



House of Commons
Treasury Committee

**Banking Crisis: dealing with
the failure of the UK banks:
Government, UK Financial
Investments Ltd and
Financial Services Authority
Responses to the Seventh
Report from the Committee**

Seventh Special Report of Session 2008–09

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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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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.

Committee staff

The current staff of the Committee are Dr John Benger (Clerk), Sian 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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Seventh Special Report

The Treasury Committee published its Seventh Report of Session 2008–09, *Banking Crisis: dealing with the failure of the UK banks*, on 1 May 2009, as House of Commons Paper No. 416. Responses to this Report from the Government and UK Financial Investments Ltd were received on 15 July 2009 and the Response from the Financial Services Authority was received on 15 June 2009. The Responses are published as appendices to this Special Report.

Appendix 1: Government response

The Government welcomes the Report of the Committee. The Government is grateful for the Committee's contributions and will continue to work constructively with the Committee on its proposals.

How did we get here?

We acknowledge the international aspects of the present crisis, and welcome the call from the Governor of the Bank of England and others for reform to the design of the international financial architecture. We will consider such reforms in our inquiry into the international context of the banking crisis. Governments, politicians, regulators and central bankers in the UK and across the world share a responsibility for sustaining the illusion that banking growth and profitability would continue for the foreseeable future. A culture of easy reward, illustrated by risky lending of credit and capital, has been underpinned by an assumption of continuous expansion in banking accompanied by an expectation of ever bigger bankers' rewards. (Paragraph 17)

We note that risk and complexity within the banking sector has increased dramatically over the last twenty years. The widespread—but at sometimes misguided—belief that risk was being dispersed and 'managed' led many banks to increase the complexity of their operations and their overall risk exposure. This was manifestly a false premise. Indeed one of the factors that is key to understanding the banking crisis is that some forms of securitisation, far from mitigating risk, actually obscured it. (Paragraph 82)

We note that the financial sector has significantly increased its leverage over the last two decades, and those firms that showed the greatest appetite for rapid growth, particularly in the last five years, through leverage are amongst the heaviest casualties. Increased debt simply led to increased risk. We will consider potential measures to control leverage in our forthcoming report on public regulation. (Paragraph 83)

The origins of the banking crisis were many and varied, including low real interest rates, a search for yield, apparent excess liquidity and a misplaced faith in financial innovation. These ingredients combined to create an environment rich in over-confidence, over-optimism and the stifling of contrary opinions. Notwithstanding this febrile environment, some of the banks have been the principal authors of their own

demise. The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed. Bankers have made an astonishing mess of the financial system. However, this was a failure not only within individual banks but also of the supervisory system designed to protect the public from systemic risk. (Paragraph 84)

Bankers complicated banking to the point where the location of risk was obscured, abandoned time-honoured principles of prudent lending and failed to manage their funding requirements appropriately. There were major failures in the modelling, procedures and structures for risk management, which we will address more fully in our future report. They did this in a reckless environment, and one in which their corporate governance was often totally ineffective. Whilst we would hope that the nature of banking, and bankers, would change in response to the crisis, and no doubt bankers will be chastened by recent experience for a short while, the responsibility falls to the financial regulator, the FSA, to create a more durable framework for stable finance. We will address the FSA's task in our forthcoming report. (Paragraph 85)

In the paper “Reforming Financial Markets”, published on 8 July 2009, the Government set out its analysