over certain regulatory and supervisory functions of the Level 3 Committees and national authorities, and apply them in a strengthened and more mandated way.

11. One of the main deficiencies in both the Commission Communication and the de Larosière report is that they are not precise about how they propose the existing arrangements and allocation of powers would be adjusted. Instead they refer vaguely to the proposed EU authority exercising "binding supervisory standards", "binding mediation" of disputes between regulators, and binding standards for the operation of colleges. The Commission is expected to publish a further Communication in May which may include more specific proposals.

12. In an attempt to introduce more precision, and to demarcate the boundary between national prerogatives and areas where an EU-level authority would be beneficial, the UK government and FSA have proposed, through the Chancellor of the Exchequer's 3rd March letter to the Presidency of the Council, and the Turner Review and Discussion Paper 09/2 respectively, a scheme under which an EU-level authority would have the power to set binding rules, but all supervisory activities and decision-making would remain at national level, with colleges being used to coordinate and streamline supervisory activity at both EU and global level.

13. Until there is more clarity and certainty about what precise interaction is proposed between EU and national responsibilities and prerogatives, and how it would affect coordination at global level, it is difficult to assess whether any particular model would improve regulatory and supervisory coordination. It is, however, vital that any adjustments to the structure of EU regulation and supervision build on and continue the quality improvements in Stage 1. We have suggested to the Commission a series of defining

characteristics which any EU authority would need to have to ensure that it maintained and improved the high quality that is needed to oversee wholesale securities markets. They would need to be clearly established, in the constitution and working procedures of any EU authority, at the outset.

(a) Governance: Explicit attention to the wholesale and global character of cross-border markets; ensure that all those who are interested in what the authority does can have their voice heard; specification of who it is answerable to; specification in advance of how the quality of its performance will be measured, and what sanctions will be available if it fails.

(b) Scope: Clear demarcation of boundaries of competence between the EU authority and national authorities, in particular as regards: scope for differential implementation of an agreed regulatory outcome; national autonomy over supervisory approaches, technical decisions, and issues not harmonised at EU level, use of comply or explain procedures. This demarcation needs to dovetail with fiscal responsibility.

(c) Regulatory philosophy: Outcome-focused regulatory approach, based on agreed public policy needs.

(d) Regulatory process: Effective regulation disciplines, including market failure analysis, impact analysis, and cost-benefit analysis, diligent consultation, and genuine dialogue with regulated entities and other interested parties, as standard procedure.

(e) Quality of staffing: Technically expert and market-aware governing council and staff; alert and rapidly responsive to market developments.

(f) Quality control: Analogous to Level 4 (with EC cooperation where necessary) to achieve consistent effective implementation of EU legislation.

(g) Differentiated regulation: Explicit acknowledgement of, and attention to, different needs of different markets and sectors: banking / securities and derivatives / infrastructure / insurance; wholesale / retail; different supervisory tasks: prudential (various) / conduct of business / market; in each case, specification of what is the scope of the EU authority's / authorities' responsibility (which might differ from one sector or task to another).

(h) Location: Proximate to the EU's key global markets, so that it can have close interaction and dialogue with them, and draw on strong pools of technical talent.

Potential Areas of Improvement in (EU) European Financial Regulation: "Passporting"

14. Home country supervision is premised on the fact that a financial institution which has branches in other Member States will be subject to supervisory and administrative decisions made in the Home Member State but which are based on minimum harmonised standards set out in EU legislation: this reflects basic Treaty principles. When an authorised financial services firm branches into a different Member State, the Host State has few if any rights to object or prevent the branching. It is important to understand that to amend this treatment would be to question the fundamental premise of the EU Single Market. The Turner Review raises questions about branch passporting in the particular context of the problems that arose in retail deposit-taking. It is important that any restrictions on existing passporting freedoms be proportionate to the problems identified and not, for example, extended beyond the special circumstances of retail deposit-taking to other business areas without separate justification. Under EU legislation host supervisors have emergency powers, but some have argued that the ability to exercise those powers may come too late to affect the outcome. There needs to a be a full discussion of rights and responsibilities in the context of the specific problems identified when assessing the more difficult and costly outcomes that can be faced in a crisis. The Turner Review says that we have a half-way house at present, and that we may need either "more Europe" or "less Europe". The complexity of the topic means, however, that the right approach is likely to be more nuanced than a simple choice between concentrating powers either in the host supervisor or in EU authorities. However, as indicated above, it will be particularly important to consider, at least in the "less Europe" context, a proportionate response which appropriately distinguishes between different sectors of the market, and restricts existing passporting freedoms as little as possible, consistent with systemic risk management.

Global Cross-border Financial Regulation

15. The 2 April 2009 London Summit's Global Plan for Recovery and Reform and the Summit's Declaration on Strengthening the Financial System set the agenda for improvements to global regulation to be made on a consistent basis through global standard setters such as the Basel Committee on Banking Supervision and International Organisation of Securities Commissions (IOSCO), coordinated by the re-constituted and expanded Financial Stability Board. These initiatives will need to build on the considerable policy improvements that have already been in progress for well over a year under the aegis of the Financial Stability Forum.

16. In all these contexts, it is important for policy makers to take account of the steps that market participants have themselves taken to reduce or manage risk and to improve the operation of markets, in particular in the securitisation and credit default swap markets. Further developments need to continue to be made in dialogue with market participants, applying thoroughly the disciplines of effective regulation,

including market failure analysis, impact analysis, cost-benefit analysis, and consultation. The fact that failures have occurred does not negate the principle that new requirements must be determined in accordance with due process.

17. Once global standards have been established, it is important that national and regional authorities fulfil the commitments in the London Summit communiqués to streamline rules with the global consensus. This may necessitate adjusting EU or UK rules that have been or may be put in place in several areas—including the capital treatment of securitisations and re-securitisations; regulation of liquidity; and regulation of credit rating agencies—ahead of, and in some cases diverging from, the global consensus.

Colleges of Supervisors

18. Colleges have long been used as the mechanism for global supervisory cooperation. The London Summit's and EU's current focus on colleges is thus a *development* and formalisation of existing policy, not the *creation* of a new policy. When discussing colleges, it is important to be clear about use of terms, and to distinguish in particular between two different uses of the word 'college' at global and EU level, eliminate the scope for duplication and conflict between them, and avoid the consequent increase in risk.

19. In the global context "college" is commonly used to refer to a grouping of supervisors, who do not share a common legal framework, exchanging information and possibly agreeing coordination, on the basis of memoranda of understanding, but with no legal commitment and no interference in the rights and obligations of national supervisors. This is a flexible structure that allows variation depending on the differences in how different groups are constituted, or the differing focus of their business and their supervisors' priorities. The London Summit confirmed these colleges as the basis for global cooperation, under the guidance of the Financial Stability Board, in supervising the major transnational firms.

20. Some commentators have criticised colleges for being ineffective, or because they do not provide a firm enough legal basis for decisive cooperation. In the EU context, for example in the Capital Requirements Directive, and the de Larosière Report, the term "college" has been coopted to refer to a more structured interaction between supervisors, based on EU law, with a stronger and more mandatory directing and coordinating role for the consolidating supervisor.

21. It is clearly important to use EU legislation to the extent possible and appropriate to align EU requirements and streamline supervision by giving responsibilities and tasks that cover the whole group to the consolidating supervisor of the parent EU entity. It is also important to ensure that arrangements for group supervision within the EU are adaptable enough to reconcile the need for supervisory efficiency with the legitimate interests of Member States, including the Lender of Last Resort responsibilities which attach specifically to national authorities. To a significant degree Group Supervision is already in place in the EU as there are already consolidated supervision requirements and a number of supervisory arrangements to deal with group structures that include multiple subsidiaries within the EU. But the treatment of a group will be very different depending on whether, for example (i) all subsidiaries are owned by a single holding company within the EU; or (ii) multiple subsidiaries within the EU are owned by a parent outside the EU. Even in the first case, the subsidiaries of EU companies that are incorporated outside the EU could not be brought within a single group supervisor model. It is necessary in all cases to balance the legitimate interests of national supervisors with the need for streamlined supervision, and the public policy need for efficient, effective, and well-coordinated group supervision, taking account of the global as well as the EU dimension. The most appropriate arrangements may differ in different supervisory fields: it is therefore important to ensure that any "unified" system of supervision across borders is not also a "rigid" system that diminishes effectiveness or impedes cooperation with certain countries.

22. All major cross-border groups are global, and agreements on cooperation between sovereign authorities necessarily rely heavily on political commitments rather than the force of law. Equally it is clear that there is no legal framework that can apply to all jurisdictions. Much experience in the operation of global colleges has been gained in recent years which can now be used to improve the operation of colleges. The political impetus to international cooperation in the wake of the financial turmoil provides a context in which necessary further improvements can be pursued strongly.

23. To be effective EU arrangements need to take account of the global dimension. It would be duplicative, inefficient, and risky to seek to force EU and global colleges to operate separately. Binding EU requirements cannot, by definition, apply to non-EU authorities, so it is difficult in practice to envisage how direct EU oversight of and intervention in global colleges, on the model that the Commission Communication and de Larosière Report envisage, could be compatible with international cooperation. To be effective, policy in the EU and elsewhere must focus on treating global colleges, under the aegis of the FSB as agreed by the London Summit, as the prime forum for international supervisory cooperation, separately from the use of EU legislation and supervisory coordination to align supervisory practice in the EU sub-group.

RECOMMENDATIONS THAT WE WOULD LIKE THE COMMITTEE TO CONSIDER INCLUDING IN ITS REPORT

24. We would be grateful if the Committee would consider including in its report the points listed in paragraph 2(a)–(g) above.

May 2009

Memorandum from the Bretton Woods Project

INTRODUCTION AND EXECUTIVE SUMMARY

1. The Bretton Woods Project is an independent NGO established by a network of UK-based NGOs in 1995 to take forward their work of monitoring and advocating for change at the World Bank and International Monetary Fund (IMF). See www.brettonwoodsproject.org/about for more details. We warmly welcome the Treasury Committee's decision to hold this inquiry, which is both timely and important.

2. The current crisis shows a profound mismatch between the global reach and interconnectedness of financial flows crossing all national borders, and the absence of any international systems to oversee them. There are two major problems which interacted together to cause the crisis: the failure of the financial regulatory and supervisory systems and the failure of the international monetary system.

3. Global financial regulation: Financial regulation must prioritise social and environmental goals and understand that a stable financial system is only a means towards these ends. International regulatory standards in their current format are incomplete in scope, are not legally binding, are not specific enough and therefore do not ensure appropriate national regulation. They are not developed in a transparent and accountable manner and most countries affected by them do not participate in their development. This leads to externalities, because countries with important financial sectors do not have to compensate countries harmed by regulatory failures, leading to inefficient low levels of regulation. There is inadequate incorporation of environmental sustainability into regulation. The failure of international regulation has negative impacts on stability, poverty reduction, growth, environmental sustainability, investment and economic development.

4. There is a need for a new vision of global financial regulation to ensure sound regulation at an international level, what some have called a World Financial Organisation or World Financial Authority. This can be accomplished by reforming the Financial Stability Board (FSB) so that it fulfils the role of a global regulatory authority. Important reforms include increased membership and extensive institutionalised outreach; increased accountability and transparency; and democratic decision-making procedures. Once these reforms have been undertaken, the FSB would have the legitimacy to issue specific guidelines that have to be implemented by national regulators.

5. International monetary system: The current monetary system creates high costs for developing countries and business and does NOT adequately deal with imbalances in financial and trade flows. Any reform will need to ensure it is seen as legitimate by all countries, and allows for the policy space needed for economic development in poorer countries.

6. To reform the international monetary system, countries should agree to create an international currency, international clearing union, and system of globally managed exchange rates. This kind of reform will take time to agree among all countries of the globe, so a process must be launched immediately to begin the negotiations. In the meantime deeper reform of IMF governance is necessary.

VISION OF A GLOBAL REGULATORY AUTHORITY

The need for effective and efficient global regulation

7. The current crisis shows a profound mismatch between the global reach and interconnectedness of financial flows, and the absence of an effective international regulatory regime that could govern them.

8. The international financial system is regulated by a set of 12 voluntary standards and principles developed by a range of private and public standard setting bodies and multilateral organisations.[5] The ones directly important for financial markets cover insolvency, corporate governance, accounting, auditing, payment settlements, market integrity, banking and insurance supervision, and securities regulation.[6] Furthermore, the Financial Stability Board (FSB)[7] is currently working on standards for compensation schemes and guidelines for the establishment of supervisory colleges and how national regulators should

[5] For an overview about the standard setting bodies and which standards they develop, see: Financial Stability Board, "Who are the Standard-Setting Bodies?", http://www.fsforum.org/cos/wssb.htm, retrieved 28 April 2009; and footnote 16.

[6] Financial Stability Board, "12 Key Standards for Sound Financial Systems", http://www.fsforum.org/cos/key_standards.htm.

[7] The Financial Stability Board is the re-established Financial Stability Forum. The Financial Stability Forum and now the Financial Stability Board brings together national financial authorities, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank to facilitate the exchange of information and opinions. It acquired new responsibilities and a renew mandate at the London summit, spelled out in the "Declaration on Strengthening the Financial System", http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm.

define a "systemically important firm"; and the participants of the London summit have agreed to use Code of Conduct Fundamentals developed by the International Organisation of Securities Commissions (IOSCO) for overseeing credit rating agencies.[8] Lacking so far are standards for alternative investment firms such as hedge funds, and the existing standards do not cover all important aspects. In the case of banking regulation, for example, Basle II does not cover the problems of off-balance sheets.

9. Besides the gaps, one should also not overrate the capacity of the standards to ensure appropriate national regulation. Not only are they voluntary, they are also very broad. They take the form of *principles*, practices and *guidelines*, whereby, as the Financial Stability Board explains, principles are broad tenets, practices are more specific and only guidelines allow for "objective assessment of the degree of observance".[9] Most of the standards such as the ones governing accounting, market integrity, banking and insurance supervision, and securities regulation, are in the form of *principles*, ie still in very broad form; and the one on market integrity is only in the form of recommendations.[10] As the FSB argues, standards are not a guarantee for successful implementation and thus effective regulation by national regulators, since they require interpretation, application, implementation and enforcement.[11] This is especially true for broad principles, whose observance cannot be objectively assessed. The existence of a set of principles must therefore not lead to the illusion, that we currently ensure appropriate national regulation through international agreements.

10. Furthermore, the Financial Stability Board argues that the current standards are "generally accepted by the international community as being objective and relatively free of national biases".[12] However, almost all developing countries and emerging markets are still excluded from the important standard setting bodies or at least their most powerful committees. Currently, only very few countries are members of the Basel Committee on Banking Supervision (BCBS), and many countries are not in the technical committee of the International Organization of Securities Commissions (IOSCO), which is its most powerful body.[13] The US-based Financial Accounting Standards Board (FASB) and its international counterpart, the International Accounting Standards Board (IASB), are even more problematic, since they are private bodies with no public accountability. This leads to dangerous externalities, because countries with globally important financial sectors that can and did trigger crises do not have to compensate those countries harmed by regulatory failures. This is not only problematic under aspects of fairness, externalities also lead to inefficient, ie too low, levels of regulation.

11. To counter this lack of international regulation, the G20 have agreed to establish colleges of supervisors for the 30 largest banks. However, these are by no means satisfactory, because they cover only a small portion of international financial flows, and the international colleges do not create any legal rights or obligations but merely facilitate the exchange of information and views. As Lord Turner, chairman of the FSA, has pointed out in his review, the crisis raises question about appropriate regulation of issues relevant for banks "irrespective of whether they operate entirely within national markets or on a cross-border basis".[14] The G20 countries agreed that all systemically important financial firms shall be overseen and that the assessment shall be made according to economic substance not legal form, potentially bringing in firms such as hedge funds. However, colleges of supervisors for those firms would again have no decision-making powers and merely facilitating the exchange of information and opinions.

12. The lack of an effective international regulatory regime is problematic not only in times of crises. The market for commodities derivatives, for example, is said to have a profound impact on the price level and volatility of underlying commodities.[15] Research produced at the Bank of International Settlements has shown that price development in the commodities market is not fully determined by supply and demand but also by speculation, making it less influenced by fundamentals.[16] This has a profound impact on producers as well as consumers, of which many live in countries with no or marginal influence over the regulation of these markets, leading to inefficiently low levels of regulation.

13. To sum up, the current regulatory regime needs considerable improvement regarding content as well as governance aspects. Standards need to be more specific, in the form of concrete guidelines rather than broad principles, they need to be legally binding and enforcement at national levels must be assessed and incentivised at an international level. To ensure adequate levels of regulation, the process of standard settings need improvement in the realm of participation, accountability and transparency. All countries affected by

[8] "Declaration on Strengthening the Financial System", http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm.

[9] Financial Stability Board, "What are Standards?", http://www.fsforum.org/cos/standards.htm.

[10] As can be seen in the case of the Madoff fraud, insufficient national regulation regarding market integrity has ramifications far beyond national borders, affecting investors all over the world.

[11] Financial Stability Board, "Why are Standards Important?", http://www.fsforum.org/cos/wasi.htm.

[12] Financial Stability Board, "Why are Standards Important?", http://www.fsforum.org/cos/wasi.htm.

[13] The BCBS has 11 countries, including no developing countries or emerging market economies. The IOSCO technical committee has 15 members, including only Hong Kong and Mexico from the group of emerging markets, but including neither important emerging markets such as China, India, Russia, or Brazil, nor any other developing country.

[14] Financial Services Authority, "The Turner Review", March 2009, http://www.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml.

[15] Noemi Pace; Andrew Seal; Anthony Costello, "Has financial speculation in food commodity markets increased food prices?", 2008, http://fex.ennonline.net/34/has.aspx.

[16] Dietrich Domanski; Alexandra Heath, "Financial investors and commodity markets", BIS Quarterly Review, March 2007, http://www.bis.org/publ/qtrpdf/r_qt0703g.pdf.

regulation need to have a clear, institutionalised channel of participation in the development of standards, and the process needs to meet high standards of transparency and accountability to ensure the involvement of parliament, other stakeholders, and national constituencies.

14. Given these weaknesses in the current architecture, we see the need to develop a new vision of how global financial regulation should look like to ensure sound regulation at an international level. Among the first ones to propose a global regulatory authority were Lord Eatwell and Lance Taylor and it has also been backed by economists such as Barry Eichengreen.[17] Along the same lines, several UN bodies including the UN Committee for Development Planning and the Secretary-General of UNCTAD have called for a World Finance Organisation[18], which could serve as an institutionalised forum for the development and assessment of regulatory guidelines.

15. Such an authority must aim for regulation that integrates social and environmental goals and understands that a stable financial system is a means towards these ends. The goals of any regulatory authority, including a global one, should not be only the stability of a financial system to enable the individual accumulation of wealth. There must be a wider social remit.

The idea of a global regulatory authority

16. A global regulatory body could be set up as a super structure under which national regulators still exist but are guided and overseen by an international body. Power should be assigned according to the principle of subsidiarity, ensuring that countries retain as much national sovereignty as compatible with sound international regulation.

17. A global financial regulator could issue guidelines for regulation that give national regulators sufficient room to respond to national peculiarities, but are more specific than most of the current standards and, most importantly, are legally binding. Monitoring compliance and supervision of day-to-day activities of financial firms should stay with national regulatory authorities.

18. To ensure that a global authority actually has the capacity to regulate and becomes more than a talking shop, incentive mechanisms for national compliance with international standards and principles have to be in place. Incentives for membership in such a regulatory body and for subsequent compliance could take the form of restrictions for financial firms chartered in non-compliant countries to enter member countries' markets.

Democratic principles for global regulation

19. Given the importance and political nature of regulation, such a body must not be run by independent officials but rather be multilateral to ensure accountability to citizens in member countries.

20. To ensure efficient regulation and tackle current externalities, it is important that global financial regulation, just like national regulation, is decided along democratic lines. This means that those that are affected by regulation should have the power and the right to influence it. This means that in principle, all countries should be able to participate, a demand also made by the President of the UN General Assembly, and echoed by the Secretary-General of UNCTAD.[19]

21. However, direct participation in day-to-day discussions needs to be limited to ensure effectiveness. One possibility is that countries are represented by regional multilateral bodies. However, interests and power differ and representation must ensure that poorer countries are not sidelined again as they have been in the IMF. As regional trade and economic integration increases, regional groupings could fulfil the role of representation. The prime example is the EU, with highly integrated markets including in financial services, within which the Commission, overseen by the European Parliament, could be given the authority to represent the EU member states.

22. Furthermore, voting and other decision-making mechanisms must follow democratic principles. National GDP should not be taken as the criterion for determining voting shares, since the rich countries are, as this crisis shows, not the only nor the most affected ones in a global crisis triggered by regulatory failure. Additionally GDP bears no relation to the subject at hand, as the ratio of the financial sector to GDP varies dramatically across countries. One possibility could be a combination of population size; vulnerability (measured by an index that captures the fact that poor people are hit hardest due to spill-over effects of financial crises into the real economy); and the size of national financial sector (to ensure systemically important markets are engaged). Strong consideration should be given to either positive consensus, or the use of multiple majorities in decision making.

[17] John Eatwell and Lance Taylor, "Why We Need a World Financial Authority", *WiderAngle*, No. 3, 1998, http://www.wider.unu.edu/publications/newsletter/en_GB/introduction-angle/_files/80458472453374328/default/angl9802.pdf; Barry Eichengreen, "The Global Credit Crisis as History", 2009, http://www.econ.berkeley.edu/~eichengr/global_credit_crisis_history_12-3-08.pdf.

[18] No author, "UN body proposes new world financial organisation", Journal of the Group of 77, No. 3, 1998, http://www.g77.org/nc/journal/3-98/9.htm; Supachai Panitchpakdi, 2008, "Towards a World Financial Organisation", World Economy & Development In Brief, Luxembourg, 24. November 2008, http://www.weltwirtschaft-und-entwicklung.org/cms_en/wearchiv/042ae69b600e5fd01.php.

[19] Supachai Panitchpakdi, 2008, "Towards a World Financial Organisation", World Economy & Development In Brief, Luxembourg, 24. November 2008, http://www.weltwirtschaft-und-entwicklung.org/cms_en/wearchiv/042ae69b600e5fd01.php.

23. Other key components of democratic governance are accountability (including accountability of country representatives to national parliaments), transparency (working under a presumption of disclosure with very limited clearly specified exemptions), and participation of all stakeholders at the national as well as directly at the international level. This must include the participation of civil society, trade unions, the private sector, and other stakeholders. Additionally, such a regulatory authority could be accountable to a UN body like ECOSOC or the currently discussed UN Economic Council.

24. The existing international financial institutions all have problems with their governance structures. The World Bank and IMF are dominated by developed countries, and they have used these institutions to push their own agendas. The same is true of the World Trade Organisation (WTO), which has a more equitable governance system, but within which exclusionary meetings and power politics still dominate. For a global financial regulator to have genuine clout it should have a distribution of power markedly different from the existing institutions.

The problem of differentiation

25. One fundamentally problematic aspect of global financial regulation is that it has to manage a tension. On the one hand, as has been argued above, rules need to be specific enough to render them effective and to set a bottom floor to ensure that countries do not deregulate at the expense of others. On the other hand, countries have very different preferences for the level and content of regulation depending on their overall economic and financial structure, and values such as risk-aversion and degree of state involvement prevailing in society. Developing countries can thus not be expected to implement the same rules as developed countries, and rules implemented in any country should not adversely affect the financial flows needed for development.

26. One worry about a global financial regulator is that if the governance is dominated by developed countries, it may end up with an institutional bias towards policies that are favourable to developed countries and their large financial services firms. Within a global financial regulator it must be clear that powers to control the capital account and limit financial services liberalisation must remain with countries, especially developing countries.

27. Therefore, a global regulator should strictly operate on the principle of subsidiarity. Similar to the system in the WTO, rules need to be specific, but exemptions and differentiation must be possible. These, however, should not be purely at the discretion of a country, but need to be negotiated multilaterally, ensuring that rules and exemptions enable, not hinder, prosperity and development in all parts of the world. Basel II, for example, had higher capital requirements for banks not rated by external rating agencies, putting smaller banks in developing countries at a disadvantage. Given that under Basle II unrated banks cannot have a lower charge than the sovereign they are located in, small banks in developing countries had higher capital costs and less incoming financial flows regardless of their actual creditworthiness.[20] This example also shows the link between governance structures and rules. Only if all developing countries, not just the big emerging market economies, can affectively participate in decision-making processes, will regulation take into account all costs and benefits.

28. Some argue that regulatory competition helps to identify successful regulatory strategies and better regulation. However, as the current crisis shows, countries cannot shield themselves from the negative effects of a crisis in another country however well-designed their own regulation turns out to be. To ensure that risk-taking financial activity is beneficial, countries must be able to ensure that they do not pay the price for regulatory failures in other countries. Therefore, they should have a say and share responsibility for systemically relevant firms, markets and products present at the international level.

29. If decision-making and representation mechanisms in a global regulation authority are democratic and inclusive, people, including British citizens, regain the possibility to influence the decisions that profoundly affect their lives.

Establishing a global regulatory regime: reforming the FSB

30. Such a regulator is not likely to be founded overnight. To avoid overlapping or contradictory mandates, it is would be easier to reform existing institutions rather than creating a completely new one. The Financial Stability Board (FSB) could serve as a starting point, since it already has some of the responsibilities a global regulator needs. However, several immediate changes are required:

30.1 The FSB should change its current commitment to "open markets" in favour of a more fine-tuned commitment to financial markets that promote development, justice, access and sustainability. It should recognise that greater capital account openness or financial services liberalisation is not always positive.

30.2 The FSB needs to increase participation. Extensive outreach to countries affected by regulatory standards should be guaranteed, institutionalised and becomes rules-based as a first step to improving the current arbitrary and insufficient outreach activities. Membership should be expanded to give affected small countries a voice.

[20] Stijn Claessens; Geoffrey Underhill; Xiaoke Zhan, "The Political Economy of Basle II: the costs for poor countries", *The World Economy*, Vol. 31, Issue 3, pp. 313–344, 2008.

30.3 Transparency and accountability of the FSB need to be radically increased, ensuring that parliaments and stakeholders can effectively monitor FSB activities and provide input. This is especially important given the importance assigned to the FSB at the London summit. Countries need to be mainly represented through ministries that are subject to democratic scrutiny and accountability rather than independent regulators or central banks, which should have a consultative function.

30.4 The chair of the FSB and, depending on his or her responsibilities, also the secretary-general should be appointed in a transparent merit-based selection process, open to all regardless of nationality. Patently problematic rules, such as the appointment of the members of the steering committee by its chair they are supposed to oversee, have to be replaced.

31. These immediate changes need to be complemented by gradual changes in the mid- to long-term future: If such governance reforms were undertaken, the FSB would have the legitimacy to not only recommend broad principles but to actively regulate systemically relevant firms, instruments and markets.

31.1 The FSB could regulate firms by issuing specific guidelines for regulation to be implemented by national regulators. Implementation should not be voluntary but made legally binding by decision at the FSB.

31.2 The FSB already has the mandate to monitor the work of standard setting bodies (SSBs). This should be expanded to also monitor their governance and set-up. The SSBs should gradually be incorporated into the FSB and subject to the same standards of governance, accountability, transparency and participation. In addition to opening up to more countries, the decision-making process at these bodies should also institutionalise mechanisms for input from civil society and other stakeholders including from other government departments.

31.3 The FSB need to closer cooperate with other international organisations, not only with the IMF but also with the WTO and relevant UN bodies to ensure that global financial regulation is coherent with other international trade, environmental or social agreements and vice versa. Additionally, such a regulatory authority could be accountable to a UN body like ECOSOC or the currently discussed UN Economic Council.

32. Although we are convinced of the urgent need and principal possibility of a global financial regulatory authority, we are aware that currently the political will to give up sufficient sovereignty is low. However, it is noteworthy to point out that countries have committed themselves similarly in other areas, such as trade, subjecting themselves to legally binding agreements, a one-country-one-vote decision-making mechanism, and a dispute settlement panel in the WTO. This is a long process but first steps and the establishment of a long-term vision should be made now.

Reforms to the International Monetary System

33. While regulatory failure has been a key driver of the crisis, it has interacted with public policy failures in the international monetary system to create the conditions for a deeper and more pervasive economic crash. Distortions and imbalances in the international monetary system, have built up over the last decade. The massive current account surpluses in some countries have fed the liquidity of the financial system, pushing financial "innovation" that attempted to satisfy the search for profit from an increasing large pool of investable resources.[21]

34. The current international monetary system has negative effects on both developing countries and business investment globally. Volatility and the speculation that ensues only benefits traders who profit from volatility, while creating enormous costs. The system needs reform in order to make it more development-friendly and more stable. One of the key ways to do this is through the creation of an international currency, international clearing union, and system of globally managed exchange rates.

Problems with the existing system

35. Effect on business investment: Even in times of relative global stability, volatility in exchange rates damages economic planning and investment in rich and poor countries. Business investment often requires several years if not more to recoup costs and start generating profits. Sales and income growth for businesses often come through exports. If there is a lack of stability in exchange rates, businesses must either undertake costly hedging strategies to manage exchange rate risk, or plan on volatility and incorporate that risk into their projections. In either case, investment will be lower, because investments which might be profitable with stable exchange rates, will either be unprofitable, or not undertaken by risk-averse investors. This reduces job creation, growth, trade and economic development.[22]

[21] See International Monetary Fund, "Lessons of the Global Crisis for Macroeconomic Policy", International Monetary Fund, IMF Policy Paper, 19 February 2009, http://www.imf.org/external/np/pp/eng/2009/021909.pdf, retrieved 28 April 2009.

[22] See for example: Luis Servén, "Real-Exchange-Rate Uncertainty and Private Investment in LDCs", *The Review of Economics and Statistics*, February 2003, Vol. 85, No. 1, pp 212–8;

36. Risks to developing countries: Developing countries and small economies are extremely vulnerable to swings in their exchange rates. One need only think of Europe to realise the benefits of stability in exchange rates. A country like Ireland, had it not been in the eurozone, would have been forced into a destabilising and damaging devaluation of its currency. Smaller developing countries are even more susceptible to this problem in times of crisis. This devaluation increases foreign debt service and makes imports, including of essential commodities more expensive. The small nature of the markets in most developing countries' currencies also makes them susceptible to speculation and even manipulation of currency markets. The flows of "hot money" into and out of countries increase the risk of financial and economic crisis. Crises of these sorts have devastating social impacts, increasing poverty, worsening human development, and reversing the gains of economic development.

37. Costs to developing countries: Aside from the costs of volatility in exchange rates, the current system has direct costs for the governments of developing countries. Assets held in reserves are by definition those not used to finance productive activity, including investment in infrastructure, education, health or other activities which have long-run benefits in terms of growth, productivity, and employment. Additionally the accumulation of large balances of reserves affects the domestic monetary supply, and to counteract inflation, countries will have to undertake "sterilisation". This has a direct cost to the country concerned, as generally the interest a government must pay on the domestic debt that that is issued in the sterilisation operation, is higher than the interest received from the holding of foreign currency-denominated assets. This may seem like a small differential, but as countries hold large volumes of reserves, these costs have increased significantly.[23]

38. Accumulation of reserves: Developing countries have accumulated large stashes of foreign currency reserves for a number of reasons. One of the primary reasons was wariness about the IMF. During the Asian financial crisis from 1997–98, the IMF was perceived to have required policy changes that were detrimental to Asian countries, forcing devaluations, causing massive unemployment, corporate bankruptcy, and poverty. This has pushed countries, particularly in Asia, to opt for self-insurance in the form of foreign reserves rather than relying on the IMF as a crisis resolution mechanism. This is compounded by the perceived lack of legitimacy of the IMF's governing structure.[24]

39. An additional reason for the large accumulations of foreign exchange was an economic model oriented toward exports. This model was part of the Washington consensus heavily pushed by the World Bank and the IMF. Investment is predicated on achieving exports and thus profitable investment for export will push trade imbalances. While export-oriented growth has achieved remarkable results in some countries in East Asia, it also created vulnerabilities to economic growth in the case of export market slowdowns. The export oriented model creates the modalities by which current account surpluses flourish and foreign exchange reserves are built.

40. Limits of IMF influence: Since the end of the Bretton Woods exchange rate system in 1971, the IMF has not had the ability to concretely influence the policies of rich countries. The last time the IMF put conditions on a developed country (before the Iceland loan of last year) was in 1976 when Britain went to the IMF. Since then, the free-floating of exchange rates and ability of rich countries to raise balance of payments financing on credit markets has meant that the IMF does not lend to rich countries, and thus can not use conditionality. There is no mechanism except persuasive power to influence rich country policies. In the context of global imbalances, despite repeated exhortations to rich countries to rein in current account deficits, they have not taken action.

41. The IMF did institute a new process called "multilateral consultations" in early 2006, and undertook a year long exercise with US, China, Japan, the euro zone and Saudi Arabia in order to address global imbalances. In the end the consultations yielded many policy recommendations but few concrete actions.[25] The Turner Review by the Financial Services Authority has also identified that IMF analysis is subject to political influence so that it "fit[s] in better with dominant intellectual assumptions and … avoid[s] overt criticism of major powers."[26] Without independent, sanctioning power the IMF will be unable to address imbalances and thus not able to mitigate the risks that they create.

42. International spillovers: The policies of major economies, as the issuers of reserve currencies, have international spillovers, which those countries are not forced to think about when they decide their policies. For example, changes in interest rates of the major reserve countries are usually targeted at domestic price stability and, in the case of the US, domestic unemployment. However those interest rate decisions have enormous impact on developing countries' access to and cost of capital.[27] There are worries that increased

[23] See for example: Abhijit Sen Gupta, "Cost of Holding Excess Reserves: The Indian Experience", Indian Council for Research on International Economic Relations, Working Papers 206, March 2008, http://www.icrier.org/publication/WORKING%20PAPER%20206.pdf; Jang-Yung Lee, "Sterlizing Capital Inflows", International Monetary Fund, Economic Issues No. 7, March 1997, http://www.imf.org/EXTERNAL/PUBS/FT/ISSUES7/issue7.pdf.

[24] See for example: Davesh Kapur and Richard Webb, "Beyond the IMF", G-24 Discussion Paper Series No. 43, February 2007, http://www.g24.org/pbno1.pdf.

[25] See Bretton Woods Project, "IMF crisis prevention: running on the spot", *Bretton Woods Update* No. 54, 31 January 2007, http://www.brettonwoodsproject.org/crisis54.

[26] Financial Services Authority, "The Turner Review: A regulatory response to the global banking crisis", March 2009, pp 85-6.

[27] For a fuller discussion see: William Cline, *The United States as a Debtor Nation*, Institute for International Economics, September 2005, available at: http://bookstore.petersoninstitute.org/book-store/3993.html.

borrowing by highly credit-worthy countries to finance fiscal stimulus may mop up liquidity in the market and increase the costs of developing country sovereign and corporate borrowing. The IMF has no way force rich countries to think about the international impacts of their domestic policies.

Issues that need to be resolved

43. The IMF is the institution that was created to manage the international monetary system. However, its governance has not kept pace with changes in the world economy. Thus its voting rights are dominated by rich countries, despite having most of its operations in emerging markets and low-income countries. This democratic deficit, combined with the perception that its prescriptions in the Asian financial crisis were influenced to the benefit of rich countries, has reduced the IMF's legitimacy. With a lack of legitimacy, it will be difficult to give the IMF greater control or power in international monetary arrangements.

44. The changes to IMF governance that were agreed in April 2008 are too small to overcome the perceived lack of legitimacy. Less than 3% of the IMF's votes will be shifted from rich countries to low- and middle-income countries. Belgium, with a population of 10 million, will still have more votes than G20 members Brazil (200 million people), Mexico (111 million people) or South Korea (48 million). Additionally the changes did not address the composition of the IMF executive board or the lack of transparency and accountability at all levels of the institution. Adequate reforms must be in place before the IMF can resume a leading role in managing any international monetary system, including one with a supra-national international reserve asset (see paras 48–52).[28]

45. There is also a clear need for any reforms to the international monetary system to take into account the different needs of different countries. At different stages of economic development, there are different concerns, including the balance between inflation, investment and employment creation. The size of economies also differs, meaning that some will be more at risk from currency speculation or hot money flows, while others will have more scope to manage such concerns. The system needs to be rules-based, but will need to have flexibility for countries in different circumstances.

46. Whatever the reform to the international monetary system, the international body that is tasked with implementing any aspect of the system must be accountable to both its members and to a broader set of stakeholders. A lack of accountability is a recipe for inappropriate, ineffective and inefficient policy-making. The IMF has some accountability to its members, but none to stakeholders. For example in the UK, Her Majesty's Treasury is supposed to report annually to parliament on its activities at the International Monetary Fund. However, HM Treasury has not yet submitted the report for calendar year 2007, let alone 2008.[29] There is clearly scope for creating more accountability.

Potential reforms to the system

47. In 2007 the IMF rewrote its surveillance decision—the framework under which the IMF analyses country's exchange rates and economic policies.[30] It included the concept of "fundamental exchange rate misalignment" but did not agree any sanctions for countries that had misaligned exchange rates (either overvaluation or undervaluation). In the same year, the IMF's Independent Evaluation Office (IEO) issued a report about the IMF's exchange rate surveillance. One of the clear subtexts of the report and subsequent discussions was the accusation that exchange-rate surveillance was not even-handed simply because the IMF has no ability to influence the exchange rate policy decisions of advanced economies. The evaluation finds: "The reduced traction is in danger of being extended to large emerging market economies, and beyond. Such an evolution is corrosive, breeds cynicism amongst the staff as well as the members, and builds on perceptions of a lack of even-handedness." Some have proposed that the IMF strengthen its exchange rate surveillance as the mechanism for helping to resolve global imbalances, but without sanctioning power, this is unlikely to be effective.

48. The current crisis has helped to revive interest in the original proposals made by John Maynard Keynes in the run up to the creation of the IMF in 1944. In a government White Paper (CMD 6347), the UK treasury set out its proposals for an international currency called the "bancor" and an International Clearing Union which would settle transactions in this currency. The bancor would have been based on a basket of commodities prices, giving it a basis in the real economy, and not just a basket of currencies.

49. The clearing union idea effectively removes the holding of foreign exchange reserves, and replaces it with a system whereby balances are managed by the clearing union. These balances would be denominated in the bancor. Persistent large trade surpluses and deficits would be penalised by an interest charge, providing incentives for both surplus and deficit countries to change policy to eliminate the imbalances. Notional exchange rates would be changed, by mutual consent at the clearing union, based on trade balances. This

[28] For more detail on the changes to IMF governance in 2008 see: "IMF governance renovations: fresh paint while foundations rot", Bretton Woods Project, *Bretton Woods Update* No. 60, 1 April 2008, http://www.brettonwoodsproject.org/imfgov60; Bretton Woods Project, "IMF challenged on accountability, governance", Bretton Woods Update No. 61, 17 June 2008, http://www.brettonwoodsproject.org/imfgov61.

[29] HM Treasury's annual reports (2001-2006) on the IMF can be found at: http://www.hm-treasury.gov.uk/int_ii_ukimf.htm.

[30] For a more in-depth treatment of the surveillance decision see Bretton Woods Project, "Heated exchanges over exchange rates", *Bretton Woods Update* No. 56, 2 July 2007, http://www.brettonwoodsproject.org/imfxrates56; Bretton Woods Project, "IMF surveillance role: fundamentally misalign?", *Bretton Woods Update* No. 57, 5 October 2007, http://www.brettonwoodsproject.org/imfroles57.

is roughly how exchange rates were managed under the Bretton Woods system that was in operation from 1945 to 1971, with the exception that the balances were denominated in dollars that were backed by gold. Keynes' ideas remain an excellent basis to start a new discussion, but need updating in the context of freer mobility of capital and international financial flows. The basic proposals would be workable only if countries with freely floating exchange rates are willing to move away from such a system.

50. The UN Conference on Trade and Development (UNCTAD) has long argued that the current international monetary system is detrimental to development prospects of developing countries. In a mid-March report[31], UNCTAD wrote: "Multilateral or even global exchange rate arrangements are urgently needed to maintain global stability, to avoid the collapse of the international trading system and to pre-empt pro-cyclical policies by crisis-stricken countries." In the absence of a global system, regional currency arrangements, such as the euro, can help moderate risk and improve the ability of countries to manage volatility.

51. In March, the governor of the Peoples Bank of China published a paper calling for reform of the international monetary system.[32] He argues for "an international reserve currency that is disconnected from individual nations and is able to remain strong in the long run, thus removing inherent deficiencies caused by using credit-based national currencies." However, governor Zhou calls for a gradual process that would begin with giving the IMF's special drawing right[33] (SDR) a greater role, including larger allocations, a settlements system, the use of SDRs in trade and commodity pricing, and financial assets denominated in SDRs.

52. The UN General Assembly president's commission of experts on financial reform, a task force of economists and policy makers from around the globe that was chaired by Nobel laureate Joseph Stiglitz, also recommended the creation of an international reserve currency.[34] "The global imbalances which played an important role in this crisis can only be addressed if there is a better way of dealing with international economic risks facing countries than the current system of accumulating international reserves." The committee concluded: "To resolve this problem a new Global Reserve System—what may be viewed as a greatly expanded SDR, with regular or cyclically adjusted emissions calibrated to the size of reserve accumulations—could contribute to global stability, economic strength, and global equity." [original emphasis]

53. The current crisis has shown that the system has failed to deliver on many of its objectives. While the persistent under-development and under-investment in developing countries was evidence of this, the crisis has also demonstrated that it has not worked for rich countries, where massive losses due to risky financial activity are being socialised and economies are entering deep recessions. As the economic hegemony of the US wanes, there is a practical limit to how long the anachronistic system of a single country's currency serving as the vehicle for all global reserve holdings can be maintained. The creation of an international currency, international clearing union, and system of globally managed exchange rates should be on the agenda.

54. In times of crisis there is much greater political will to undertake reform. Agreement on ambitious reforms such as these will take considerable negotiation. If the run up to the Bretton Woods conference in 1944 is any guide, it will take two years of work. A fair, transparent process will be needed to undertake these negotiations: one that involves all countries of the world, and is open to civil society and parliaments, under the auspices of the United Nations. This has been demanded by thousands of civil society organisations[35], but as of yet this call has not be heeded by the leaders of the G20.

55. Given that the IMF will likely be at the centre of any international monetary system, a profound reform of its governance is needed even more urgently.[36] Following up on our evidence to your inquiry on the IMF in 2006, the following actions are needed:

55.1 The IMF should adopt a double-majority voting system as an interim step to a more comprehensive reform leading to the inclusion of population size in determining voting shares.

55.2 Leadership selection, for all management and director level positions, should be transparent, open and merit-based, without respect to nationality.

[31] *The global economic crisis: systemic failures and multilateral remedies*, UN Conference on Trade and Development, 19 March 2009, http://www.unctad.org/Templates/webflyer.asp?docid = 11200&intItemID = 2068.

[32] Zhou Xiaochuan, "Reform of the International Monetary System", People's Bank of China, 23 April 2009, http://www.pbc.gov.cn/english//detail.asp?col = 6500&ID = 178.

[33] For an explanation of the special drawing right (SDR) see: Bretton Woods Project, "Inside the institution: the IMF's special drawing rights (SDRs)", *Bretton Woods Update* No. 65, 1 April 2009, http://www.brettonwoodsproject.org/sdrs65; and International Monetary Fund, "IMF Factsheet: Special Drawing Rights (SDRs)", February 2009, http://www.imf.org/external/np/exr/facts/sdr.htm.

[34] United Nations General Assembly, "Recommendations by the Commission of Experts of the President of the General Assembly on reforms of the international monetary and financial system", 19 March 2009, http://www.un.org/ga/president/63/letters/recommendationExperts200309.pdf.

[35] See: "Let's put finance in its place! Call to action from the 2009 World Social Forum", http://www.choike.org/campaigns/camp.php?5; "Statement on the proposed "Global Summit" to reform the international financial system", http://www.choike.org/bw2/index.html. In the UK see: "Put People First", http://www.putpeoplefirst.org.uk/wp-content/uploads/2009/03/ppf-policyplatform.pdf.

[36] See "UK NGO open statement on governance reform of the IMF", Bretton Woods Project, 21 July 2006, http://www.brettonwoodsproject.org/ukimfreform; and "European CSO open statement on governance reform of the IMF", Bretton Woods Project, 17 July 2006, http://www.brettonwoodsproject.org/euroimfreform.

55.3 All executive board chairs should be elected, express their position with formal votes rather than informal indications, and be subject to democratic accountability. The UK should step forward by abandoning its appointed chair in favour of elections and push on a European level for a consolidation of European seats on the board.

55.4 The IMF should increase transparency, quickly publish transcripts of IMF board meetings and draft policy documents, work under the presumption of disclosure and base exemptions on a clear description of the harm of disclosure, keeping them to a minimum.

Memorandum from Jan Toporowski

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Executive Summary

It is utopian to consider the issue of international banking regulation in isolation from global macroeconomic imbalances and their financing. It highlights the role of asset inflation in giving temporary stability to financial systems, at the cost of severe damage to banking systems when that inflation ceased [paragraphs 1–3]. Prudent banking policy needs to be supplemented by accommodating fiscal policy, if only because (domestic) government debt is a stabilising factor in bank balance sheets [4–6]. But government re-capitalisation of banks may be a wasteful use of government resources [5]. The evidence takes issue with the view that the markets or independent regulators can regulate financial markets effectively or well [7–8]. The evidence criticises more extensively the view that additional equity capital cushions banks against risks in their lending. In fact such additional capital reduces the equity capital available to non-financial firms. Such firms then have to rely on debt financing. Such "forced" debt financing discourages productive investment, weakens the liquidity of the non-financial business sector, and in this way degrades the quality of bank assets [11–18]. Over-capitalisation of banks is exacerbated by cross-border lending, which under present arrangements requires more capital to be put aside [21]. The evidence concludes by suggesting an alternative system in which cross-border lending to the private sector abroad is supported by additional, contingent lending commitments to foreign governments that may be required to refinance the foreign debts of their private sector [22–24].

Evidence

I. *Introduction: Banking Depends on Macroeconomic Conditions*

1. Institutions, how they function together in markets, and how macroeconomic imbalances are accommodated are more important than principles of banking regulation abstracted from the actual intermediation functions of banks. The present crisis is not due to deregulation (which had occurred in 1980s) but precisely because commercial credit was allowed to take up the slack in the economy that arose after the dot.com bubble burst in 2000. Commercial credit was able to support consumption through housing market inflation, and corporate liquidity through capital market inflation, at the cost of rising indebtedness that emerged as excess debt when housing and financial asset prices fell.

2. A second disadvantage of discussing bank regulation abstracted from actual conditions of financial intermediation is the unreality of any discussion that starts with general principles of regulation when banking and financial markets are gripped, or at least driven, by crises in the U.S. and U.K. that are notable for their durability rather than their tractability. Much of the recent discussion among academic economists of "optimum" regulation in a private sector banking system, hardly addresses the current prospects for banking. The current difficulties are largely regarded as policy problems, rather than regulatory ones. Especially in the most financially advanced countries, banking will be in the state sector for a long time to come and will be affected for decades, if not years by the measures taken to deal with the crisis. Discussions of bank regulation that abstract from the banking structures being currently worked upon are either frankly utopian or else implicitly nostalgic for a recent, but receding, past when macroeconomic imbalances were accommodated by asset inflation, rather than the efficiency of deregulated banking.

3. The durability of the present crisis suggests that the discussion should be centred upon not so much financial regulation, but financial reconstruction. Such financial reconstruction has to take place within a broader programme of the reconstruction of our economic institutions, whose aim must be to reduce the dependence of global economic activity on financial market conjunctures. Such dependence has been embedded in the financialised economies, such as the U.S., the U.K., and Iceland, through funded pension schemes, the use of privatisation as a source of government revenue, and the increasing use of the housing market to support household consumption, while the non-financialised economies, such as Germany or China, through their increasing direct or indirect reliance on exporting to financialised economies, thereby acquired an indirect dependence on financial inflation. Economic activity must be reorganised to make the real economy more stable and financial markets more boring, so that enterprise is focussed on innovations that enhance welfare, rather than financial inflation.

4. The macroeconomic preconditions for financial stability must include appropriate fiscal accommodation. It is important to remember that the stability of banking and financial markets after the Second World War was not only due to regulation, but also due to the overhang of government debt largely held by banks and kept liquid by central banks. Such government debt operations must be part of any effective stabilisation of banking markets. To some extent this is already happening as government debt expands rapidly to refinance banks; stabilising banks by distributing among financial balance sheets government paper backed, in effect, by claims on banks.

5. An important limitation of this emergence of the government as financial intermediary to bankers is that government credit operations are being used to support credit ("finance is financing finance") rather than activity in the real economy, as happened in previous government debt expansions. There is a benefit in that it facilitates "quantitative easing", that is the purchase from banks of government paper by central banks to provide commercial banks with additional reserves. But the benefits of quantitative easing have always been greatly exaggerated: It did not have any significant economic effect in Japan when it was tried at the end of the 1990s, when the ratio of Japanese Government debt to Gross Domestic Product was approximately 150% (the U.S. and U.K. government debt to GDP ratios currently stand at 60% and 50% respectively).

6. A particular difficulty, which may have added to the fragility of banking systems in the U.S. and the U.K. and which today limits central bank operations with commercial banks, is the concentration of government paper in the reserves of central banks and long-term investment institutions (insurance companies and pension funds). The clear preference among long term investment institutions, partly for regulatory reasons, for government paper means that the return of ailing government-supported banks to the private sector will be limited by weak demand in the capital market for shares or common stocks. This means that banks are likely to stay in the public sector for a while. (This is further discussed in the next section of this evidence.) The discussion on bank regulation will remain utopian as long as it ignores the distinctive functions that public sector banks must perform.

7. On the agenda of discussions about financial reconstruction has to be elimination of so-called "independent" central banks and regulators. One of things wrong with our institutions is the narrowing of the policy agenda to consumer price inflation and employment. This allowed regulators to tolerate inflation in the financial markets and get away with it, while delegating awkward questions of regulation to an abstracted market in which "rational" agents prevail, or independent regulators who had no overview of how banks were functioning in the economy as a whole. The crisis has brought home to everyone what was apparent in the 1930s, namely that in a capitalist market economy in general, and in financial markets in particular, the "rational" generation of cash flow does not result in any kind of social equilibrium or optimum.

8. More importantly, in the moment of crisis, it is most obvious that the previous cash flows generated by inflation in asset markets concealed structural imbalances in those markets. Delegating regulation to market participants, or even to those experienced in generating cash flows from asset markets, ie, so-called "expert practitioners" means delegating to those acting under the influence of illusions created by those cash flows. Among those illusions is the belief, now widely held among banking experts that the banking system's exposure to macroeconomic hazard arises merely out of inter-bank financial transactions which leave banks with sizable exposures to default by a single bank (see, for example, the so-called "Geneva Report", Brunnermeier, M., Crockett, A., Goodhart, C.A.E., Persaud, A.D., and Shin, H. (2009) *The Fundamental Principles of Financial Regulation, Preliminary Conference draft* Geneva: International Center for Monetary and Banking Studies). Such a definition of "macro-prudential regulation", and the concern for securing the survival of "systemically important" financial institutions (ie, institutions whose default would have an adverse impact on the balance sheets of a large number of banks) reflects the "capture" of financial regulators by the institutions which they are supposed to regulate. Financial inflation expands cross-holdings of each others assets by banks in liquid markets whose cash flow creates an illusion of successful credit operations. Independent regulators will always incline to deregulation at such times. The answer is to have publicly accountable regulators imbued with an ethos of public service capable of auditing market structures and market processes, rather than practitioners whose expertise in individual balance sheet restructuring blinds them to market structures and imbalances. It is vital that a public, democratically-accountable authority be able to modify banking and financial market regulation in line with changing macroeconomic conditions, and the emergence of structural imbalances in the economy or in the financial markets. The need to coordinate such regulation with the availability of government paper to stabilise bank balance sheets suggests that this regulation should be done by an agency associated with H.M. Treasury.

II. *Capital Adequacy Requirements*

9. Conventional wisdom since the 1980s has it that banks can be made more secure by having capital that is sufficient to meet a decline in the quality of banks' assets (loans or bonds). This thinking was reflected in the Basle Agreement of 1988, laying down minimum capital requirements in relation to the supposed riskiness of assets. Apart from the fact that there is considerable uncertainty about the precise riskiness of assets, the strategy of securing bank stability by capital adequacy is based on a fallacy of composition: what is good for one bank is not necessarily good for all banks taken together.

10. Essentially, the strategy is based on a microeconomic presumption that each bank can determine its liabilities (ie, the scale and distribution of its liabilities between deposits and capital) without affecting the liabilities of other banks and firms in the economy. This is a fallacy because the process of issuing capital or liabilities is subject to two constraints. The first of these is the balance sheet constraint that each bank's or firm's liabilities must be some other firm's or bank's assets. Secondly, even if one assumes that the price system (ie, the return offered and accepted on liabilities and assets) will allow all banks and firms to issue the kind of liabilities that they wish to have in their individual balance sheets, there is no guarantee that their assets will generate sufficient income to allow each individual bank or firm to make those payments on their liabilities.

11. In practice banks cannot determine their capital without affecting the availability of capital for other economic enterprises. If we exclude the possibility of bank holding companies and bank capital cross-holdings (see below, paragraph 20) the supply of capital today in the financially advanced markets of the OECD countries is principally determined by the cash flow and the respective liability structures of other financial intermediaries, such as pension funds and insurance companies. Given a certain capacity on the part of other, non-bank, financial intermediaries for purchasing equity, a regulatory requirement to increase bank capital reduces the amount of capital available for non-financial firms. If non-financial firms are unable to raise the amount of equity capital that they need, they are obliged to raise capital through the issue of debt instruments in the form of corporate bonds or company paper. In this way, stabilising banks by raising capital requirements becomes a way of "forcing" companies into debt.

12. The "enforced indebtedness" of companies is a crucial factor in bringing about financial crisis and recession. Both the 1929 Crash, and the Crash of 2007–08 were preceded by rising capital issues by financial intermediaries and the growing indebtedness of non-financial firms. The response of non-financial firms to rising levels of debt is to reduce their (productive) investment in fixed capital. Such falls in fixed capital formation are a key factor in bringing about recession in the real (non-financial) economy and, in the case of the 1930s (or in Japan after 1992) prolonging that recession into economic stagnation and depression.

13. The "crowding out" of the non-financial business sector's demand for capital also raises the cost to them of the eventual capital that they raise. Because banks have to satisfy a regulatory requirement for capital they are willing to pay whatever price it takes to get the capital onto their books. This "inelastic" demand for capital means that banks may end up promising a higher return on the capital that they raise. Non-financial firms wishing to raise equity capital must then match or offer even higher returns on the capital that they wish to issue. This is reflected in the rising yields on corporate equity issues since 2000.

14. The other way in which banks can accommodate demands for higher capital ratios (ie, ratios of capital to assets) is by securitisation, ie, by packaging up bank loans as bonds, and selling the resulting bonds to other financial intermediaries (insurance companies and pension funds). This raises banks' capital/asset ratios by reducing the amount of risky assets on those banks' balance sheets. Securitisation has recently had a bad press because of its role in the "business model" of failed banks, such as Northern Rock. But there is also another channel by which securitisation has contributed to financial fragility. This is through the sale of loan-backed bonds to other financial intermediaries. Such sales effectively reduce the pool of capital that non-financial firms can raise in the markets. This is another means of "enforced indebtedness" of companies.

15. "Enforced indebtedness" increases the financial fragility of the economy as a whole. Firms which would have preferred to finance themselves with equity capital find themselves holding levels of debt which over their planning horizon they would prefer to reduce. They can accommodate this excess debt in one of two ways. Firms can hold larger amounts of liquid assets (bank deposits, foreign currency deposits, short term bills). But this means that capital which they have issued is 'wasted' by being held as financial assets, rather than being applied productively to the expansion of output or fixed capital. Alternatively, firms can reduce their fixed capital investment in order to build up those liquid assets. Either way, productive investment ends up being less than it would otherwise be. If sufficient firms succumb to indebtedness in this way, the economy moves to a lower growth trajectory. Fixed capital formation is a key factor in the liquidity of firms, with higher investment in fixed capital being associated with higher retained profits of firms. Lower investment in fixed capital therefore reduces the liquidity of firms and their ability to service their debts. Indirectly, therefore, the company indebtedness enforced by raising capital requirements for banks itself may cause a decline in the quality of bank assets.

16. Looking at this issue over the course of the business cycle, it is easy to see how regulatory bank capital requirements may make fluctuations in economic activity even more extreme. Given even moderate business fluctuations, it is prudent for non-financial firms to raise additional equity capital as a boom proceeds because the longer the boom lasts, the closer is the eventual recession, and therefore the more likely is a fall in the return on the productive assets of non-financial firms. If, however, banks are increasing their issue of equity capital, then non-financial firms may find themselves unable to issue additional equity or relying on debt finance. In this way, when the recession comes, it is made worse by the greater indebtedness of companies. In the recession the returns on all assets, including those in bank portfolios, deteriorate. To ensure their survival non-financial firms should now be converting debt into equity. But since the deterioration of their assets is obliging banks to raise more equity capital themselves, this bank capitalisation reduces the already diminishing pool of equity capital available to non-financial firms.

17. More recently there have been proposals to stabilise bank balance sheets by requiring banks to raise the capital to risk-weighted assets ratios over the course of an economic boom. The reason for this is that the present fixed capital to risk-weighted asset ratios is pro-cyclical in the sense that, in the course of an economic boom, the liquidity and net worth of balance sheets increases. A fixed capital ratio would therefore fail to discourage banks' risky lending and may even encourage it because the risks would be less apparent in the boom. The policy of requiring banks to raise capital ratios as a boom proceeds is sometimes referred to as "dynamic provisioning".

18. There are three objections to this dynamic provisioning approach. In the first place the risks that are supposed to evoke higher capital ratios are rather nebulous, and evidenced only by defaults in a recession if it comes, so that it becomes difficult to enforce higher capital ratios if the boom is prolonged. Secondly, the approach would require banks to drain the available pool of equity capital even more rapidly than under fixed capital ratios, causing a corresponding greater indebtedness on the part of companies, and forcing up even more the cost of capital that non-financial firms could issue. Far from stabilising banks and the economy, dynamic provisioning would destabilise the economy and the credit system, including banks, by indebting companies more rapidly in a boom, or else discouraging company investment, and by these means increasing the risk of companies' default on their debt. The third problem arises in an international setting in which some banks may have a diversified portfolio of assets spread across countries, some of which are in a boom, and some of which are in recession. Such banks would on balance have a much more stable portfolio of loans and could reasonable argue that they should not be required to increase their capital ratios as much as banks exposed only to countries in recession.

19. A far more effective form of dynamic provisioning would be to require companies (and households with mortgages, if we are to extend our considerations to household debt) to increase the equity capital that they have as a boom proceeds. This would make companies' remaining debt more manageable in the face of a recession, and thereby reduce the probability of default on that debt. The latter in turn would improve the quality of bank assets.

20. So far in this evidence consideration has only been given to the issue of bank capitalisation through the sale of equity capital to financial institutions such as insurance companies and pension funds. The sale of equity capital to private individuals is not an effective means of raising capital because few private individuals are wealthy enough to be able to hold significant quantities of capital on the scale required by banks. However, there is another means of raising bank capital, namely that of bank holding companies, or cross-holdings of bank capital. A bank could issue equity capital which might be held by a holding company financed mostly with debt instruments, such as bonds. Alternatively two banks could agree to issue capital to each other. The holding company method is a way of creating capital that is really debt, and this would show up in consolidated accounts. Moreover, it is a highly speculative form of financing because the holding company ends up with financial commitments that must be serviced out of less liquid assets whose value and income is much less certain that the holding company's liabilities. This is why, in the past, bank holding companies were strictly regulated. The second method gives rise to a "layering" of capital within the financial system, with banks holding other banks' capital in their assets. Such cross-holdings have adverse effects on competition among banks, on bank efficiency, and on the vulnerability of banks grouped in this way to any risks which might affect the assets of a single one of them.

III. *International bank stabilisation*

21. The arguments presented here apply to a national economy. They apply even more to the international economy insofar as national financial systems are integrated into an international system. In a situation in which banks have cross-border exposures in the form of assets in other countries, exposures made more risky by the current mix of floating exchange rates with such rates fixed in particular regions (for example, the Euro-zone and associated member states of the European Union) the present Basle Agreement and European Commission Directives would require even higher capital ratios, than if individual bank assets and liabilities were confined to only one country. Those even higher capital ratios imply an even greater indebtedness of companies.

22. In such an internationally integrated financial system, banks and economies would be much more effectively stabilised if cross-border lending to the private sector were matched by a commitment to lend, in the domestic currency of the bank, to the government of the country of that private sector, in the event of lending to that country being reduced. Thus, if a bank located, for example, in the U.K. lends to companies in South Africa, the bank would commit itself to lend to the South African government the equivalent of any reduction in lending by the bank to those companies. In this way, capital outflows would be matched by new capital inflows to governments which would then be in a position to stabilise the foreign borrowing of banks and companies in their respective countries.

23. The government bonds thus issued to foreign banks would be long-term, or at least sufficiently long-term to avoid repayment pressures on the issuing governments in the midst of crisis. Banks holding such foreign government bonds should be given an option to sell them after a given period, but before they are repaid, to a multilateral monetary agency such as the International Monetary Fund at a price mutually agreed.

24. Such a system of advance, or contingent lending commitments would encourage due caution with cross-border lending, while stabilising cross-border bank capital flows. It would obviously be least taken up in countries with relatively little private sector foreign borrowing, such as some of the major OECD countries. However, smaller countries and emerging, developing and transition economies, their banks and their companies, could benefit from the greater stability that such a system would bring. In this way, contingent commitments to lend to governments in the event of private sector lending withdrawals would strengthen and stabilise the international financial system.

April 2009

Memorandum from the Jubilee Debt Campaign

1. Introduction

Jubilee Debt Campaign is part of a global movement working for full cancellation of unpayable and unjust poor country debts, by fair and transparent means. Jubilee Debt Campaign is a UK coalition of about 200 national organisations and local groups, supported by thousands of individuals. It is a company limited by guarantee (number 3201959) and a charity registered in England and Wales (number 1055675). See www.jubileedebtcampaign.org.uk for more details.

2. This evidence relates particularly to the Committee's concern with global cross-border financial regulation and also in part to the role of off-shore financial centres in relation to this. It describes the role of financial market actors known as "vulture funds" and the measures that need to be taken, at the international level, to prevent their activities.

3. The need for Global Regulation of "Vulture Funds"

The huge overexposure to risk and accumulation of bad debts brought about by the banking crisis has revealed widespread under-regulation of financial market actors, including hedge funds and other actors in secondary debt and derivatives markets. This evidence focuses on the role of distressed debt funds, or "vulture funds", as an example of unregulated financial activities which have put profit before the wider aims and values of UK society and the international community.

4. Companies known as "vulture funds" seek to make profit by buying up defaulted debt at a highly discounted price, then trying to recover the full amount, often through the courts. Civil society groups including Jubilee Debt Campaign are particularly concerned about those companies that target highly indebted developing countries, or their trading and investment partners. National legislation would go some way towards tackling this problem, however ultimately only global regulation and changes to the international debt and lending frameworks can cover all the jurisdictions in which these funds operate.

5. Background

At least 54 companies are known to have taken legal action against 12 of the world's poorest countries, for claims amounting to $1.5 billion. One-fifth of these cases are or will be tried in UK courts. Some of these companies are the original creditors; many are secondary purchasers, ie vulture funds whose sole aim is to make as much profit as possible from the debts, costs and fees that they add on.

6. The activities of vulture funds stand in contradiction to, and indeed undermine, international efforts to reduce the unsustainable debts of the poorest countries, through initiatives such as the Heavily Indebted Poor Countries scheme, managed by the World Bank and the International Monetary Fund. Such initiatives are voluntary, so a situation has arisen whereby the international community, led by the UK, has agreed to debt relief, but vulture funds have been able to free-ride over these arrangements, refusing to participate and instead pursuing repayment and costs through litigation. Indeed some commentators accuse vulture funds of purposefully buying up debts of countries qualifying for debt relief schemes, in the knowledge that the schemes will release assets that could be seized.

7. Who are the Vulture Funds?

These companies tend to be secretive, and many of them are based in off-shore financial centres. Some are owned by large, often US-based financial institutions such as hedge funds. In other cases, there is no information on who owns them. Often companies are set up simply to pursue one debt, then shut down again. Donegal International Limited, for instance, the company that sued Zambia, is registered in the British Virgin Islands. Its only business was to pursue the Zambian debt. The court in London failed to discover who are the ultimate owners of Donegal, and of other sister companies such as Walker International, which sued the Republic of Congo, because of the lack of transparency in the off-shore jurisdictions in which they were registered.

8. Exploiting the Proceeds of Debt Cancellation

24 countries, including Zambia, have now completed the Heavily Indebted Poor Countries (HIPC) initiative and up to 16 more are eligible to do so. Countries completing HIPC also become eligible for the Multilateral Debt Relief Initiative, agreed at the Gleneagles G8 in 2005, and through both these schemes secure cancellation of a large proportion of their debts to the World Bank, IMF, African Development Fund and the richest country governments. This cancellation is of huge benefit, and is proven to increase investment in essential services such as health and education.

9. Completing HIPC does not bring any guarantee that debt cancellation will come through however. Even after debtor countries spend years meeting the conditions in order to get HIPC debt relief, many creditors simply do not comply. In particular, many commercial creditors have been reluctant to take part in debt relief processes, in some cases selling on claims to vultures, and sometimes suing for the amounts themselves.

10. Number of Cases

It is very hard to know how many cases have taken place or are still underway, as the companies do not publicise their actions. However there have been at over 50 lawsuits by commercial creditors against Heavily Indebted Poor Countries, many still outstanding. These are recorded each year in a survey undertaken by the IMF and published in the HIPC Status of Implementation report[37].

11. This list can be seen as merely the tip of the iceberg. For example it does not record actions that companies take against a sovereign state's trading partners or other assets to which they seek to attach orders. An ongoing case involves a company called FG Hemisphere, who are suing the Democratic Republic of Congo in at least three jurisdictions, and in the latest attempt are claiming rights to some of the assets of a mining company operating in DRC. Such actions undermine normal trading relations with developing countries, which are critical to those countries' economic growth and development efforts.

12. Legal actions have also included trying to divert funds intended as official development assistance. A vulture fund called Kensington International bought some of the debts of Congo-Brazzaville on the secondary market for a total of $1.8 million. The vulture fund then sued Congo for $120 million and attempted to seize funds which were supposedly destined for the country. This included a €10.3 million Belgian development cooperation grant to fund a thermal power station in the country and a €587,000 national television grant[38].

13. Zambia Case Study

The cancellation of some $6.5 billion of Zambia's debt in 2005 was an important moment. It meant a country that had been crippled by debt repayments, had significant funds released to provide essential services for its population. However, ultimately a significant proportion of this money has instead been paid out to a vulture fund.

14. In 1979 Zambia was lent $15 million by Romania. This was to be used to purchase tractors and other farming machinery (some of which arrived in an unusable state). Twenty years on Zambia was unable to repay its debts and became eligible for debt relief. The Zambian and Romanian governments were negotiating the cancellation of the tractor debt as part of this process.

15. At the last moment Donegal International purchased the debt from Romania for $3.3 million. Donegal took the Zambian government to court, using the UK legal system, as this was the jurisdiction given in the loan contract. Donegal were suing for $55 million from Zambia. The judge highlighted the dishonesty used by the company in their dealing with Zambia, but as they had a case in law he granted them $15.5 million.

16. As Presidential Advisor Kalunga-Banda pointed out, paying Donegal meant *"the treatment, the Medicare, the medicines that would have been available to in excess of 100,000 people in the country will not be available."*

17. Donegal bought the debt at a vastly reduced price from Zambia, a country with high levels of extreme poverty and qualifying for international debt relief. Wealthy country creditors, including the UK, had agreed to cancel Zambia's debts to them on the understanding that Zambia should then have extra funds available for poverty reduction, rather than extra funds to repay other creditors in full.

[37] The latest table is in *Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation*, IDA/ IMF 2008, http://siteresources.worldbank.org/INTDEBTDEPT/ProgressReports/21899739/HIPCProgressReport20080912.pdf

[38] *Taming The Vultures: Are New Measures Enough To Protect Debt Relief Gains?* Gail Hurley, Eurodad, August 2008

18. Role of the UK Government

> "The Government deplores the activities of so-called vulture funds… We continue to keep all options for tackling this problem under consideration."

Ian Pearson, Economic Secretary to the Treasury, House of Commons Written Answers, 5 March 2009.

19. Vulture funds have been described as "immoral" by the Department for International Development and the UK has been involved in a number of initiatives to help tackle the problem. This has included working with the World Bank to help poor countries buy back their commercial debts at a deep discount through the Debt Reduction Facility (DRF). The aim of this is to reduce the risk of debts falling into the hands of vulture funds.

20. Last year, for example, they provided £1.8 million to assist with Nicaragua's commercial debt buy-back operation. The UK has also committed up to £10 million towards future DRF country operations to help tackle the threat of vulture funds. They have also backed plans at the African Development Bank to establish an independent legal support facility to advise countries on how best to tackle vulture fund activity. While these activities are commendable, preventative action is needed in order to stop the activities of vulture funds in the first place.

21. What needs to be done

There are 16 countries yet to complete the Heavily Indebted Poor Countries (HIPC) debt relief scheme, and some of them have a large proportion of commercial creditors. As they receive debt relief, as with Zambia, they may find themselves facing legal challenges to actually hold on to the money. Other poor countries, some of which do not qualify for HIPC, also have high levels of unpayable commercial debts, which could already be owned by, or may be sold on to, vulture funds.

22. Debt Work-out Mechanism[39]

In the long term an international fair and transparent debt work-out mechanism is needed to deal comprehensively with developing country debts. Creditors of sovereign debtors could be compelled to participate in collective action through the mechanism, whereby all creditors have to provide comparable terms to any rescheduling or relief agreed by a majority of creditors. This would be similar to regulations governing individual debtors in the UK, which require all creditors to abide by any debt relief plan agreed by 75% of creditors.

23. A debt work-out mechanism would take account of the origins of debts as well as their current impact and sustainability, and place the same moral and legal obligations on companies as it does on governments. Civil society groups are calling for this measure to be part of any reform packages being prepared in the wake of the global financial crisis, for example it should be part of the upcoming discussions on financial reforms at the G20 and the UN.

24. Tackling Tax Havens

The UK also has a key role to play in tackling tax havens. The Prime Minister's bold statements in the run up to the G20 in this regard are to be welcomed. Vulture funds are often based in tax havens, as this facilitates the secretive way in which they operate. A key priority must be to end this secrecy and lack of transparency. The UK's overseas territories, Crown dependencies and Commonwealth countries hold nearly half the world's tax havens between them. Therefore any action taken by the UK would have a truly global impact.

25. Legislation against Vultures

In terms of more immediate, specific actions, the introduction of legislation against vulture funds is a priority. English law is cited as the legal jurisdiction in many debt contracts. The courts here have heard at least seven cases against heavily indebted poor countries, including the notorious Donegal International versus Zambia case in 2007. Six of these cases have resulted in judgements in favour of the creditors totalling \$236.1 million on debt with a nominal face value of just \$65.3 million[40].

26. The Stop Vultures Bill: Legislation in the United States

On 1 August 2008, Representative Maxine Waters introduced the Stop Vulture Funds Act to the US House of Representatives, a piece of legislation that would prevent vulture funds from making excessive profit at the expense of heavily indebted developing countries. The Stop Vulture Funds Act outlaws profiteering from sovereign debt by capping the amount of profit that a fund can reap through litigating against poor countries to collect defaulted debts. It also requires disclosures from any fund which pursues vulture fund activity through the US courts.

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[39] For more details on this, please refer to our submission to the Committee's inquiry on *Financing For Development: The Outcomes Of The Doha Follow-Up International Conference*, December 2008

[40] Eurodad, ibid.

27. As a new Congressional session gets underway, Representative Waters is planning to reintroduce this bill in the coming weeks. Civil society groups including Jubilee USA and TransAfrica Forum will be calling for a change in the law, and we hope that the UK Government will consider similar measures here.

28. Possible National Legislation and International Regulation

Legislation or regulation should cover two major aspects:

— Restricting the amount that can be awarded to a creditor seeking repayment of a defaulted debt from a developing country. The award could be limited to the amount the creditor paid for the debt (or originally lent, if they are the primary creditor) plus a nominal amount of interest, thus removing the profiteering incentive of vulture funds.

— Forcing disclosure. Vulture funds operate in highly secretive ways so legislation should compel them to request permission from the courts to take the action, registering their company details and details of their claims with the courts and with the Government.

The Government should promote such measures internationally, for example in the upcoming UN conference on the impact of the financial crisis on development in June, and in its role as Chair of the G20 throughout the year.

29. Responsible Lending to Developing Countries

Another aspect of global regulation to prevent vulture fund activity is to regulate the provisions of international loan agreements, so as to standardise collective action clauses within such agreements. While this would not prevent the problem of those debts that are already in the hands of vulture funds, it would mitigate against this problem in the future.

30. In this regard, the G8's 2007 commitment to a "Charter on Responsible Lending" must be translated into reality. This should involve a binding legal framework that sets out what responsible lending entails, and fairly allocates the burden of responsibility between both creditors and debtors. As a step towards this goal, we encourage consideration of the *Charter on Responsible Financing* developed by Eurodad, with Jubilee Debt Campaign and others[41], which outlines the essential components of a responsible lending process, including collective action provisions to prevent free-riding and profiteering in the event of a debt restructure, re-scheduling or cancellation.

31. Conclusion

The activities of vulture funds have been widely condemned. The Prime Minister and many other leaders across Europe and North America, as well as civil society groups, have all recognised the immorality of seeking to profit from those countries which have been able, through debt cancellation, to direct much needed funds into poverty reduction.

32. In the context of the banking crisis, the activities of vulture funds can clearly be seen as an example of the rogue behaviour of some actors in an unregulated financial system, and by which developing countries are particularly affected. Specific proposals, including national legislation, global regulation, changes to the international debt architecture and changes to regulate international loan agreements, would all help to prevent this behaviour. Measures to tackle vulture funds should therefore be an essential element within the discussions on global financial reforms.

May 2009

Memorandum from the Commitee for a Democratic U.N.

Executive Summary

As a consequence of the global financial crisis, the Group of Twenty has identified the need to reform the Bretton Woods institutions. Such reform shall contribute to enhancing oversight and the institutions' transparency, accountability and legitimacy. By contrast to the universal recognition of the principle of democratic representation at the national level and its increasing importance in regional intergovernmental bodies, the Bretton Woods institutions, just as the United Nations and the World Trade Organization, do not yet allow for formal parliamentary involvement in their governance structures. However, among other things, a global parliamentary body could exercise genuinely independent oversight, monitor the institutions' activities and assess the impact of their policies. It would thus help to meet the goals set out by the Group of Twenty in this area. In the past years, support for the establishment of such a United Nations Parliamentary Assembly has grown considerably, in particular in parliamentary quarters. It is recommended that the Treasury Committee endorses the proposal and suggests that the assembly shall be vested with consultative and oversight functions in reformed governance structures of IFIs.

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[41] *Charter on Responsible Financing*, Gail Hurley, Eurodad, January 2008, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Responsible_Financing_Charter_report.pdf

About the Committee for a Democratic U.N.

1. The Committee for a Democratic UN (KDUN) was established 2003 and champions a democratization and strengthening of the United Nations and other international organizations. KDUN is specialized on the establishment of a Parliamentary Assembly at the United Nations (UNPA) as an intermediary step towards the long-term goal of a world parliament. The organization connects academics, parliamentarians, non-governmental organizations, public persons and dedicated citizens from all around the world who work on this subject. As specialized think tank we develop political recommendations and provide expertise. In particular, KDUN has been briefing parliamentary committees and individual parliamentarians in various countries on the subject of a UNPA.

2. KDUN is co-founder and Secretariat of the international Campaign for the Establishment of a United Nations Parliamentary Assembly (CEUNPA) which was launched in 2007. CEUNPA is a global coordination network of parliamentarians and non-governmental organizations from over 100 countries. The Committee, based in Berlin, is non-partisan, non-governmental and recognized as charitable by German authorities.

Introduction and Factual Information

3. As a consequence of the global financial crisis the Leaders of the Group of Twenty, among other things, have agreed that a "broader policy response" is needed and committed themselves "to advancing the reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness." The Group of Twenty has agreed that "that the Bretton Woods Institutions must be comprehensively reformed".[42] US-President Barack Obama has stated that "strong oversight" and "rigorous transparency and accountability" need to be guaranteed.[43]

4. Freedom House based in Washington D.C. rates 121 out of 193 countries in the world as electoral democracies.[44] Popular representation through elected parliaments is internationally recognized as the decisive means to legitimize and supervise executive power at the national level.

5. Proportionally to increasing competencies granted to intergovernmental organizations, this principle is also increasingly applied at the regional level. It is most advanced in the European Union. The European Parliament is directly elected and vested with legislative powers. It is an example other bodies draw upon. The African Union has established the Pan-African Parliament (PAP), the South American trade block Mercosur has a Parliament, too, and other bodies such as the Council of Europe, the Organization for Security and Cooperation in Europe, the North Atlantic Treaty Organization and sub-regional bodies such as Southern African Development Community possess Parliamentary Assemblies.

6. At the global level, however, the situation is still different. Despite their grown role, the United Nations (UN), the International Monetary Fund (IMF), the World Bank Group (World Bank) and the World Trade Organization (WTO) do not provide for formal bodies to enable parliamentary representation. Experts have thus rightfully referred to the "puzzling disconnect" between the universal advocacy of democracy and the neglect of state actors to take steps to democratize global governance.[45]

7. In a "Call for Global Democratic Oversight of International Financial and Economic Institutions"[46] which was presented to the Commission of Experts on Reforms of the International Monetary and Financial System set up by the President of the UN General Assembly,[47] CEUNPA stressed, among other things, that "at this critical juncture it must be ensured that any renewed system of international monetary, financial and economic institutions will be sufficiently mandated, more credible, legitimate, transparent, accountable, representative, responsive and more democratic. The setup of the reformed system has to guarantee that the world's citizens, those affected by its policies and decision-making, are able to have their voices heard in the formulation, implementation and evaluation of these policies. This task should be supported by the creation of a global body of elected representatives."

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[42] Group of Twenty. "Declaration of the Summit on Financial Markets and the World Economy." Washington D.C., November 15, 2008.

[43] Obama, Barack. "A time for global action." White House, Office of the Press Secretary, March 24, 2009. http://www.whitehouse.gov/the_press_office/President-Obama-Op-Ed-A-Time-for-Global-Action/.

[44] Freedom in the World 2008: The Annual Survey of Political Rights and Civil Liberties. Freedom House, Rowman & Littlefield, 2009. http://www.freedomhouse.org/template.cfm?page=363&year=2008.

[45] Falk, Richard. "What comes after Westphalia: The Democratic Challenge." Widener Law Review 13, no. 2 (2007): 243-253.

[46] Campaign for the Establishment of a United Nations Parliamentary Assembly. "Call for global democratic oversight of international financial and economic institutions," April 2009. http://www.unpacampaign.org/statements/financial_crisis/en.pdf.

[47] See United Nations Non-Governmental Liaison Service. Civil Society Consultation on the Work of the President of the UN General Assembly's Commission of Experts on Reforms of the International Monetary and Financial System. New York, Geneva, 2009, p. 25

8. The establishment of a UN Parliamentary Assembly[48] before was already recommended, among others, by the European Parliament,[49] the Pan-African Parliament,[50] the Latin-American Parliament,[51] the Parliamentary Assembly of the Council of Europe,[52] the Senate of the Republic of Argentina,[53] the Standing Committee on Foreign Affairs and International Development of the Canadian House of Commons,[54] and international political networks such as the Socialist International,[55] the Liberal International[56] or the Global Greens.[57]

9. Building on the example of the European Parliament,[58] a UN Parliamentary Assembly could initially be established as a largely consultative body. This is possible without a cumbersome change of the UN Charter. Firstly, a UNPA could be set up by a vote of the UN General Assembly under Article 22 of the UN Charter. Secondly, it could be created on the basis of a new intergovernmental treaty followed by an agreement which links it to the UN.

10. The European Parliament has suggested that the UN Parliamentary Assembly "should be vested with genuine rights of information, participation and control, and should be able to adopt recommendations directed at the UN General Assembly."[59]

11. Among other things, a UNPA could be a means to establish a formal in-house parliamentary dimension of IFIs and the WTO and, as CEUNPA has pointed out, "monitor the interlinkage and impact of the system's financial and economic policies in other fields such as sustainable development, food supply, education, health or eradication of povertyinternational economic and financial policy."

12. A major characteristic of a UNPA would be that its seats would be held by individual delegates. At the beginning, these delegates could be dispatched by national and regional parliaments. The apportionment of seats may be linked, under various possible formulas, to population size, dues to the UN and/or GDP. Models for the seat apportionment assessed by KDUN suggest that delegates from electoral democracies could have a majority in the assembly.

13. As a parliamentary body, a UNPA would be well equipped to exercise independent oversight and thus increase the transparency and accountability of IFIs, WTO and the UN.

14. According to KDUN's analysis, a UN Parliamentary Assembly would not replace or duplicate the functions of the Inter-Parliamentary Union (IPU), the umbrella organization of national parliaments.[60] CEUNPA similarly concluded that the proposed UNPA and the IPU would be complementary institutions. "A UNPA would provide a response to the democratic deficit in global governance which the IPU in its current structure is unable to offer."[61]

April 2009

[48] For a comprehensive introduction see Bummel, Andreas. Internationale Demokratie entwickeln. Fr eine Parlamentarische Versammlung bei den Vereinten Nationen / Developing International Democracy. For a Parliamentary Assembly at the United Nations. 1. ed. Stuttgart: Horizonte, 2005. http://www.kdun.org/en/documents/unpa-paper.pdf.

[49] European Parliament. Resolution on the role of the Union within the UN and the problems of reforming the UN. A3-0331/93, 1994. http://www.kdun.org/en/documents/a3-0331-93.PDF; and European Parliament resolution on the reform of the United Nations. P6_TAPROV(2005)0237, 2005. http://www.kdun.org/en/documents/B6-0328-2005-EP-EN.pdf.

[50] Pan-African Parliament. "A United Nations Parliamentary Assembly." Resolution adopted at the 8th Ordinary Session, Midrand, South Africa, October 24, 2007. http://www.kdun.org/en/documents/PAP_UNPA.pdf.

[51] Latin-American Parliament. "Parliamentary Assembly of the United Nations." Resolution OA/2008/26 adopted at the XXIV. Ordinary Assembly, Panam—, December 6, 2008. http://www.kdun.org/en/documents/200812parlatino_en.pdf.

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RECOMMENDATIONS

The Treasury Committee—

15. endorses the establishment of a United Nations Parliamentary Assembly.

16. stresses that the Assembly shall be vested with consultative and oversight functions in reformed governance structures of IFIs.

17. recommends that the U.K. government takes the lead in introducing the proposal into the ongoing multilateral deliberations at EU, G7, G20 and UN level.

Memorandum from Jubilee Scotland

This evidence relates particularly to the Committee's concern with potential reforms to the international monetary system.

INTRODUCTION TO THE ORGANISATION

1. Jubilee Scotland is part of a global movement working for full cancellation of unpayable and unjust poor country debts, by fair and transparent means. Jubilee Scotland is a Scottish coalition of about 30 national organisations and supported by thousands of individuals. It is a company limited by guarantee and a charity registered in Scotland (number SC031827). See www.jubileescotland.org.uk for more details.

EXECUTIVE SUMMARY

2. The banking crisis has spread globally and has had a significant impact on the poorest countries. Many of these countries now face the threat of struggling with their external debt repayments. Current international frameworks are entirely inadequate to meet this challenge. Existing debt cancellation programmes have not left in place a sustainable framework for coping with countries facing debt crisis, a shortcoming which will soon be comprehensively exposed if the IMF's forecasts for global economic growth are borne out. A Fair and Transparent Arbitration process (FTA), at which the debtor and creditor can meet on equal terms—and under the rule of law—to reassess the repayments of disputed debts, is therefore needed. Such a body would also be able to challenge those debts which violate the peremptory norms of international law, and lead to the greater stability in international capital flows which will be essential to assist the world's exit from the current financial crisis.

BACKGROUND

3. Between 1999 and 2005 substantial progress has been achieved in terms of debt relief for developing countries. During this process the international community failed, however, to develop lasting institutions for the prevention of debt poverty. The Heavily Indebted Poor Country (HIPC) and Multilateral Debt Relief Initiative (MDRI) relief schemes have been deliberately designed as one-off exercises. Thus, a newly over-indebted developing country would face today the same problems which countries had after the crisis' outbreak in 1982: there exists no comprehensive mechanism to reduce a country's exposure to all its creditors in an orderly and pre-defined way.

4. A HIPC which has gone through the debt relief process has no mechanism or procedure to refer to once it runs into new payment problems. Even before the global financial crisis took effect on the poorest countries, the World Bank acknowledged in its 2008 HIPC status of implementation report a "high risk of new debt distress" in 4 countries and a "moderate" one in an additional 10. When we consider that the IMF has now forecast economic growth rates of about 1% for the developing world, it must be assumed that the situation has already turned more critical for more countries since the report's publication, and will continue to do so during 2009.

5. Additionally to countries that have gone through the HIPC process, which run into new debt distress, other developing countries are very likely to run into over-indebtedness as a result of the global financial crisis and ensuing downturn, and that countries which never managed to get out of the debt crisis of the 1980s and 1990s will be pushed over the edge.

6. At the same time the spectrum of creditors and the variety of instruments these creditors use, has considerably widened in the past years. Some transformation and emerging economies have become important lenders themselves, and there is evidence that some of these newer lenders may lead a 'race to the bottom' in international lending. Philippe Maystadt, President of the European Investment Bank (EIB) told the Financial Times recently that, "the competition of the Chinese banks is clear [...] they don't bother about social or human rights conditions".[62] Debt driven by private investment funds and domestic lenders has also escalated.

[62] Financial Times, EIB accuses Chinese Banks of undercutting Africa loans, 28 November 2006

7. There is a danger that in both low and middle income countries a new round of defensive lending by multilateral institutions will start a new debt cycle like the one of the 1990s. The Stiglitz Commission, in their 2009 report for the United Nations General Assembly on reform in the international financial and monetary system remarked that:

> "A number of countries may face difficulties in meeting their external debt commitments as the crisis worsens and debt rescheduling becomes more and more difficult due to an increase in creditors not represented in the Paris Club. The current crisis has already seen a number of bankruptcies of companies that operate across national borders, and their number is likely to increase. The absence of a formal mechanism for dealing with the impact of cross border bankruptcy and insolvency, especially when related to financial institutions, transmits the adverse economic effects to the global economy."[63]

8. Further, no current framework exists for dealing with debt that violates jus cogens or the peremptory norms of international law. These would include the predatory activities of vulture funds, and the odious and illegitimate debts which were made to dictators or for ill-conceived projects, for example debts incurred by the apartheid regime in South Africa—clearly in these cases insolvency is not an issue. While currently countries can take steps to cancel, audit or repudiate these debts (as with the Norwegian cancellation of $80 million in 2006 or the Ecuadorian audit of 2008) there is no current process for co-ordinating these developments that does not violate the fundamental principal of the Rule of Law, namely that no one must be allowed to be judge in one's own cause.

The Fair and Transparent Arbitration Process

9. A fair and transparent debt work-out mechanism is essential to deal comprehensively and sustainably with developing country debts. The Stiglitz Commission make the following observation:

> "There is an urgent need for renewed commitment to develop an equitable and generally acceptable Sovereign Debt Restructuring Mechanism, as well as an improved framework for handling cross border bankruptcies. One way by which this might be done is through the creation of an independent structure, such as an International Bankruptcy Court. The United Nations Commission on International Trade Law provides a model that could be extended to the harmonisation of national legislation on cross border disputes dealing with trade in financial services."[64]

10. The main practical requirement of a Fair and Transparent Arbitration mechanism would be a panel to which both creditor and debtor could nominate either one or two persons, in the presence of the neutral third party traditional in international law. The arbitrators would chair and support negotiations and if necessary reach a decision.

11. There are several precedents for this form of arbitration which also offer routes open to the international community in developing Fair and Transparent Arbitration, none of which require new treaty:

— Arbitration is effectively used in the case of trade and investment disputes—through the International Centre for the Settlement of Investment Disputes—to whose jurisdiction both parties agree *ad idem* in the case of dispute arising.

— An arbitration process could be set up under the existing framework supplied by the United Nations Commission on International Trade Law (UNICTRAL), which involve 109 states and which has provided an effective context for Law of the Sea disputes.

— The Permanent Court of Arbitration in the Hague could begin to take sovereign debt arbitration within its ambit were new loans to have a clause in them stipulating the use of this body in the event of dispute.

12. It is vital that such a body does not merely preside over cases of insolvency, but also is able to encompass instances of debt which violate *jus cogens*. A proper arbitration mechanism would be able to address debt on this basis—such as the South African apartheid example—without raising the question of insolvency.

13. From a purely economic point of view, an FTA would have a positive effect on the functioning of the global economy. The impunity of bodies that currently lend to sovereign borrowers—protected by *pacta sunt servanda*—leads to an absence of risk that leads to distortion of the market. Equally, the increased certainty given to potential lenders by such a body would stabilise and consolidate the flow of essential and responsible capital to the developing world.

[63] J. Stiglitz—Recommendations by the Commission of Experts of the President of the General Assembly on reforms of the international monetary and financial system.

[64] J. Stiglitz—Recommendations by the Commission of Experts of the President of the General Assembly on reforms of the international monetary and financial system.

POLICY OPTIONS FOR THE UK GOVERNMENT

14. The UK could use its standing within international fora to promote the development of Fair and Transparent Arbitration. In particular, it can take advantage of the UN Summit in June 2009 to champion the idea, as well as taking the opportunity of the G20 meetings throughout the rest of 2009 to promote it.

15. In 2007 as part of the G8 the UK government made a commitment to a Charter for Responsible Lending which would set out the terms by which responsible new loan agreements would be made. It is now even more critical for the Government to make progress with this initiative and for it to include provision for Fair and Transparent Arbitration. At the same time the UK government should include a clause that refers to Fair and Transparent Arbitration in all new loan agreements guaranteed by the Export Credit Guarantee Department. This could be modelled on the suggestions laid out in the Charter for Responsible Lending of the European Network on Debt and Development (EURODAD)

> "the loan document should provide a provision for an independent and transparent arbitration process in case of repayment difficulties or dispute (at the request of borrower or lender). There will be a stay on debt repayment difficulties or dispute (at the request of borrower or lender). There will be a stay on debt repayments while negotiations are underway. The borrower will also be protected from litigation while negotiations are in progress. Borrowers and lenders will abide by the decision of the independent arbitrator and there is a right to appeal."[65]

Memorandum from the Association of British Insurers

The Association of British Insurers (ABI) is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. Through the ABI their voice is heard in Government and in public debate on insurance, savings and investment matters.

The insurance industry plays an important role in the financial services sector, not only as a provider of protection and savings products to the public, but also, through its investment activity, as a large provider of long term capital to British banks and industry. Members therefore have a strong interest in the smooth functioning of the financial system and are keen to play their part in contributing to solutions to the financial crisis.

We welcome the leadership the Treasury Select Committee has shown in its inquiry into the crisis and have already been pleased to respond to previous consultations. The Committee's inquiry has a wide remit. Our memorandum focuses on the proposals in the De Larosière report for changes to the supervisory architecture, on the conclusions of the G20 Summit, and on the proposals common to both for the establishment of supervisory Colleges.

EXECUTIVE SUMMARY

1. The key to restoring confidence in the financial system will be renewed confidence among consumers. The ABI therefore believes that changes to the supervisory architecture in financial services at EU and international level should be driven by the interests of consumers.

2. Consumers expect a safe and secure financial services system. Insurance is integrated into the financial system and so is not immune to the financial crisis. However, the conservative business model of insurance has allowed most insurers to weather the crisis, supported by an appropriate regulatory regime. All parts of the financial system should benefit from a similarly advanced regulatory environment. However, we should take care to avoid applying regulatory solutions automatically to all sectors of financial services. Insurance, banking and asset management have different characteristics, and require tailor-made regulatory regimes.

3. To make a real impact on consumers and deliver a financial system in which consumers can have confidence, it is not sufficient to write regulations. This legislative framework needs to deliver high quality supervisory decisions taken day-to-day across all sectors.

4. However, regulation must also promote competition and innovation that ensures markets work for the consumer. The response to the financial crisis carries a risk of over-regulation that would stifle innovation and increase costs, excluding consumers from the protection of insurance and other financial products. This is a particular risk for the UK, with our expertise in financial services, which can reasonably be expected to lead us out of recession.

5. In a world of globalised financial services, regulation must also work across borders. Colleges have a key role to play here. Without co-operation between national supervisory authorities, there is a real risk of regulatory fragmentation. This is why ABI supports the strengthening of the EU supervisory framework, broadly along the lines proposed in the De Larosière report. We must work to ensure that EU level initiatives are integrated into a global framework.

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[65] EURODAD Charter on Responsible Financing—2008

Potential areas of improvement in European Financial Regulation

European Systemic Risk Council

6. The De Larosière report suggests the establishment of a new body called the European Systemic Risk Council (ESRC). The role of the ESRC would be to pool and analyse information relevant for financial stability—looking at macro economic conditions and macro prudential developments in all sectors.

7. We agree that improved identification of macroeconomic risks is required and would have led to earlier action to prevent the current difficulties in the financial system and a faster response once the crisis had developed.

8. Such an institution would increase information sharing and promote a more comprehensive understanding of the risks to macro stability across the EU and the interaction with global developments. It has become even more evident in recent times that the financial sector is heavily inter-connected and the current crisis is global. We therefore believe the ESRC should work closely with other agencies internationally to improve understanding of systemic risks and enhance the opportunities for a co-ordinated, global response to these issues.

European System of Financial Supervisors

9. The ABI strongly supports the creation of colleges for the supervision of cross-border groups. We have long argued for an enhanced approach to supervision of groups and the Solvency II Directive, which we strongly support, has taken some important steps forward in this direction. We believe there is a strong case to move swiftly and boldly to deliver a more effective, consistent and harmonised supervision of insurance groups.

10. We agree with the proposal to establish a European System of Financial Supervisors (ESFS). This should facilitate more effective co-operation and consistency in supervision across the EU. We agree that as part of this process, the existing Level 3 Committees, CEBS, CEIOPS and CESR should be enhanced and established as independent authorities, free from direct political control, but clearly anchored within the existing EU legislative and institutional framework. They would be given the role of overseeing the quality of supervision and supervisory standards, including through peer review, and ensuring effective co-operation between supervisors, with the power to resolve disputes if necessary. They should not undertake supervision themselves, which would remain with national supervisors, and the remit of the ESFS should be confined to prudential issues.

11. We recognise that this will require a significant increase in the resources currently provided to the Level 3 Committees.

12. We agree that the three working together as the ESFS, should have the key competences identified in the De Larosière report, namely:

- i) Mediation between national supervisors. In the event of a dispute between home and host supervisors concerning the activities of a cross-border group, all efforts should be made within the college to reach an agreement.
- ii) Adoption of binding supervisory standards, where necessary to achieve harmonisation.
- iii) Adoption of binding technical decisions applicable to individual financial institutions, in support of (i) and (ii) above.
- iv) Oversight and coordination of colleges of supervisors; it should determine how the colleges are organised, allowing sufficient flexibility to allow each college to reflect the differing nature of the groups.
- v) Designation, only where needed, of group supervisors. We believe the home supervisor is best placed to have a full picture of the overall financial health of a cross-border group, through close contact and coordination within the college, and should by default be the lead supervisor.
- vi) Licensing and oversight of specific EU-wide institutions (eg Credit Rating Agencies, and post-trading infrastructures); A single-entry point for registration would be far less complex and burdensome.
- vii) Cooperation with the ESRC to ensure adequate macro-prudential supervision.

13. Whilst we support the proposed remit of the ESFS to improve the standard of supervision and harmonisation across the EU, in the context particularly of points (i), (ii) and (iii), we strongly support the assertions by the De Larosière group that national supervisory authorities must continue to be fully responsible for the day-to-day supervision of firms. Instead, we are looking to strengthen the overarching EU framework and so we welcome the creation of the regulatory structures outlined in De Larosière. We have long asserted the need for consistent supervision across the EU. We also recognise that such fundamental restructuring needs careful consideration, following proper consultation of the detailed measures as noted by the De Larosière Group and so we have significant concerns about the more truncated timetable proposed by the European Commission.

14. In other more radical areas (identified by De Larosière as Stage 2) we believe it is important to ensure the details are properly considered and implemented. These structural changes are for the long term and must be built to last.

Global Cross-Border Financial Regulation—Follow up to the G20

15. Insurance is a global business, and regulatory fragmentation is a major risk to our business model. We support convergence between European regulators. But by the same token the European framework has to work in harmony with regimes in other major jurisdictions.

16. The G20 meeting in London on 2 April hammered out a consensus on the international response to the financial crisis. We welcome the recognition by the G20 of the risks of protection and regulatory fragmentation, and their plans for meaningful co-operation between regulators at international level. However, the fine words came at the cost of a heavy regulatory programme among the international financial institutions.

17. The reports' analysis of the causes of the crisis omits any suggestion that regulators might bear a share of the responsibility. Their recommendations for the future appear to assume unquestioningly that any proposal to increase the level of regulation, or indeed to "expand the perimeter of regulation" must be beneficial. We do not support this simplistic view and believe that the costs and benefits of any new regulation must be carefully considered and should be subject to post-implementation review, to assess the effectiveness of the new proposals and consider other side effects of the new regulation.

18. The challenge now is for governments and regulators to follow fine words with sensible measures. The G20 conclusions do nothing to mitigate the risks of damage to the financial system from over-regulation in response to the crisis. The future of London as a financial centre rests on the development of a regulatory regime that is workable, and follows the grain of the markets. Insurers face a particular risk that banking-inspired measures will be extended thoughtlessly to insurance.

19. Much of the G20 agenda is already familiar from existing proposals by the FSA, the European Commission and other regulatory bodies:

- The International Accounting Standards Board has already made one set of changes to the international accounting rules on financial instruments, and there is an extensive debate on the need for further changes;
- The establishment by the G20 of the Financial Stability Board mirrors at international level the improvements to the Tripartite System in the UK, and De Larosiere's proposal for a European Systemic Risk Council at EU level;
- Remuneration has already been the subject of a paper by the Financial Stability Force and a draft FSA code of conduct; a recommendation by the European Commission is expected shortly;
- The European Commission has already published legislation on credit rating agencies, and restrictions on issuers of credit derivatives in the revision of the Capital Requirements Directive. We expect a proposal on hedge funds shortly;
- The International Association of Insurance Supervisors (IAIS) has already started revising standards on solvency, group supervision and risk management in the light of insurers' experience in the financial crisis.

20. However, some of the ideas set in the working papers for the G20 are potentially much more radical:

- The International Monetary Fund (IMF) is due to present a report in the autumn on systemic institutions, to include guidelines on the institutions and activities that might be considered "systemic". Radical solutions are being canvassed for institutions deemed "too big to fail": restrictions on risky activities, increased capital charges, leverage floors, and enforced structural separation;
- An IAIS Task Force on internationally active insurance groups under Michel Flamee is due to report in June, with significant implications for group supervision;
- Last year the FSA made proposals on liquidity buffers for banks, and work is in hand in the Basel Committee. The IAIS is also looking at liquidity in an insurance context;
- There are ongoing Basel Committee and IMF workstreams on banking resolution regimes, mirroring action taken by the British Government in the Banking Reform Act. These developments are of close interest to us as investors and as major holders of bank debt. However, the G20 working papers include an explicit recommendation that this work be extended to consider a resolution regime for insurers;
- Basel Committee work on improving the quality of tier 1 capital is very likely to have implications for Solvency II secondary legislation;
- The IMF and the Bank for International Settlements have a forward work programme on monitoring asset prices. There are clearly implications for insurers as well as for banks.

21. The implications for insurance of these ideas are not always fully thought through. There is more than a hint of regulators hastily extending their thinking to insurance as an afterthought. It will be important to ensure that they have adequate access to insurance expertise over the next six months.

Supervisory Colleges

22. Colleges of supervisors have been in existence for some time for cross-border groups. They do not work effectively and must be reformed. They rarely meet and lead supervisors are not noted for their attention to the views of others. They must have a clearer role and a stronger mandate. By bringing together the supervisors who have a particular responsibility for a part of the group, they can collectively consider the financial soundness of the group, or any part of it and co-ordinate any required action.

23. There is currently no formal procedure for the organisation of a College. Under current conventions, the home member states (known under Solvency II as the group supervisor) would take the lead in the College, being well positioned to have a good understanding of the entire group. In order to avoid too wide a variation of how Colleges work from one group to the other we favour more formal guidance on the operation of Colleges, to introduce consistency and certainty in their scope and remit. However, it is important to ensure that some flexibility remains as group structures vary.

24. We are also keen to stress that the limits of supervision and co-ordination for groups should not be at EU borders, because many groups conduct significant business outside the EU and may even have their headquarters outside the EU. It is imperative that appropriate consideration is given to how best to achieve effective co-ordination between all involved in the supervision of a group which operates in third countries.

April 2009

Memorandum from the CBI

1. Introductory Comments

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 the majority of the FTSE 100, some 200,000 small and medium-sized enterprises (SMEs), more than 20,000 manufacturers and over 150 sectoral associations.

The CBI welcomes the opportunity to submit evidence to the Treasury Select Committee's inquiry into the international dimension of the banking crisis. We have restricted our comments to section 2 of the Terms of Reference ("The potential reforms to the international financial regulatory system").

Given the nature of cross-border regulation and supervision that impacts the UK's financial services industry we refer principally to the de Larosière report (25 February 2009), the associated EU Commission's Communication (4 March 2009) and the UK's Turner Review (18 March 2009) in setting out our comments below.

The CBI has broadly welcomed the de Larosière report in principle and its focus on trying to improve the robustness of European Financial Services supervision and financial stability management in the context of the need for enhanced global co-ordination and co-operation. We support well-regulated financial markets and believe that any changes proposed should be aimed at restoring confidence in the financial system and improving the quality of supervision and financial stability management within the EU and globally.

It is important that any proposed changes in the UK and Europe take place in the context of the developments and improvements to the international frameworks, and that EU rules and structures are not out of line with them. Given the rapid change in circumstances within the global financial system it is not possible to propose changes in all areas simultaneously. We have therefore set out our key concerns with respect to the current proposals identified to date.

One fundamental aspect of any proposed changes must be to ensure that the European supervision framework builds and maintains the highest quality of supervision. National supervisors play an essential role in the supervision of individual firms. Whilst we continue to support enhanced, globally co-ordinated colleges of supervisors with well-resourced and expert level 3 committees, it must be made clear that the responsibility for supervision of individual firms be left with national supervisors.

2. Cross Border Financial Regulation and Supervision

There are two principal sets of proposals that we have considered below:

a) European body to oversee the stability of the financial system as a whole (macro-prudential)

b) Proposals on the architecture of European financial supervision (micro-prudential)

a) *Macro-prudential oversight*

We welcome and encourage the principle of a body to oversee financial stability, to act in a macro-prudential capacity to capture and analyse data across the financial services industry and to point out issues to key participants.

However, we have raised concerns regarding the structure of the European Systemic Risk Council (ESRC), the body proposed in Europe to address such a need. Whilst we understand that the operational matters of the ESRC are still to be worked out, we have emphasised the need to pay sufficient attention to non-banking bodies, as acknowledged by the de Larosière group, to reflect the full financial universe in its membership. Furthermore, we have highlighted that the ESRC's constitution under the auspices of the ECB may in our view not be wholly appropriate for a system of pan-European macro-prudential supervision including countries outside the Eurozone not withstanding that non-Eurozone central banks will be members of the ESRC.

The other principal issue (as clearly identified by the FSA Chairman Lord Turner in his review)[66] relates to the way in which the body will interact with member state organisations from a political and practical perspective. To be truly effective this needs to be subject to a robust mechanism of reaction from individual countries to ensure that warning signals are properly considered and acted upon. This mechanism needs to be balanced in order to provide an appropriate degree of flexibility and a "comply or explain" approach may be one way to achieve this.

The interaction with the International Financial Institutions (IFIs) such as the revised Financial Board, the International Monetary Fund, the Basel Committee, and IOSCO is also key. Financial stability surveillance should flow from global to regional to national (and back the other way where necessary). The IFIs need to be able to analyse, alert and consider required actions, and appropriate connections and communication is essential to achieve this.

At a national level, the Turner Review and the associated discussion paper[67] both make a compelling case for the FSA to be involved in a macro-prudential capacity in conjunction with the Bank of England. We support the conclusion that the FSA needs to take an industry-wide view of risk to financial stability, so it can fulfil its crucial supervisory role. But this bottom-up approach must dovetail with the Bank of England's top down view of financial stability across the financial system, to avoid the danger of duplication and dual supervision.

b) *Micro-prudential supervision, particularly in Europe*

Given the focus on cross-border supervision of firms, in particular within Europe, *both the de Larosière report and the EU Commission communication* propose a two-stage process to develop further a European System of Financial Supervision (ESFS).

We have supported de Larosière's first stage in which the three current level 3 committees (CEBS, CEIOPS, CESR) are strengthened to improve the quality of supervision in the EU, although remain wary of the difficulties that may arise given the ambitious timetable that is being proposed. These improvements are vital and urgent and a necessary precursor to further structural changes.

With respect to the proposed second stage whereby the level 3 committees are transformed into Authorities we make the following points:

— The regulatory philosophy of the proposed new bodies and structures should be clear from the outset. So far, there has been much discussion on the process and organisational issues, whereas there needs to be a focus on the "why" as well as the "how".

— It must be made explicitly clear that the responsibility for supervision of individual firms be left with national supervisors.

— The role of the European-wide bodies (however constituted) should confine itself to oversight of the system of European colleges of supervisors, to improve co-ordination of supervisors and ensure the convergence of supervisory opinions through peer group review of national supervisors, and assistance with developing consistency of technical rule-making across Europe.

— In articulating the responsibilities of the Authorities it must be made clear that they do not have power over national supervisors to make or change individual regulatory decisions and that this is not a transfer of supervisory power from individual Member States. Until such time as political decisions are taken on cross-border burden sharing in the event of a crisis and lender of last resort issues, moves to reassign supervisory authority from individual Member States will not help.

[66] Turner Review, 18 March 2009

[67] DP09/2, "A regulatory response to the global banking crisis", FSA, 18 March 2009

— We support the desire to improve rule-making in a co-ordinated manner, eliminating harmful national differences between regulatory regimes and regulatory arbitrage and providing oversight and "best practice peer review" of national supervisory operations. However, there must remain some degree of flexibility at national level with respect to rule-making for conduct of business regulation which needs to be appropriate for the national marketplace.

— The European colleges should be compatible and/or integrated with the global system of colleges being proposed. Parallel systems will duplicate efforts, be inefficient and could increase risks.

The overriding principle must be that fiscal responsibility (which resides at national level) leads to supervisory responsibility and vice versa.

In the UK, Lord Turner has proposed a new single EU level financial regulatory body, which would replace the three level 3 committees. As articulated earlier, our view is that a key first step in the development of the European financial supervisory framework should be the enhancement of the existing level 3 committees. Should moves towards a single body be pursued then we would strongly endorse Lord Turner's statement that such a body would have *"no powers over national supervisors to change individual regulatory decisions, nor to prescribe detailed supervisory practice"*. This would represent a necessary "line in the sand" with respect to the balance of regulatory and supervisory powers between the European Union and Member States.

We are concerned, however that the body proposed would have regulatory scope for both prudential and conduct of business regulation. As above, we remain of the view that there must remain some degree of flexibility at national level with respect to rule-making for conduct of business regulation which needs to be appropriate for the national marketplace.

International Co-operation and Global Consistency

We strongly support the need for international co-operation, international consistency and global colleges (which are already being established) to supervise cross-border organisations. EU arrangements must complement, and not duplicate, global college arrangements.

We do not believe that proposals intended to increase capital requirements specifically for organisations "investing in or doing business with poorly regulated or supervised financial centres…" are necessary. Such activity should already be captured by a risk based prudential capital regime, and we do not wish to see further artificial changes to the requirements.

3. Other Matters

Deposit protection schemes

Whilst we support a strong framework of deposit protection within the financial industry to ensure consumer confidence, we do not support pre-funding of deposit protection schemes and the current EU proposals in this area (as set out in the de Larosière report and EU Commission communication). The amounts required for any major organisation in the EU are not feasible. This is particularly relevant given the timeframes envisaged and at a time when the focus is on re-building banks' balance sheets. In addition, the standing fund is likely to be an inefficient use of capital and proposals should instead focus on harmonisation of outputs (eg levels and scope of protection, payout timings etc).

Crisis management

We strongly support the increased regulatory and supervisory focus on "what to do in a crisis situation". Such activities, which are perhaps straightforward, have been shown to be lacking in the recent financial crisis. This includes simple logistical points such as phone numbers for contact out of hours. Such straightforward proposals would assist co-ordination during crisis situations.

Timing of implementation of change

The timescales proposed for the supervisory changes in the de Larosière report, the EU Commission communication and, to a lesser extent, the FSA's Turner Report are tight. Whilst we recognise the desire to ensure the European regulatory architecture is robust, we are concerned that the timing is not realistic and the risk of disrupting the quality of supervision in the EU is high.

It is important that the "Better Regulation Agenda" is brought to bear on any proposals and that a thorough regulatory impact assessment is done as the costs and dangers of unintended consequences could be very significant. Given the long lasting effects of the proposed changes it is crucial to take the right and proportionate approach and the timing should be co-ordinated with other international developments to avoid opportunities for regulatory arbitrage.

Comments on the Chancellor's letter to Czech presidency regarding European financial regulation and supervision

We believe that the Chancellor's letter to the Czech Minister of Finance (3 March 2009) which sets out HMT's views on the de Larosière report proposals represents a missed opportunity to articulate the views of the UK industry and the necessary points set out in the document.

4. Conclusion

In determining the future shape of the European and global cross-border 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 in the global financial system. Our key concerns are to ensure that:

- The amendments currently proposed by the European Union are subject to better regulation principles and full regulatory impact assessments, are proportionate and do not damage the functioning of European markets to the detriment of our corporate and financial members, their customers and investors, and the European economy;
- The future issues of competition and the unwinding of Government intervention in a timely manner when the financial crisis has passed are examined;
- The improvements achieve a robust pan-European financial supervisory and financial stability framework that is well integrated with a robust global framework of standard-setting, supervisory co-ordination through colleges, and global arrangements for financial stability management. This approach must be supported by focussing on improving the quality of European supervisory co-operation through the level 3 committees;
- There is greater clarity around the proposed improvements for the ESFS to ensure the responsibilities, composition and accountability of the new and existing bodies and Member States are appropriate and clearly defined; and
- The changes to the regulatory and supervisory framework should not undermine responsible innovation and appropriate risk-taking.

April 2009

Memorandum by the Investment Management Association

Executive Summary

1. The IMA[68] welcomes the opportunity to submit evidence to the Committee's Inquiry. We represent the buy side of financial markets in the UK and our members' business activities are defined by their cross-border nature. In particular the great bulk of funds business is carried out under the UCITS[69] Directives. IMA members, therefore, have a strong interest in a harmonised European supervisory framework with powerful European authorities cooperating closely with national supervisors. The inherent logic of the internal market calls for Community legislation to be accompanied by harmonised EU-supervisory standards, thereby reducing the compliance costs linked with 27 supervisory practices.

2. IMA welcomes both the proposals made by the de Larosière Group on the future supervisory framework and the European Commission's Communication "Driving European Recovery" which set out a clear roadmap for a reform of the financial system. However, we are concerned that by simply following the Group's recommendations, the EU might approach modernisation from a purely banking and insurance perspective, ignoring the securities sector in general and the asset management industry in particular. Experience from recent legislative initiatives indicates a tendency to approach EU legislation from the perspective of the sell side, paying insufficient attention to the interests of investors.

3. Supervision should aim to encourage the smooth functioning of markets and the development of a competitive industry. However, even competent supervision cannot compensate for failures in financial regulatory policy. Therefore, we comment not only on the proposals for the future supervisory architecture, but also on the regulatory framework.

4. At the heart of the debate about how the financial crisis came about, how to deal with it, and how to prevent it in the future lies the question of regulation. The years ahead will witness the most important regulatory reform debate of our time. While there will be proposals from the EU, for example on hedge funds and future supervisory structures, the focus should be on the regulation of banking. We need banks which

[68] The Investment Management Association (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 £3.4 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.

[69] Undertakings for Collective Investment in Transferable Securities

are simpler, more transparent and once again capable of attracting private capital. The last two years have been devastating for the European economy and for its financial infrastructure. It is encouraging to see the EU is addressing the issues with real intent and commitment to reform.

5. In this context, we take note of the European Commission's intention to modify the Capital Requirements Directive further. Notwithstanding the urgency, we urge it to ensure that changes to the regulatory capital regime for banks do not unintentionally or disproportionately impact other sectors of the industry also subject to CRD, such as asset managers. The business model of banks differs fundamentally from that of asset managers where clients' assets are kept separate from the assets of the managers. Therefore, a one-size-fits-all approach should not be applied.

6. Stable financial markets and trust among all market participants are a necessary prerequisite for an effective asset management industry. IMA strongly supports well regulated financial markets. They are to the benefit of investors and hence the investment management industry. Current regulation of the investment management industry has served the industry and its clients well, and the IMA considers that the fund and asset management sector as a whole has proved fairly robust over the past months in the UK despite the continuing crisis in the financial system.

7. The long term challenge will be to develop equally robust regulatory structures and regimes for other parts of the financial sector. While a consistent approach internationally would clearly be desirable to avoid regulatory arbitrage, it would be unrealistic to expect that a fully integrated and comprehensive set of global reforms will provide a complete solution. The financial crisis has not affected every country as severely as it has the UK and US banking systems—for example, within Europe, the Scandinavian banks have not suffered to the same extent, and the impact has been less in Asia than in Europe and North America. And there remain important issues to address at the national level, for example the current review of UK insolvency arrangements in the wake of the collapse of Lehmans.

8. In conclusion, we are convinced that regulatory reform must be targeted, measured and considered, and regulatory arbitrage must be avoided. Reform should focus on those sub-sectors where regulatory deficiencies have been identified. There must be no automatic read-across of regulation to the asset management sector which was not at the origin of the crisis and where existing regulation proved adequate.

European Supervisory Structure

Macro-prudential oversight

9. We recognise the need for adequate macro-prudential supervision and effective early warning mechanisms. Therefore, we welcome the creation of a European Systemic Risk Council and we share the de Larosière Group's view that "to be effective macro-prudential supervision must encompass all sectors of finance and not be confined to banks, as well as the wider macro-economic context." We also welcome the G20 conclusion to reinforce the role of the Financial Stability Forum as it becomes the Financial Stability Board. Good coordination between the two bodies will be essential as the stability issues do not recognise continental borders.

10. We want to stress that in gathering the data needed by the new body, a duplication of reporting requirements, ie that the same information has to be provided to various bodies in various formats, must be avoided, and that existing information sources should be exploited fully before imposing new requirements. The efficiency and success of the ESRC will depend on the information flow between the ESRC and the micro-prudential, ie the future European Authorities and national supervisors. Asset managers should not be required to report the same information to various authorities, instead authorities should agree to exchange this information amongst them. This implies that reporting requirements should be streamlined both in terms of format and content whilst being proportionate and tailored to the specific characteristics of the entities required to report. Indeed, the reporting requirements should not place an unreasonable burden upon market participants in terms of costs and efforts, and an obligation to report each and every transaction should be avoided.

11. Finally, we believe that a proper and permanent representation of the asset management industry must be ensured in a future "European Systemic Risk Council". We welcome Recommendation 16 of the de Larosière report stating that "high-level alternates to the central bank Governors should take part in the discussions, in particular when insurance or securities markets issues are discussed". However, we are concerned that the permission of the high-level alternates to take part only in specific discussions (and not on an ongoing basis) will not sufficiently take into account the importance and needs of the asset management industry as the buy-side in financial markets. We see the risk that macro-prudential supervision will be exercised from a purely banking perspective, which should be avoided.

Micro-Prudential Oversight

Establishing a European System of Financial Supervision

12. IMA members provide asset management services, distribute investment funds and act as investors in the securities markets of all the 27 EU Member States. A harmonised regulatory and supervisory framework is therefore of crucial interest to us. It is very expensive and inefficient to operate under 27 different sets of rules/differing interpretations of the EU rules. So far in many areas of financial markets regulation and especially supervision national differences remain strong beneath a thin layer of European harmonisation.

13. There has also been all too much gold-plating of the EU rules, with national regulators adding requirements on top of the EU requirements as they see fit. There are a lot of examples on this for instance with the Markets in Financial Instruments Directive (MiFID) and UCITS Directives. The simplified prospectus for UCITS funds is a good example where the benign intentions of European legislators to achieve a short, harmonised document to be used across Europe failed completely because of the diverse implementation and gold-plating by national regulators. This necessitated a review of these requirements in the UCITS IV package and again expectations are high that Europe gets it right this time, but only national implementation will tell whether the aims will be achieved this time around.

14. The 3L3 Committees (CEBS, CEIOPS and CESR) have reached their limits, not only in terms of resources, but also legal powers. Therefore, we strongly support the strengthening of the 3L3 Committees and transforming them into European Authorities (European Banking Authority, European Insurance Authority and European Securities Authority) with real powers, whilst leaving day-to-day supervision to national supervisors, thus making full use of their local knowledge. This will help to reduce significantly the huge compliance costs faced by IMA members who operate on a cross-border basis in the securities markets of all 27 EU Member States.

15. In particular, we welcome the proposal that the future authorities should be able to adopt binding technical level 3 interpretation and supervisory standards. This will help to prevent Member States and national regulators from gold-plating of EU rules. In this context, we stress the need for timely interpretation of EU rules, meaning that for each project, deadlines should be fixed by which binding technical level 3 interpretation and supervisory standards have to be issued in order to ensure coherent interpretation across Europe, legal certainty and a smooth functioning of the internal market.

16. We strongly support the Commission's proposed actions to introduce a far more consistent set of supervisory rules. We also support the proposed overall supervisory structure, establishing a European System of Financial Supervision, with national supervisors still responsible for the day-to-day supervision but with a strengthened coordination at the European Level. Local knowledge is needed to apply the rules to the supervised entities, but more and more the aim should be one set of rules so strong coordination of the supervisors at European level is needed. We support the strengthening of the 3L3 Committees and transforming them into European Authorities with real powers. Our members need certainty of the rules applicable.

Mediation and arbitration

17. In addition to the new legally binding mediation mechanism between national supervisors and the new legally binding technical level 3 interpretation that will be issued by the future Authorities, we would welcome a legally binding arbitration mechanism covering disputes between an individual firm and its national supervisor. Such disputes should include diverging views between a national supervisor and an individual firm on national interpretation of an EU Directive.

Accountability

18. IMA agrees with the de Larosière Group's view that governance and accountability of the three future Authorities will be crucial, and that the right balance must be found between accountability on the one hand and a high degree of independence on the other.

Timing

19. Although we believe that a new European supervisory architecture should be introduced sooner rather than later and that the EU should use the political momentum to make substantial progress, the quality of the structure and expertise should not be given up at the expense of speed. Therefore, we believe that the two-step approach proposed by the de Larosière Group is sensible and might better guarantee that the interests of all stakeholders are taken into account and that "easy wins" such as reinforced resources for the Level 3 Committees could be realised at an early stage.

Global Crisis Calls for Global Solutions

20. It cannot be stressed enough that financial markets are global and their problems are global, but that regulation/supervision remains mainly national. We urge Europe to coordinate with the key non-EU jurisdictions the regulatory measures to address the crisis. Future EU actions should be consistent with the G20 decisions.

21. We believe that protectionism would be very harmful in the long run for Europe's financial markets and European market participants. There have been worrying examples of this such as the Commission proposal for a Regulation of Credit Rating Agencies which as originally proposed would have allowed European market participants only to invest in rated issues if the rating is European.

22. We do not believe that taking the view that only European regulation can protect investors is valid or beneficial for Europe's financial markets. The position of third countries must be carefully taken into account in a balanced manner. For example, the UK/European asset management industry is a major exporter of EU harmonised investment funds (UCITS) into Asia and Latin America. Closing Europe's borders is not an option in the globalised economy. We agree that Europe can and should take the lead, but it must act responsibly and in coordination with other continents.

April 2009

Memorandum from ACCA

INQUIRY INTO THE INTERNATIONAL DIMENSION OF THE BANKING CRISIS, WITH SPECIFIC REFERENCE TO THE DE LAROSIÈRE REPORT

1.0 INTRODUCTION

1.1 The Association of Chartered Certified Accountants (ACCA) welcomes the opportunity to respond to the Treasury Committee's inquiry into the international dimension of the banking crisis. Our global footprint and expertise puts us in a strong position to comment on these issues.

1.2 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.

1.3 ACCA has its headquarters in London and 141,330 of our members, students and affiliates are based in the UK. Globally, we support our 131,500 members and 362,000 students throughout their careers, providing services through a network of 82 offices and centres around the world.

1.4 The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; pensions; education; and corporate governance and corporate social responsibility.

1.5 Our staff around the world have been working with members and others in the financial services sector to develop the network necessary to understand the financial crisis from the perspectives of governance, remuneration, regulatory and accounting stances.

2.0 SUMMARY OF KEY POINTS

a. Be clear on the purpose of regulation

The purpose of regulation is to facilitate legitimate and competitive business activity while providing safeguards for the interests of stakeholders. Regulation should be flexible and principles-based, with a strong emphasis on ethical codes and practices. It should recognise the complexity of trading in global markets, while being grounded in simplicity.

b. Co-ordinated national action

It is vital that governments pursue coordinated national action for the regulation of financial markets.

c. Complexity

The complexity and opacity of some investment products contributed to the crisis. Neither regulators nor bank boards appear to have sufficiently understood or controlled these products. Effective regulatory control at any level requires both transparency and comprehensibility; regulation should encourage greater clarity and understanding and, where necessary, demand proper explanation of opaque financial instruments.

d. Segmented regulation

Some banks are perceived to have become too big and interconnected to be allowed to fail; more importantly, many have become too complex to manage and therefore to regulate. This is unsatisfactory and a lasting solution needs to be found. Combining retail and investment activities increases complexity considerably. Although a return to the Glass Steagall separation of retail and investment activities may no longer be practicable regulators need to pay attention to complexity as well as materiality.

e. Capital adequacy: encourage stability not pro-cyclicality.

Basel 2 capital requirements added to pro-cyclicality in the business cycle, because the accord requires banks to increase their capital ratios when they face greater risks. Unfortunately, this may require them to lend less during a recession or a credit crunch, which could aggravate the downturn. Regulation should act as a shock absorber and limit the worst effects of pro-cyclicality to ensure a smoother ride for the economy. Consideration should be given to designing a series of indicators to help regulators assess risk; these might include trends in trade deficits or economies and levels of leverage and indebtedness at country, firm and individual level.

f. Supervision

It has been argued that many of the present problems arise from poor supervision of existing regulation rather than insufficient regulation. The nature of the reforms proposed will place additional demands of supervisors. They will almost certainly need additional resources and skills to meet what will be needed of them.

3.0 Context

3.1 Broad consensus is emerging that the financial system is broken and must be fixed. These views are outlined in a number of key reports published recently, including:

— The report by the Group of Thirty, chaired by Paul Volcker, Financial Reform: A Framework for Financial Stability[70]

— The Turner Report, A Regulatory Response to the Banking Crisis[71]

— The Geneva Report on the World Economy, *The Fundamental Principles of Financial Regulation*[72]

3.2 The de Larosière report represents a rigorous assessment of the shortcomings of the current, mainly national-based regulatory system while also making recommendations to resolve these shortcomings. Although the report does not set down new rules, it provides a series of recommendations; these proposals will be key drivers of the shape of regulation and supervision in the EU in the months and years to come.

3.3 The overall approach suggested by de Larosière is three-tiered and involves:

— A systemic risk regulator at the "top"—the European Systemic Risk Council, which the Report recommends be housed at the European Central Bank.

— Functional regulators in the "middle"—European banking authority, European insurance authority, and European securities authority, for the respective functions.

— National versions of the three functional regulators at the "bottom"

3.4 The de Larosière report is focused on the EU, but it does cover global aspects of the new reforms it proposes. The report is an important contribution to the future global financial architecture, especially its proposals for reform of EU regulatory supervision and global coordination.

3.5 Previous attempts to overhaul EU financial regulation have exposed divisions between countries in favour of a single European regulator and those opposed to the idea.

4.0 Response to specific points in the report

4.1 *The European Systemic Risk Council*

4.1.1 The aim of the European Systemic Risk Council would be to collect information and analyse it to detect sources of systemic risk and financial instability, bringing together representatives from the central banks and financial regulators of all the EU's 27 member states, under the chairmanship of the European Central Bank.

4.1.2 The global financial regulatory frameworks currently pays too little attention to "systemic risk". As a result, while individual risks are properly dealt with in normal times, the system itself remains vulnerable to large macroeconomic shocks.

4.1.3 The report is clear on the need to introduce macro-prudential supervision, taking the view that the financial crisis has illustrated that the micro-focus of supervisors on individual institutions is not enough. The report rightly argues that a binding mechanism is needed to make sure that the macro-prudential findings of the ECB are followed by the micro-prudential supervisors. The focus should be supplemented by a macro-approach to detect the development of imbalances in the financial system, such as excessive capital growth. Moreover, a macro-approach is needed to counter the pro-cyclical nature of capital adequacy rules. The report assigns this task to the European Central Bank.

4.1.4 Overall, this structure is logical. It makes it clear that the key is to coordinate, rather than to centralise all activities in one institution. It also makes a definitive bid to set up an overarching regulator that can take a systemic perspective and cut across the various functional regulators and institutions. It

[70] http://www.group30.org/pubs/reformreport.pdf
[71] http://www.fsa.gov.uk/pubs/other/turner_review.pdf
[72] http://www.voxeu.org/reports/Geneva11.pdf

recommends setting up global "colleges" of supervisors for cross-border institutions. We agree that the ECB should undertake this task in the context of the general council, covering all EU countries, rather than in the governing council, covering only the eurozone.

4.1.5 However, the first step towards regulating systemic risk is to measure it. However, it is unclear how this should be undertaken, what should define how much a particular firm contributes to systemic risk and how Value at Risk (VaR) measures and risk management practices inside financial firms can be improved and can create the basis for constructive dialogue between these firms and their regulators. More empirical work is needed to show that the proposed measures can be used to identify institutions that pose systemic risk before a crisis hits.

4.2 *Basel II, capital requirements and procyclicality*

4.2.1 Lord Turner and de Larosière both agree that recent turmoil has confirmed concerns previously expressed by the industry itself that in severe conditions the Basel II Accord would increase strains on bank capital ie that it was "procyclical" in effect. Although the relatively new Basel II capital requirements were not blamed for the crisis, a fundamental review of Basel II is recommended. In particular:

— an increase in minimum capital requirements and an improvement in the quality of capital

— a reduction in pro-cyclicality

— stricter rules for off balance sheet items

— a review of the inclusion of hybrid instruments in tier 1 capital

4.2.2 Both reports suggest that capital adequacy requirements should incorporate liquidity risk, and that they should be tightened in good times—when systemic risk is building up but has not yet been realised—and should be loosened in bad times when banks need a breathing space to weather the crisis.

4.2.3 As stated above, ACCA agrees that Basel II capital requirements added to pro-cyclicality in the business cycle. The accord requires banks to increase their capital ratios when they face greater risks. Unfortunately, this may require them to lend less during a recession or a credit crunch, which could aggravate the downturn. We believe that regulation should act as a shock absorber and limit the worst effects of pro-cyclicality to ensure a smoother ride for the economy.

4.2.4 Consideration should be given to designing a series of indicators to help regulators assess risk; such indicators might include trends in trade deficits for economies and levels of leverage and indebtedness at country, firm and individual level. Capital requirements should be cyclically adjusted and increase when the economy recovers from the current situation

4.3 *Large Complex Financial Institutions (LCFIs) and moral hazard*

4.3.1 Both Turner and de Larosière agree that current regulations do not deal adequately with LCFIs. A key problem in improving LCFI regulation is that there is not currently a single, solid definition of LCFIs.

4.3.2 LCFIs across the world tend to have global footprints, as they operate both domestically and across national borders. These institutions are regulated differently in the various countries in which they operate. In the light of the current financial crisis, it may be more sensible to regulate these institutions as unified entities in order to achieve a better oversight of their operations.

4.3.3 Some banks are perceived to have become too big and interconnected to be allowed to fail; combining retail and investment activities increases complexity considerably and makes them difficult to regulate. This is unsatisfactory and a solution needs to be found.

4.3.4 The costs of LCFI failures are large and concentrated. It is therefore tempting for regulators to focus on bailouts rather than on incentives. But this is clearly the wrong policy for the long term, and incentives and accountability must be improved.

4.3.5 Regulators in the banking sector should adopt a risk-based approach to concentrate regulatory efforts on those institutions which wield disproportionate market influence and whose failure would pose the greatest threat to the financial system.

4.3.6 Firms themselves should be expected to satisfy the authorities on an ongoing basis that they are managing risk actively and competently in the particular circumstances of their business. Regulators need to be acutely aware of responding correctly to those firms which have fundamentally changed their business model.

4.4 *Supervision and the correction of regulatory weakness*

4.4.1 The financial crisis has made it clear that many aspects of financial regulation need to be reconsidered. The regulatory framework needs to be redesigned to cater for increasingly complex financial structures, and steps need to be taken to improve the transparency and stability of financial markets. The de Larosière report makes the distinction between regulation (the set of rules and standards financial institutions must adhere to) and supervision (the process designed to oversee financial institutions).

4.4.2 There is a need to be clear on the purpose of regulation. The purpose of regulation is to facilitate legitimate and competitive business activity while providing safeguards for the interests of stakeholders. That regulation should be flexible and principles-based, with a strong emphasis on ethical codes and practices, should recognise the complexity of trading in global markets, but also be grounded in simplicity.

4.4.3 There should also be a separation of policy-making (rules and regulations) and compliance (monitoring and enforcement). There should be public oversight of the system with "heavyweight" industry experts to conduct monitoring, with legal and regulatory teeth to pursue issues identified.

4.4.4 Plans to reform the way the financial services sector is regulated also need to forestall future crises, not simply focus on past failings in the system. While areas of financial abuse need to be addressed in any new approach to regulation, we need to ensure that it is sufficiently principles-based and flexible to be relevant and applicable to a fast changing business environment. The priority has to be to ensure that existing legislative and regulatory measures are implemented and enforced effectively, rather than reactively rushing through new legislation. In areas such as accounting, being too prescriptive with global measures could backfire. Issuing guidance that results in mechanical rule-following would be a recipe for disaster. Principles-based standard setting and professional judgement have a vital role to play and should not stifle recovery.

4.4.5 A significant portion of the report discusses the supervisory structure in the EU. Although the report does not suggest that the national regulators should be replaced by a single EU regulator, some changes to the structure of EU supervision are proposed including:

— A macro-prudential supervision role for the European Central Bank (ECB)

— A new European Systemic Risk Council (ESRC) to review macro-economic conditions and prudential requirements

— The set up of a new European System of Financial Supervisors (ESFS)

— Replacement of the three so-called "Lamfalussy Committees"[73] with three new European authorities to coordinate the application of supervisory standards

The report proposes a two-stage timetable for the establishment of this new European system of financial supervision with completion in 2012.

4.4.6 The nature of the reforms proposed will place additional demands on supervisors. They will almost certainly need additional resources and skills to meet what will be required of them.

4.4.7 A consensus is emerging that a new system of global regulation is required. The global governance issues that need to be considered are many and varied and include:

— the need to improve co-ordination at global level

— the design and implementation of a global early warning system which will pick up on future risks to global economic and financial stability and ensure that avoidance measures are taken early

— globally accepted standards of supervision and regulation applied equally and consistently in all countries

— effective cross-border supervision of global firms, possibly through international colleges of supervisors

— the need to review the role of international financial institutions

4.4.8 The EU should take a lead here in shaping the new global governance around progressive values and it is vital that governments pursue coordinated national action for the regulation of financial markets.

4.5 *Complexity and the "parallel banking system"*

4.5.1 The term "parallel banking system" is normally used to refer to firms engaged in financial activities such as hedge funds, investment banks and mortgage brokers, which are not banks. The complexity and opacity of some investment products made it difficult for regulators to understand the extent of risk-taking in the international financial system and therefore contributed to the crisis. Neither regulators nor bank boards appear to have sufficiently understood or controlled their use.

4.5.2 The de Larosière report recommends appropriate regulation of the parallel banking system and highlights the importance of identifying systemically important hedge funds since banks are often major lenders to these funds. The report also suggests the need for greater transparency and disclosure requirements.

4.5.3 Effective regulatory control at any level requires both transparency and comprehensibility; regulation should encourage greater clarity and understanding and, where necessary, demand proper explanation of opaque financial instruments. At consumer level, regulation should seek to enable individuals to understand what they are buying. Financial literacy programmes should be encouraged.

[73] The Committee of European Banking Supervisors (CEBS), the Commitee of European Insurance and Occupational Pensions Supvisors (CEIOPS), and the Committee of European Securities Regulators (CESR)

4.5.4 It is also crucial that regulation, at both national and international level, is characterised by simplicity to the extent that both regulators and the regulated understand what is expected of participants.

4.5.5 The EU has used regulation as an effective tool to promote a more efficient financial services market where there has been market failure. However, in the process of developing such regulation it is essential that all stakeholders are consulted, particularly consumers and SMEs, to ensure that their needs are reflected in Directives. Between October 2002 and June 2005 there were 1,680 responses to 46 European financial services consultations. Only 13 of these responses derived from consumer groups. ACCA therefore believes that the greater efforts should be made to ensure adequate consumer representation, especially on issues as serious as this.

4.6 *Mark to market accounting*

4.6.1 The report highlights the difficulty of applying mark to market accounting in certain market conditions, especially markets which become illiquid, and identifies International Financial Reporting Standards (IFRS) as also having had a pro-cyclical impact. It recommends a review of the mark to market principle, concluding that moving to mark to market accounting, rather than the more traditional held to maturity, exacerbated volatility in the accounts of banks—with valuation becoming practically impossible for some securities as the market in them disappeared.

4.6.2 ACCA does not believe that fair value accounting is a cause of the banking crisis, but accepts that it may have exacerbated it. 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. Some may not have accepted the answers produced by fair value accounting and therefore concluded that the method must be wrong. Others perhaps have believed the figures but considered the information too dangerous to be in the public domain.

4.6.3 ACCA believes, however, that the extent of the optional use of fair value has possibly 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. The International Accounting Standards Boards (IASB) should not allow further classes of assets or liabilities to be stated at fair value, beyond those currently permitted.

4.6.4 Overall, we see no case for the extension of the use of fair values in accounting standards at present, particularly in areas where markets are non-existent or thin such as partially complete sales or insurance contracts. The current crisis has highlighted the risks of using unreliable values. Conversely, the IASB should not narrow the definition of fair value to a current market exit value, but permit some flexibility to allow that different sorts of current values might be needed in different circumstances.

4.6.5 There have also been criticisms that fair value has removed the role of the accountant's judgement by allowing values to be dictated by whatever could be achieved in the market on a given balance sheet date. The process is still unfolding and only hindsight will tell us if the values for much of the instruments in question will turn out to be unrealistically low or about right.

4.6.6 ACCA believes that alternative values, such as historical cost, should also be disclosed in the accounts if fair value is being used so that users can make up their own mind on whether current, possibly depressed, prices accurately reflect true underlying value. The issue then would be whether this represents beneficial additional transparency or information overload. The IASB and FASB, both of whose standards have attracted criticism for length and complexity, could consider this point when continuing their convergence roadmap process.

4.7 *Corporate governance and compensation incentives*

4.7.1 ACCA agrees that underlying much of the credit crunch has been a fundamental failure in corporate governance. ACCA is actively involved around the world in promoting best corporate governance practice, and has examined this issue in detail, producing discussion papers including *Corporate Governance and the Credit Crunch,*[74] *Climbing out of the Credit Crunch*[75] *and the Corporate Governance and Risk Management Agenda.*[76] *These papers are the result of meetings held by ACCA with experts from financial services, academia and accounting about the causes of and lessons to be learned from the credit crunch. They take a wide view of the factors leading to the credit crunch and explore how poor corporate governance contributed to the problems. ACCA has identified ten corporate governance principles, which include:*

- Boards, shareholders and stakeholders sharing a common understanding of the purpose and scope of corporate governance
- Boards leading by example
- Boards appropriately empowering executive management and committees
- Boards ensuring that their strategy actively considers both risk and reward over time
- Boards are balanced

[74] http://www.accaglobal.com/pubs/economy/analysis/acca/technical_papers/tech_2.pdf
[75] http://www.accaglobal.com/pdfs/credit_crunch.pdf
[76] http://www.accaglobal.com/pubs/economy/analysis/acca/technical_papers/tech_2a.pdf

— Executive remuneration promoting organisational performance and being transparent

— An organisation's risk management and control is objectively challenged, independently of line management

— Boards account to shareholders and, where appropriate, other stakeholders for their stewardship

— Shareholders and other significant stakeholders hold boards to account

— Corporate governance should evolving and improving over time

4.7.2 The compensation and bonus structures at financial institutions are also criticised and recommendations are made that bonuses are in future better aligned to the long term profitability of the firm. Turner, de Larosière and the G7 group have all recommended changes to the remuneration of executives with a particular focus on changing the bonus culture.

4.7.3 ACCA believes that executive remuneration arrangements should promote organisational performance. Existing incentive and career structures of banks meant enormous rewards but reinforced short term thinking.

4.7.4 If not addressed, remuneration issues will continue to frustrate other attempts for reform. This is a human behaviour challenge. Risk management and remuneration and incentive systems must be linked. Executive payments should be deferred (eg held in an escrow account) until profits have been realised, cash received and accounting transactions cannot be reversed. Instead of paying out on paper profits, there must be a much stronger link to genuine operational cash flows. These measures would make the risk management function more important in organisations—risk managers should be regarded as having a status equal to those in the 'front office' and should be remunerated accordingly.

4.7.5 We question whether the relative share of bank income paid as remuneration compared with dividends over the last decade has been in the best interests of shareholders. Investors and shareholders have limited ability to influence companies they own. Not all shareholders invest for the long-term and not all of them have an interest in holding boards to account for their stewardship. This is a fundamental governance challenge in capital markets where shares are widely held, and is not confined to the banking sector. The emergence of new strategies (eg using derivatives) for participating in corporate profitability and new types of shareholder, such as sovereign wealth funds, compounds the challenge.

4.7.6 One way to help address both challenges is to ensure that boards and shareholders receive appropriate, clear, timely and reliable information on risk and financial results.

5.0 Conclusion

ACCA believes that the de Larosière report represents an important contribution to providing a blueprint for the future global financial architecture. It takes several important steps forward, especially on its proposals for reform of the supervisory role in the EU regulation and to an extent also in the global coordination of reforms.

Most of ACCA's recommendations do not require more regulation but more common sense in the implementation of existing rules, and many of the required improvements could be the result of better standards and principles agreed upon by the financial services industry.

The need to look forward makes it essential that a new regulatory regime is thoroughly thought through, is consistent with G-20 deliberations and includes a robust early warning system. In future we need a system where sound regulation, supervision and good corporate governance reinforce each other. While we prefer a market solution rather than a regulatory answer to the other contributory factors, ACCA urges regulators to consider the problem as a whole.

April 2009

Memorandum from the TUC

International Finance Reform

Introduction

The TUC welcomes this opportunity to give evidence to the Treasury Committee inquiry into the international dimension of the banking crisis. The TUC represents nearly 6.5 million workers in 59 trade unions. We represent workers in the financial sector currently losing their jobs because of the failings of their institutions' leaders; we represent workers in the rest of the private sector, also increasingly at risk of redundancy; and those in the public sector who are in danger of paying for the costs of bailing out the banks with lower wages and job cuts. It is essential that lessons are learned from this crisis and reforms of both national and international financial regulatory systems put in place. There must be no return to "business as usual".

The TUC is a member of the European Trade Union Confederation, the International Trade Union Confederation (ITUC) and the Trade Union Advisory Committee to the OECD (TUAC). The ITUC and TUAC, together with the Global Union Federations, submitted a statement on behalf of the international trade union movement to the G20 meeting in London.[77] This statement is attached as an annex for the Committee's information.

Macroeconomic imbalances

There has rightly been much discussion of the weaknesses in financial regulation and practices which were a major cause of the current global economic crisis. However, weak financial regulation and practice, though very important, were not the only causes of the crisis. The abundance of cheap credit in the countries, particularly the US, from where the crisis stemmed was a significant factor in the scale of the sub-prime loans that were made and the heavy leveraging of financial transactions that magnified the losses into the toxic debt of still unknown proportions that continues to drag down the whole of the financial system.

Behind the availability of cheap credit in the US, the UK and other advanced economies were the massive trade deficit of the US and to a lesser extent the UK and countries such as Spain, and the massive trade surpluses of, in particular, China, Japan and Germany, oil exporting countries and some other Asian economies such as South Korea. The rapid growth of Sovereign Wealth Funds financed mainly from the foreign reserves surpluses of oil exporting countries, China and Korea is a symptom of the enormous current account surpluses that these economies were running.[78]

Even with much tighter financial regulation, a surplus of over-cheap credit is very likely to lead to distortions in economic behaviour. Alongside weak regulation, the easy availability of credit was a major factor in encouraging the sharp rise in sub-prime mortgage lending to people who did not have the ability to pay back the loans.

The sharp rise in the scale and number of private equity buyouts in recent years relied heavily on the availability of cheap credit, which fuelled the size of the buyouts and the ever-increasing debt ratios that were employed in the purchases. The risks of such high rates of leverage—raised by the TUC and others—were ignored by private equity funds in the face of the willingness of the banks to lend them vast sums of money, as illustrated by this quote from Blackstone CEO Stephen Schwarzman: "When it ends it always ends badly. One of the signs is when the dummies can get money, and that's where we are now". A letter from private equity fund TPG to its investors is explicit about the link between cheap credit and the private equity model of loading portfolio companies with debt: "When debt is mispriced and inexpensive, as with the case before 2008, it makes sense to replace equity with debt, hence the abundance of LBOs"[79].

Some commentators have been warning about the consequences of macroeconomic imbalances since the 1990s, and setting out policy prescriptions for addressing the imbalances.[80] The IMF itself brought together the US, the European Union, China and Japan with the aim of finding a solution to the problem, but the debtor and surplus countries each wanted the other to make the necessary adjustments, with debtor countries advocating that surplus countries expand domestic demand and surplus countries advocating that debtor countries should curb their booming housing markets.[81]

As Martin Wolf has put it: "Cheap money encouraged an orgy of financial innovation, borrowing and spending"[82]. He goes on to describe what has happened in the global economy since 2000: "high-income countries with elastic credit systems and households willing to take on rising debt levels offset the massive surplus savings in the rest of the world. The lax monetary policies facilitated this excess spending, while the housing bubble was the vehicle through which it worked".[83]

Thus there is clearly a very significant international public interest in reducing macroeconomic imbalances within the world's largest economies. For the world's poorest countries, however, different conditions and arguments apply. Many poor countries with weak industrial sectors may need to run trade and current account imbalances over a prolonged period of time in order to develop the infrastructure necessary for development and serve the needs of their populations. This should be recognised as a legitimate stage of development and such countries should be given support to enable them to import what they need while economic and social development takes place. Given the relatively small size of the world's poorest economies, allowing them to run trade deficits for developmental purposes does not threaten the stability of the international financial system.

In the main, the reasons why some countries have been running such large current account surpluses in some countries and others such large deficits are specific to each of those individual countries, although there may be some shared factors. In the case of the oil exporting countries, the reason for their current account

77 http://www.tuac.org/en/public/e-docs/00/00/04/58/document_doc.phtml
78 The value of SWF's combined assets estimated to have increased by around 18% during 2007.
79 Quoted in the Financial Times 5 May 2009
80 See, for example, papers from the Levy Economics Institute of Bard College; a recent example is Wynne Godley, Dimitri Papaditriou and Gennaro Zezza, Prospects for the United States and the World: A Crisis that Conventional Remedies Cannot Resolve, Strategic Analysis December 2008
81 Guardian, 27 April 2009
82 Martin Wolf, Financial Times, 8 October 2008
83 ibid

surpluses is clearly the high price of their main export, oil, in relation to the costs of goods that they need to import for their often relatively small populations. Unless the price of oil stabilises at a lower rate than is currently the case, this is unlikely to change.

In recent years, the country with the highest current account surplus has been China. Zhou Xiaochuan, Governor of the People's Bank of China has suggested reasons for the high saving ratio of East Asian countries:[84]

— national tradition and culture—people are influenced by Confucian values of thrift and self-discipline;

— family structure—families in East Asia tend to carry higher social responsibilities than is the case in many developed countries and need to save in order to fulfil these responsibilities;

— demographic factors and development stage—a high proportion of China's population is working age and it has experienced high economic growth, both of which contribute to higher saving ratios;

— Asian countries boosted exports and savings in response to the Asian financial crisis, partly to arm themselves better against speculative currency flows in the future and in part as a result of the conditionalities attached to the rescue packages.

Zhou Xiaochuan also argues it is simplistic to argue that that nominal exchange rate adjustments will have a meaningful impact on the level of savings, which is significant because devaluation of the yuan is precisely what the US Government has argued should take place to reduce China's trade surplus.

There are many reasons why the US, the world's largest current account deficit country, has been running such large deficits. However, one factor that has contributed to the low level of household savings in the US is that despite productivity increases real wages have been stagnant, which, combined with the easy availability of credit, led households to rely heavily on credit in order to fund consumption.

Ensuring that real wages rise in line with productivity and economic growth is an essential part of running a healthy and balanced economy. Maintaining and increasing the value of real wages contributes to social development, especially in poorer countries, by ensuring that workers take a fair share in the benefits of economic growth and are able to access a standard of living that would otherwise be denied them. However, it is also important in ensuring that sustainable domestic demand enables Governments to run a balanced economy which is not over-dependent on exports or consumer credit. Inhibiting wage growth in order to boost the competitiveness of exports, as Germany has sought to do over recent years, has left the country exposed now that demand for its exports has fallen away.

Reserve currency

1.1 Countries with hard or tradable currencies are able to borrow in currency markets in order to fund current account deficits, rather than turning to the IMF as was originally envisaged when the Bretton Woods was established. Since the end of the Bretton Woods fixed exchange rate system in 1971, the only developed country to ask the IMF for assistance until last year was the UK in 1976. This has cemented the IMF's role as an organisation able to impose macroeconomic prescriptions on poor countries through its loan conditionality, while having little or no impact on the macroeconomic management of richer, developed countries.

One factor that has made it easier for the US to run such high current account deficits is that the dollar is the world's main reserve currency. The willingness of so many Governments to hold their foreign exchange in dollars has enabled the US to spend beyond its means without fuelling domestic inflation. However, the current economic crisis and the resulting sharp increase in US debt has led to increasing questioning of the sustainability of this position. As George Soros said at the World Economic Forum in January 2008: "The current crisis is not only the bust that follows the housing boom, it's basically the end of a 60-year period of continuing credit expansion based on the dollar as the reserve currency. Now the rest of the world is increasingly unwilling to accumulate dollars".

In recent months, Chinese and Russian leaders have both expressed reservations about the continued use of the dollar as the world's reserve currency. At this year's World Economic Forum, Russian Prime Minister Vladimir Putin called for the emergence of strong regional currencies to counteract dependency on one global reserve currency. Zhou Xiaochuan, has argued that using a credit-based national currency as a reserve currency creates problems for both issuing and other economies, as monetary authorities in the issuing country cannot necessarily pursue policies that are appropriate for both the domestic and the global economies at the same time.[85] He argues for the creation of "an international reserve currency with a stable value, rule-based issuance and manageable supply". As a step towards this, he proposes expanding the IMF's Special Drawing Rights or SDR to enable it to play the role of a reserve currency, and setting up a settlement system between the SDR and other currencies to enable it to become an accepted method of payment in trade and financial transactions.[86]

[84] Speech by Dr Zhou Xiachuan at the High Level Conference Hosted by Bank Negara Malaysia 10 February 2009 in Kuala Lumpur, Malaysia

[85] http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178

[86] ibid

The Stiglitz Commission has also recommended the establishment of a new global reserve system and said that this could be viewed as "a greatly expanded SDR, with regularly or cyclically adjusted emissions calibrated to the size of reserve accumulations".[87] The Commission argues that while a single-currency reserve system can undermine stability, a two or three country reserve system could be equally unstable.

Recommendations for Reform

The TUC believes that the international community needs to give urgent consideration to the management of macroeconomic imbalances. Both surplus and deficit countries will need to change their patterns of economic growth and development to address the macroeconomic imbalances that currently exist. It is important that countries on both sides of the equation recognise that they have a vital role to play in terms of addressing the imbalances; it will not be possible for either surplus or deficit countries to act alone. However, given the role of macroeconomic imbalances in creating the conditions for the current crisis, all parties have a strong interest in trying to find a solution.

The economic and political implications of this issue mean that a special meeting devoted only to this issue is likely to provide the best opportunity to make progress—much like the original Bretton Woods conference of 1944. The TUC believes that the following principles should govern the creation of a mechanism for reducing and managing macroeconomic imbalances:

- large, developed economies should aim towards a balance between imports and exports to enable them to run roughly balanced current accounts over time;
- surplus savings should be turned into consumption by the world's poor through either domestic or international mechanisms in order to create an international economy where wealth and demand are more equitably distributed;
- recognition that at times less developed and developing countries may need to run deficits while following expansionary fiscal policies in order to invest in economic and social development without having to rely heavily on private sector borrowing which may lead to instability in funding;
- a key factor in both economic stability for large developed countries and for progress towards development in poorer countries is ensuring that wages maintain and increase their real value in line with economic growth;
- where macroeconomic imbalances occur, there should be a mechanism for talks between the relevant countries managed by an international organisation tasked with supervision of the global economy and the management of macroeconomic imbalances;
- this organisation should be accountable to the UN and should be democratically run, ensuring that representation reflects emerging and least developed economies as well as large, developed economies;
- mechanisms to guard against instability caused by currency speculation should be included both in discussions and in the mandate of the organisation charged with management of macroeconomic imbalances;
- consideration should be given, in conjunction with other relevant organisations such as UNCTAD, to measures to stabilise commodity prices, as the sharp variations in commodity prices cause wild fluctuations in foreign exchange earnings of some of the poorest countries in the world; measures under consideration should include curbing speculation on commodities' futures markets;
- consideration should be given to creating an international reserve currency that is not also a national currency.

International Financial Regulatory System

Putting in place the changes to enable the world economy to avoid a repeat of this financial crisis requires finding a solution to the problem of persistent large macroeconomic imbalances, as argued above. However, it also requires fundamental reform of the financial sector. Financial reform at both national and international levels will be required, and it is to the international aspects of the financial system reform agenda, that this submission will now turn. What follows is not intended to be a comprehensive agenda for international financial reform, but rather a few key points focussing in particular on the institutional arrangements for financial supervision and economic coordination on an international level.

The crisis has illustrated that the international nature of the operation and impact of the financial sector is far deeper than is reflected in current international regulations and supervisory institutions. There is a wide consensus that greater international financial coordination and supervision is necessary. Many questions remain about what sort of organisations should play this role and their remit and governance structures, and it is right that these issues should be debated thoroughly at this time.

[87] http://www.un.org/ga/president/63/letters/recommendationExperts200309.pdf

The TUC believes that an effective global financial regulatory system is essential if a repeat of this crisis is to be avoided. The G20 meetings have emphasised the role of the Financial Stability Board (previously the Financial Stability Forum) in this context. The London meeting of G20 leaders agreed to re-launch the Financial Stability Forum as the Financial Stability Board with an expanded membership and enhanced mandate and capacity.

The members of the FSF comprised three groups: national central banks and financial regulatory authorities; international organisations, including the IMF, the European Central Bank, the World Bank and the OECD; and international standard-setting bodies, including the Basel Committee on Banking Supervision (BCBS), the International Accounting Standards Board and the International Organisation of Securities Commissions.

The G20 proposed expanding the national membership to include representatives from all G20 countries plus Spain,[88] and adding the European Commission to the international representation. While this is a step in the right direction, it still leaves developing and emerging countries severely under-represented on the FSB. The imbalance in the direct national representation is compounded by further lack of representation in some of the international organisations that are included in the FSB's membership (for example, the BCBS and the OECD) and a disparity of influence in others such as the IMF.

Yet countries rich and poor alike have been affected by this financial crisis, and it is not acceptable that for organisations tasked with such important remits as have been ascribed to the FSB to exclude representation from developing and emerging economies. This representation gap must be rectified if the FSB is to command the necessary global buy-in to be effective. In addition to including representation from some of the poorer developing countries, and appropriate regional organisations, the ILO and relevant UN agencies such as UNCTAD should be included.

In addition, it is not clear how civil society and trade unions can exert influence on the Financial Stability Board. The FSB has been tasked by the G20 leaders with leading work on a wide-ranging and very important set of issues, including assessing vulnerabilities in the financial system and identifying corrective action; promoting coordination between authorities responsible for financial stability; monitoring market developments and advising on the implications for regulation; monitoring best practice in meeting regulatory standards; and setting guidelines for the supervisory colleges (also established by the G20 meeting). This is a significant remit and the way in which the FSB carries it out will have major impacts upon people across the world, including workers in all countries. It is essential, given the importance and impact of its work, that the FSB develops mechanisms to consult with civil society and trade unions in formulating its proposals.

The International Trade Union Confederation and the Trade Union Advisory Committee to the OECD have recently approached the FSB on behalf of the international trade movement to initiate discussions regarding channels for ongoing dialogue and consultation between the FSB and the trade union movement. The TUC would welcome the UK Government's support for a positive response from the FSB.

The FSB will have to make some major operational changes if it is to play the role that the G20 leaders have ascribed to it for the future. It has hitherto been a body which very few outside those directly involved with it have heard of. As well as expanding its membership and channels for consultation, it is likely to need to expand its secretariat in order to fulfil its expanded role. It would be highly beneficial if, when doing this, the FSB looks for a balance in terms of geographical origin and previous experience, so that those working for the organisation better reflect the constituencies that its work will affect. Clearly, this does not supersede the need for candidates to have the necessary knowledge and skills.

The FSF operated by drawing up recommendations by consensus which were then implemented (or not) by national or international regulators. While becoming a fully-fledged international regulator with the power to put forward binding proposals may be premature, it is clear that if the organisation is to make a successful contribution towards preventing further crises, its role and recommendations will need to gain considerably more traction than is currently the case. A greater public profile for the organisation will contribute towards this. In addition, it needs to develop a monitoring and reporting capacity so that it is able to assess the implementation of its recommendations and make these implementation assessments public. It is also essential that there is full transparency surrounding the discussions of the FSB, with discussion papers and minutes published on its website.

The crisis has demonstrated the need for more effective rules governing global finance than is currently the case. There is a continuum in the FSF's potential role between promoting greater coherence and cooperation between the regulations of national centres and existing international bodies and becoming a fully fledged rules-based organisation with the power to make binding rules. Moves towards enhancing the influence and power of the FSF must be matched by an increase in participation and influence of those affected by its decisions, in particular poor countries. This principle must govern its transformation to meet its new role.

Alongside expanded participation of those affected by its decisions, there is a need to reform the remit of the FSF. At present, the FSF's mandate, even as expanded by the G20 meeting, focuses on entirely on issues of financial stability. While it is appropriate for this to be its central focus, it must have regard, when drawing

[88] Financial Stability Forum membership included representation from twelve countries: Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, the UK and the USA

up standards and other proposals, to the implications for development and equity. There are strong economic as well as social justice reasons for this; as this crisis has shown, a world with such major divisions between rich and poor, both within and between countries, is inherently unstable, whereas a world in which income and therefore demand were much more evenly spread would be much less prone to the sorts of macroeconomic imbalances and financial crises that we are witnessing.

The TUC therefore proposes that the remit of the FSF should be expanded to include promoting equitable development and, very importantly, that a principle that protecting weaker economies and groups from negative impacts of regulations and standards should be adopted, to ensure that when there is a disparity between the interests of richer and poorer countries the interests of the poor are protected.

To conclude, the TUC believes the FSB's role as the institution with responsibility for the global financial regulation should be conditional on the following reforms:

— Expanding its membership to include the relevant institutions of poor and developing countries, appropriate regional organisations and the ILO and relevant UN agencies;

— Developing channels for trade union and civil society dialogue and consultation;

— An expanded secretariat, preferably broadening the geographical and experience background of its staff base;

— The development of a monitoring and reporting capacity in terms of the implementation of its proposals;

— Full transparency with regard to its proposals, papers and minutes of meetings;

— An expanded remit to include the principle of protecting weaker economies and groups from negative impacts of standards and regulations and the promotion of equitable development.

European financial regulatory system

The TUC notes the submission of the European Trade Union Confederation (ETUC) to the Committee on this area, and will not seek to repeat points made in that submission. However, we wish to comment briefly on the recent draft Directive on Alternative Investment Fund Managers.

The trade union movement has argued since before the financial crisis that regulation should be consistent and tight across the whole financial system, including the shadow banking industry, private equity, hedge funds, sovereign wealth funds and so on. This view has gained considerable traction since the crisis, and there have been widespread calls for regulation of previously lightly regulated financial markets and the shadow banking system. The G20 summit, for instance, "agreed that all systematically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight" and committed to "amend our regulatory systems to ensure authorities are able to identify and take account of macro-prudential risks across the financial system including in the case of regulated banks, shadow banks and private pools of capital". It also agreed that hedge funds or their managers should be registered and required to disclose information to regulators, including on their leverage.[89]

Similarly, at European level there has been recognition of the need to broaden the reach of financial regulation, with both Angela Merkel and Nicolas Sarkozy calling for greater regulation of hedge funds. The European Parliament adopted two resolutions in September calling for tighter regulation of private equity and hedge funds, based on two reports by Poul Nyrup Rasmussen, President of the Party of European Socialists.

The European Commission has recently released its proposal for a Directive on Alternative Investment Fund Managers[90] (henceforth DAIFM). However, despite the fact that the proposals put forward in the European Parliament resolutions were supported by a cross-party majority, the Commission proposal is much weaker and takes a fundamentally different approach.

Rather than regulating private equity and hedge funds themselves, the draft DAIFM regulates the alternative investment fund managers (AIFM). While some provisions apply to AIFM operating in the EU, other provisions, including the requirement for AIFM to be authorised in their home Member State, apply to AIFM domiciled in the EU. This creates an immediate potential loophole, as many AIFM are not domiciled in the EU already and others will be able to become non-EU-domiciled in order to avoid the Directive's requirements.

A fundamental problem with the DAIFM is that it focuses on issues relating to macro-prudential risk, but does not address the risks to the real economy caused by the operation of private equity and hedge funds. This is a major omission; in the current economic climate, private equity portfolio companies' high debt levels, inherited from the highly leveraged deals attached to their purchase, make them especially vulnerable. Recent research has suggested that almost half private equity portfolio companies are likely to default on their debt in the next three years, and the report's authors predict "massive cost cutting and many difficult layoffs".[91] Yet the DAIFM contains no provisions to restrict leverage levels for future transactions; indeed,

[89] http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf
[90] http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm
[91] http://www.bcg.com/impact_expertise/publications/files/Get_Ready_Private_Equity_Shakeout_Dec_2008.pdf

in the FAQs attached to the proposal, the Commission justifies the lack of any capital requirements for AIFM by arguing that hedge funds employ lower levels of leverage than investment banks, completely ignoring the fact that private equity funds have frequently borrowed at leverage levels similar to investment banks.

Furthermore, the draft DAIFM does little to address the concerns that have been raised consistently by unions over the last two years (including in evidence to this Committee) about the impact of private equity buyouts on employment conditions and levels for workers in portfolio companies. The Rasmussen resolution recommended extending the protections of the Acquired Rights' Directive to takeovers by share transfer, which would include private equity buyouts. However, apart from requiring AIFM to provide information to workers' representatives at the time of a takeover, the DAIFM includes nothing to protect workers' interests during and following a private equity buyout.

The TUC is also concerned by the proposal that compliance with the DAIFM would be sufficient to enable an AIFM to market products to professional investors in other Member States. We believe that Members States should be able to set higher standards for the marketing of alternative financial investments in their own financial markets if they so wish.

The contribution of private equity and hedge funds to macro-prudential systemic risk is not the only aspect of their operation that needs to be addressed. This is a missed opportunity to regulate the private equity and hedge funds so that they operate in the public interest and to protect workers and companies from the impact of private equity ownership. The TUC hopes that the draft Directive will be substantially revised so that it better reflects the proposals put forward in Poul Rasmussen's report and adopted by the European Parliament resolutions in September.

Memorandum from Global Witness

1) Global Witness is a non-governmental organisation based in London that investigates the links between natural resource extraction, corruption and conflict. Our investigations and campaigning were a key catalyst in the creation of the Kimberley Process, to tackle the trade in conflict diamonds, and the Extractive Industries Transparency Initiative (EITI), to encourage transparency over payments and receipts for natural resource revenues. We were co-nominated for a Nobel Peace Prize in 2003 for our work on conflict diamonds, and were awarded the 2007 Commitment to Development Ideas in Action Award, sponsored jointly by Washington DC-based Centre for Global Development and Foreign Policy magazine.

2) Our recent research has focused on the role of the financial sector in facilitating corruption, and therefore poverty and sometimes conflict, in the developing world.

3) Global Witness's latest report, *Undue Diligence: How banks do business with corrupt regimes,* provides a number of alarming case studies showing how some of the world's most objectionable dictators have done business with some of the world's largest banks. By accepting these customers, banks are contributing to corruption and poverty in some of the poorest countries in the world. These countries are rich in natural resources which could be used to lift their populations out of poverty, but these resources have been captured by a small minority for their own benefit. Without banks that are prepared to do business with these customers, grand corruption would not be possible; the amounts are too large to be managed without recourse to the international financial system. The report can be downloaded from www.undue-diligence.org, and has been sent in hard copy to the Committee as an appendix to this submission.

4) The same factors that have allowed banks to destabilize themselves and the developed world's economies have also helped banks to do business with corrupt customers. On the part of the banks, it is about a failure of the culture of due diligence. The role of due diligence failures in banks' inability to react to mounting credit risk is now well recognised; but Global Witness has interviewed a number of compliance officers who say that they are not sufficiently empowered to ensure that their financial institutions turn down corrupt business. On the part of governments, it is about a failure of regulation. These problems are exacerbated when national laws requiring due diligence are impeded by bank secrecy laws and the opacity offered by other jurisdictions, including tax havens. In preventing both corrupt financial flows, and destabilising financial flows, the key is transparency.

5) One example in *Undue Diligence* (see chapter 4) shows how a branch of Barclays continued to hold an account for Teodorin Obiang, the son of the president of Equatorial Guinea, Africa's third largest oil producer, long after a U.S. bank, Riggs, collapsed in a huge corruption scandal as a result of holding accounts for the Obiang family. Teodorin earns $4,000 a month as a minister in his father's government, yet owns a $35 million mansion and a fleet of fast cars, including a Ferrari which was partly paid for from the Barclays account. He has admitted on the public record to a South African court that in Equatorial Guinea, it is normal practice for a government minister to keep a portion of every government contract. What due diligence has Barclays done to reassure itself that the funds in this account are not the proceeds of corruption? Global Witness has asked Barclays; it will not say.

6) Another of the examples in *Undue Diligence* (see chapter 5) shows how Denis Christel Sassou Nguesso, the son of the President of Congo-Brazzaville and responsible for marketing the country's oil, used the secrecy offered by the British tax haven Anguilla to set up a company and disguise his ownership of it by putting the shares in trust. He then opened a bank account in the name of this shell company at Bank of East Asia in Hong Kong, into which Congolese oil revenues were paid.

7) These oil revenues should have been used for poverty alleviation in Congo. Instead, he used this account to pay his personal credit card bills after repeated designer shopping sprees totaling hundreds of thousands of dollars in Paris, Monaco, Marbella and Hong Kong. Just one of his credit card bills, for June 2005, came to $32,000. This would have paid for 80,000 Congolese babies to be vaccinated against measles, a major cause of child death.

8) One of the documents published by Global Witness to illustrate this case is a letter from Denis Christel Sassou Nguesso's shell company in Anguilla to his bank in Hong Kong, instructing payment of his personal credit card from the shell company account. While Global Witness does not know if the bank found out, as required, that he was the owner of the bank account, he was named explicitly on this payment instruction letter as the owner of the credit card for which payment was required. This document has been stamped, presumably by the bank, "Record of terrorists checked."

9) This is a fascinating insight: the international community has made it clear that banks must check all names against the terrorist watch-lists. But this bank does not appear to have checked whether it was dealing with a politically exposed person who might have access to his country's oil revenues. This is because there has been insufficient international political will focused on the fight against corrupt funds, compared with the fight against terrorist financing.

10) Banks are already required by anti-money laundering laws to do due diligence to identify their customer and his source of funds, and to file a suspicious activity report if they suspect that the funds have been illegally earned. Global Witness has written to all of the banks named in *Undue Diligence* to ask them what due diligence they did on their clients, and whether suspicious activity reports were filed. The banks replied to say that they could not tell us. All that Global Witness can see is the end result: that these banks have all done business with clients where there is significant evidence of corruption. Global Witness has also written to the regulators of each of these banks; they can not tell us anything either; but the fact remains that these banks were able to conduct this business.

11) Further attention to the global anti-money laundering framework is required, both to improve banks' culture of due diligence, and to improve international cooperation so that the framework is more effective globally. If the financial system remains open to corrupt funds that regulators do not have a handle on, then it also remains open to other unknown destabilising forces. The financial crisis, and its causes, have shown that the international community can no longer tolerate opacity or the continued existence of business that regulators do not know about. Global Witness therefore urges the Select Committee to consider the following recommendations, as part of a broader overhaul of the financial regulatory system.

12) The UK should require banks to reform their culture of due diligence. Banks should be explicitly required not only to identify their customer, including a beneficial owner/controller if there are companies or trusts involved, but banks should also be required to have strong evidence that the funds are not corrupt. If they do not have such evidence, the funds should not be accepted. The FSA should ensure that they are doing this.

13) The UK should require its banks to conduct an audit of accounts they hold worldwide for "politically exposed persons" (PEPs). PEPs are senior government officials, as well as their family members and associates, who could, as a result of their position, have access to state funds or be in a position to take bribes. If the bank cannot demonstrate evidence that the customer's source of funds is not corrupt, the account must be closed. Banks should provide a list of all their PEP accounts to the FSA, which should use this information to map trends and share with regulators in other jurisdictions.

14) Corporate vehicles and trusts are the most commonly used vehicles to hide ownership of corrupt money, as well, of course, as the proceeds of tax evasion, other crimes, and destabilising assets, all of which are now being targeted in the wake of the financial crisis. Transparency over ownership is therefore key. The UK should use its influence to push for each jurisdiction to publish open registries of beneficial ownership of companies and trusts. This requirement does not just apply to the more commonly recognised tax havens; by allowing UK companies to cite nominee directors and shareholders in company listings, the UK itself is allowing companies to obscure their ownership.

15) The UK should use its influence to improve international cooperation to tighten up the global anti-money laundering framework to help curtail flows of corrupt funds. This should begin by strengthening the Financial Action Task Force (FATF), a little-known inter-governmental body, of which the UK held the presidency last year. FATF sets the standards for the anti-money laundering laws. In the EU these standards are embodied in the Third EU Money Laundering Directive, which was implemented in the UK as the 2007 Money Laundering Regulations. FATF evaluates its member states' legislation, and could be hugely influential. But currently it is a technocratic body, whose civil servant participants operate with little parliamentary oversight, and which is not using its powers to name and shame its own member states. Many of its key members do not reach its own standards.

The mandate to strengthen FATF, its standards and its methods, has been established by the recent G20 summit communiquè; which noted that "We agreed that the FATF should revise and reinvigorate the review process for assessing compliance by jurisdictions with AML/CFT standards, using agreed evaluation reports where available."

The UK should take a lead in reforming FATF to ensure that it:

i) Focuses on corruption as strongly as it has focused on terrorist financing

ii) Names and shames its own members who have not reached its standards, and who are not enforcing them

iii) Publishes a clearly accessible roster of each country's compliance status with each of its recommendations, and the date by which that country has to comply

iv) Makes its workings more transparent, including by voting in open sessions, and engaging with civil society as well s the private sector

v) Engages more closely with other actors working on anti-corruption and development issues

vi) Does not permit the existence of bank secrecy laws that hinder both investigations after the money has gone, as well as the customer due diligence that ought to prevent it happening.

16) Thank you for the opportunity to make a submission to this inquiry at this late stage. We would be happy to elaborate on any of these points.

June 2009

Memorandum from SOMO

SOMO (Centre for Research on Multinational Corporations) is a non-profit Dutch research and advisory bureau. SOMO investigates the consequences of Multinational Enterprises' (MNEs) policies and the internationalisation of business worldwide, including in the financial sector.

Executive Summary

1. This submission focuses on the reforms of supervision at the national and EU level, and comments on the proposals to that extend made by the de Larosi€re Report and the European Commission (4 March 2009).[92]

2. This submission explains how supervisors' role should be more than safeguarding financial stability but also be about safeguarding the public function (ie serving the public interest such as basic bank services for all) of the financial sector and especially banks. In addition, supervisors can play a role to ensure that the financial industry is instrumental in achieving (environmental) sustainability and (social) equity in societies. Such a role of supervisors should be supported by better transparency and accountability of supervisors and better budgets for supervisors.

3. This submission also explains the principles of cooperation and coordination of supervision at European and international level.

Introduction

4. This submission is aware that the activities of supervisors are based on the mandate received from financial regulations but this document does not include comments specifically on the regulations itself proposed by the European Commission and the de Larosiere Report (see however the Annex to this submission). However, this submission takes into account that Central Banks and supervisors are advisors to regulators and therefore should in their advice take account of trends in society such as banks being challenged about the impact of bank project lending on the environment and voluntary initiatives by banks to take the environmental impact into account (e.g Equator Principles). Central Banks and supervisors are also involved setting international standards and participate in international fora dealing with financial stability. Here and there in the document below, there are suggestions of where supervisors can propose improved regulation.

The comments are in the following order

Reformulating objectives of supervisors.

Supervising beyond financial stability.

Accountability, democracy and transparency.

Global supervisory cooperation.

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[92] Commission of the European Communities, Communication for the Spring European Council : Driving European recovery—Volume 14 March 2009, COM(2009) 114 final ; Idem, Volume 2: Annexes, Brussels, 4 March 2009, COM(2009) 114 final.

Coordination.

Budget.

Other issues.

Reformulating Objectives Of Supervisors

5. According tot the European Commission (EC), the objective of a new supervisory structure is to "meet the challenge of complex international financial markets".[93] To our opinion, supervision should include meeting the challenges of the financial sector's role in societies, and especially in making societies equitable and environmentally sustainable. Promoting and protecting the public interest in the financial system should be the primary objective of supervisors. This for instance includes ensuring that marginal, poor and vulnerable clients are being served and that financial services do not focus too much on serving the rich.

6. Overall, the proposals on supervisory structures contained in the documents by the EC and the de Larosiere Report are based on an approach whereby the supervisors constantly try to catch up with the innovations and expansion of the financial sector itself. A better approach would be one whereby supervisors aim much more pro-actively at preventing financial instability based on the precautionary principle. This could be done for instance as follows:

— Implement a European-wide approval process of every new financial product brought on the market, especially speculative products. One important criterion for whether or not to approve a new financial product must be to ensure that the product does no harm to the public interest and the environment. This "do not harm principle" (directly and indirectly) should also include ensuring that the new no financial product will result in financial instability or become a "toxic" product. The innovator should demonstrate conclusively that a new product will do no harm.

— Where new financial products that have social objectives (eg cheap housing loans) could lead to less income for the financial sector (whose focus when developing innovations has been on rich and speculating clients), supervisors should ensure that such financial products do not increase risk taking (eg securitisation and credit derivatives) to increase profitability. Undue risks to increase profitability of low profit financial products leads to financial instability, as the sub-prime mortgage crisis has shown. Supervisors should indicate to politicians where commercial banking is impeding social and environmental objectives of governments, and where other financing instruments would be welcome.

— In general, supervisors should ensure that no unrealistic expectations are made about the profitability of new financial products, and the financial sector activities in general.

— Prohibition of too complex and risky financial products, or financial products that are too costly to supervise.

— The objective of supervisors should be to aim at avoiding any supervisory failures, contrary to what de Larosiere Report says (para 149 "it is inevitable that there will be failures form time to time, and the arrangements for supervision have to be seen with this in mind"), ie supervisors need to implement the precautionary principle and the speculator pays principle. This also means that supervisors should advise, and be involved in, international standard setting which aims to avoid financial instability, crisis in societies and moral hazard. Regulations in the 1950s and 1960s were able to avoid financial crises which only occurred in the last three decades (see ANNEX).

— Impose limits on the size and role of financial corporations. Supervisors should have as a mandate to prevent a bank, insurance company or another financial operator to become too big to fail, too interconnected to fail, too big to be saved or to cause too much instability so that it threatens financial systems and societies. De Larosiere report is wrong in stating that "it is unlikely that large financial institution will be broken up into component parts" (para 234) since supervisors should have the power too break up financial "giants" if they are "too big to manage" and are a threat financial instability. In addition, some financial conglomerates are already re-introducing measures to make clear separation between their banking and insurance companies (eg ING). Supervisors should work more with European and national competition authorities whose mandate should also include to intervene when banks become too big to fail and too big to be saved.

— Strict criteria should be fulfilled by CEOs, board members, management, and the supervisory bodies of financial companies in order to ensure integrity, financial stability, environmental and social sustainability, and servicing the public interest of the financial sector. Supervisors should closely supervise voluntary and legal obligations of top management, and the remuneration structure, to that extent (see also next section).

— Assess, and ensure that all financial operators have balanced dialogues with stakeholder, ie that stakeholder dialogues are not limited to shareholders and investors. All stakeholders (workers, consumers, civil society organisations and other stakeholders) should be adequately consulted and getting the necessary information through transparency measures enforced by supervisors.

[93] Commission of the European Communities, Communication for the Spring European Council : Driving European recovery—Volume 2: Annexes, Brussels, 4 March 2009, COM(2009) 114 final, Annex I, p 2 (a).

— Supervisors should not allow off shore banking and off balance sheets, and help develop rules and supervisory structures to that extend. The objective should be to avoid any risk of opacity, complexity and lack of transparency to would prevent supervisors from assessing potential and direct financial risks and other societal risks.

7. The proposals in de Larosiere Report have given in to political sensitivities whereby the national interest are being equated by protecting the national financial industry and the financial center of a country against foreign competition. However, the approach on which supervision should start is that financial services should be at the service of a sustainable society and that growth or preservation of one's national financial industry does not necessarily serve the public interest of a country. It is not a supervisor's role to protect the growth of the financial sector of a country or of the EU. In the past, political and economic pressure to ensure the 'competitiveness' of the financial industry has resulted in supervisors relaxing strict enforcement of regulations which were already being weakened by the same political interest to ensure that regulations would not prevent the growth of a country's financial industry. The UK has plaid an important role in weakening regulation and supervisoon proposed at EU level and implementing weaker interpretations than intended by EU regulations through careful wording of UK legislation. This, together with the UK's domestic light touch approach to regulation has made the EU more vulnerable to financial crises.

8. For all financial operators, not only banks or insurance companies, once they operate across borders, supervisory structures must be established on the international level as well as the EU level. This cross border supervisory structures should be subject to the principle of "do no harm" to other countries where the same cross border financial operators are active. This could be done through mechanisms and agreements on processes that allow to integrate countries' due public interests and specificities. The refusal of the UK to establish European supervisory structures whereby not the home supervisor takes the final decision, and France's refusal about European wide insurance company supervision in order to protect French insurance companies against to onerous capital reserve requirements for insurance companies should therefore be questioned.

9. Solutions to overcome differences between home and host countries should mainly serve the public interest at national, EU level and international level, and not only be taken from the perspective of the growth or protection of the financial industry. The role of the financial industry's heavy lobbying at EU and international level against strong financial regulation and supervision should be condemned eventhough financial conglomerates are interested in cross border supervision to avoid complex national supervisory requirements in each of the different countries in which they operate.

Supervising Beyond Financial Stability

10. The proposals contained in the European documents mentioned above have the objective of "consistent set of supervisory rules" with no national derogation or additions, "a harmonized core set of standards is defined and applied throughout the member states" (EC document, Annex I), "a high level minimum standard" for all supervisors in the EU (de Larosiere Report para. 41).

11. At least such supervisory rules should include the obligation that supervisors make assessments of the risks of the financial system, financial markets and particular financial operators (micro-prudential supervision and macro prudential supervision) to the environment, social development (eg gap between rich and poor) and societies as a whole. In other words, the supervision of the financial sector should not only aim at contributing to sustainable economic growth (de Larosiere Report para 151) but also to the development of sustainable, low carbon economies and equitable development in all societies in all countries.

12. In order to facilitate supervision to that extend, banks and financial institutions and their directors should be legally responsible for social, environmental and human rights impacts of the projects and companies that they finance and support, and the financial products that they sell. They must have a legal duty of care not to commit or be complicit in human rights and environmental abuses. For instance, they should not sell speculative products in food commodities that cause food prices to rise and hunger to increase, so that the right to food –a basic human right- is undermined. This should balance the (legal) duty banks currently have to maximise profits for shareholders. Supervisors should be responsible for enforcing this legal duty of care. Other stakeholders can also play a role in promoting the public interest functions of the financial industry, if sufficient transparency is guaranteed (see also next section).

Accountability, Transparency And Democracy

13. Supervisors so far have very little communication channels with stakeholders such as consumers, employees and unions, civil society and non governmental organizations (NGOs) eg those dealing with anti-poverty and social justice, environmental protection and sustainable development, and human rights. Supervisors should provide appropriate channels for communication with civil society organizations so that their views can be heard by supervisors. This should allow discussions for instance on gaps in supervision or on needed changes in the financial sector regulations (on which supervisors give advice) to guarantee the public interest.

14. Cancel privileged access: The close contacts behind closed doors between supervisors, regulators and Central Banks on the one hand and the financial industry on the other hand has lead to damaging 'regulatory capture' in the past. Banks and financial institutions have enormous (lobby) power and had great influence over national, EU and international financial policies, regulations and supervision practices. The granting to the financial industry of privileged access to decision making processes should be cancelled at national, European and international level. Advisory groups that are controlled by representatives of the financial sector should be abandoned.

15. The process leading to the creation of a European system of financial supervision (part IV of Larosiere Report) should include sufficient stakeholder consultations that are not confined to a few non-financial sector stakeholders. It should provide the means for non-financial stakeholders to meaningful participate in the dialogues, consultations, etc. (such financial support should not be confined to small investors only as now proposed). Such non-financial sector stakeholders include unions, employees of the financial sector, consumers, civil society organisations from all countries where European financial actors are operating.

16. Where supervisors have made mistakes, there must be due democratic and political procedures to make supervisors accountable for their mistakes and remove supervisors who are failing in their duty. The principle in de Larosiere Report (para 187) that supervisory work must be independent from political authorities but should be fully accountable needs further elaboration. Supervisors' and central banks' independence of political procedures needs to be reviewed as the weaknesses have been apparent in the last decade, and should be subject to criteria such as the decision-making of financial regulation that supervisors have to enforce, has to be democratic (see footnote 10 of de Larosiere Report para 187).

17. Any dialogues between supervisors and the financial industry regarding solutions to the financial crisis, supervisory structures and regulation in general, must be conducted in a transparent and democratic fashion and secrecy for pure supervisory reasons should be reduced to a minimum.

18. Supervisors and financial operators should provide much more transparency about their activities, including lending, so as to increase possibilities for better accountability and stakeholder discussions. Guaranteeing as much transparency as possible (against the argument that most financial operation require confidentiality to protect company secrets) should be a task of supervisors. In order to facilitate the work of supervisors and stakeholders, multinational corporations should be obliged to report on all their activities and transactions on a country by country basis (both third-party and intra-group), labour costs and number of employees, finance costs (third-party and intra-group), profits before tax, provisions for tax and tax actually paid, and tangible asset investment, without exception for any jurisdiction. In order to improve accounting and supervision, supervisors should increase their capacity of surveillance of accounts of financial operators. Supervisors should promote that the International Accounting Standards Board (IASB), where such accounting standards are adopted, be reformed from a private entity into a specialist Commission of the United Nations Economic and Social Committee, with appropriate input from stakeholders from civil society and business. There are great concerns about company auditing being not a function of the state, but a commercial activity commissioned by each company for itself. That practice introduces an unacceptable conflict of interests, as illustrated in auditing failures over the last decade.

Global Supervisory Cooperation

19. The supervision of European banks and European insurance companies or equity traders, in whatever form, should also include at least the consultation if not the active involvement, of supervisors or central banks of those countries beyond the EU where these European financial companies have an important market share, for instance from 10% onwards. This goes beyond the recommendation of the de Larosiere report that especially the financial "giants" should have supervisory structures at international level. In some developing countries, the presence of foreign banks or other financial operators take such an important part of the financial system that decisions taken by foreign supervisors might have major impacts on the financial and monetary systems of these countries. Also, the activities of these foreign financial operators such as foreign banks might have a negative impact (eg foreign banks withdraw saving money from host country to home country). As long as the cooperation between supervisors especially between those from Western home countries and those of developing countries is not sufficient, host country supervisors should have the precendence over home supervisors to protect the financial stability, public interest, customers and investors in the host country. For the same reason, host country supervisors should also be able to have decision-making over branches of banks.

20. All supervisors should have the duty to avoid spill-over problems into other countries of financial operators under their supervision, and should have a duty of doing no harm to host countries where financial operators under their supervision have commercial activities. The supervision of financial cross sector conglomerates is an urgent matter, especially if no splitting of those conglomerates is being envisaged. The principles established above should also apply for supervision at international level.

21. The Financial Sector Assessment Program (FSAP) of the IMF, which the G-20 suggest to be a kind of instrument of independent assessment and supervision, needs to be improved and incorporate the many principles, duties and criteria of supervision (and regulation) as described above.

22. Supervisors should not only reduce international risk and volatility by imposing restrictions on cross-border lending and cross-border bank ownership, but also on lending in any country in a foreign currency to avoid that problems are created as now in Hungary and Romania where as many as 55% of households hold foreign exchange household loans.

23. Financial supervisors need to promote competition policy, both at national, EU and international level, to ensure that financial conglomerates are being reduced in size when they become "too big to fail" and too big to manage or supervise.

24. The currenly continued system whereby international agreements on supervisory principles, such as those of the Basel Committee on Banking Supervision, are legally non binding remains a fragility in the financial system that needs to be addressed. If legally binding treaties at international level about supervisory principles will be negotiated, all countries willing to abide to the rules of that treaty should be able to participate in the negotiations. Already now, the membership of the Basel Committee on Banking Supervision needs to be further extended than decided earlier this year (2009).

Coordination

25. After the G20 summit decisions, supervision of banks and non-bank entities such as hedge funds should be organised at international level in a manner that makes supervision really meaningful and avoids duplication of EU efforts (but rather, the EU supervisory structures should underpin and strengthen international supervision). Supervisors should encourage very strict regulation of Hedge Funds and prohibit activities that cause major damage to society, such as speculating in food commodities and foreign currencies of developing countries.

26. There should be an immediate response of direct cooperation in supervision of financial conglomerates that combine retail banking, investment banking, insurance and securities trading. Some coordination is taking place at national level but the European supervisory structure is still split in supervision of banks and insurance, and securities' trading. The long term process proposed by de Larosiere report does not deal with current problems of instability and vulnerability and must be immediately complemented by a set of proposals that guarantees increased supervision at EU level of cross-sectoral financial conglomerates to ensure stability in the near term.

27. Supervisors should have the task to coordinate or at least have an overviewt of different policies towards the financial sector, and have powers to intervene to protect the public interest. For instance, supervisors have currently very little information and assessments of the impact of trade agreements (GATS agreement in the WTO, Free trade agreements including the EPA agreement between CARIFORUM and the EU) in which financial services are liberalised, regulation is restricted (see Article XVI of the GATS, and the GATS "Understanding on Commitments in Financial Services") and capital controls are severely restricted. The European Commission continues to push for liberalisation and deregulation of financial services in developing countries through free trade and investment agreements, which runs counter to what is happening at the EU level, and is not coherent with the fact that international and regional financial regulation and supervision is not yet in place.

Budget *(See De Larosiere Report Recommendation 22, p 55)*

28. Given the new many regulations that are being proposed by the G-20 on much more entities, including rating agencies, and in different ways, eg more judgment rather than relying solely on internal risk models, sufficient resources must be made available to hire the required expansion of highly skilled staff. Is there political will to provide enough budget for highly qualified staff at supervisory bodies? Will the new commitments to tackle tax evasion and avoidance provide the necessary sufficient resources? Will fraud investigations be strengthened (especially in the UK because of the behaviour of the City of London, but not only there)? Fraud is investigated by national police forces, and the EU should give a clear signal to strengthen them. This will require the fullest communication and cooperation between international supervisors and the anti-fraud police in all countries.

29. When supervisors are also authorized to control behaviour that can lead to sanctions, they will need sufficient budget to build up cases and defend themselves against legal threats by financial companies against their charges.

Other Issues and Commments

30. Priority should be given to improve transparency, accountability and oversight instead of improving the business environment. The proposal to reduce accounting burdens on micro-enterprises runs completely counter to the need for better accounting.

31. The proposals on how to transform the current bonus system should be much clearer and concrete, and should support the public function and the principle of no social and environmental harm by financial commercial operations and their managers.

32. The proposals for improved financial regulation and supervision still rely on the same neo-liberal policies that caused the crisis. Since the IMF has supported such policies, the IMF should not play a central role in international financial supervision but much more importance should be given on the role the UN could play and is already playing.

33. Economic stimulus packages should support the ecological transformation of the economy and create socially and ecologically sustainable jobs in the EU but also elsewhere in the world, and supervision is needed to ensure this happens. Supervisors should promote the introduction of global financial transaction taxes and corporate taxes to fund economic stimulus packages which aim at the ecological conversion of the economy—investment in public transport, in public services, in promoting sustainable agriculture and localized food systems, in sustainable energy production (this excludes nuclear energy or the promotion of agrofuels for transport), and to other climate change relevant investments. In the developing countries, such funds must in particular be invested into the agricultural sector, promoting localized food systems, based on organic food production.

Annex

34. The statement by the de Larosiere Report (para 149), "it is inevitable that there will be [banking] failures from time to time" cannot be supported by the following evidence. The economists Kenneth Rogoff (a Nobel Prize winner) and Carmen Reinhart have examined 18 bank-centred financial crises from the post-Second World War period, /and the earliest they found was in 1974; see:

<www.economics.harvard.edu/files/faculty/51_Is_The_US_Subprime_Crisis_So_Different.pdf>, p 3).

35. The 1950s and 1960s must have been the only period in the history of capitalism when there were no banking crises, so there must be things we can learn from the policies of that time. It seems that the following were some of the aspects and policies that kept banking and finance under control:

- fixed exchange rates;
- currency exchange controls in all countries (first removed unilaterally as late as 1979, in the UK);
- almost no lending between banks—they had to rely on customers' deposits to finance their loans;
- the bankers' primary obligation was to their depositors (whose money they have to keep safe), not their shareholders (who want a profit out of the business);
- a strict separation between different forms of banking; this varied from country to country, but the classical one was that in the US between investment (or "casino") banks and commercial (or 'utility') banks under the Glass-Steagall Act, which was repealed in 1999;
- no financial derivatives (even commodity futures were much simpler, more limited in scope and better regulated than they later became);
- strict rules on bank lending, for example in the availability and amounts of loans for house purchases, and strict limits on consumer borrowing.

Printed in the United Kingdom by The Stationery Office Limited
7/2009 431794 19585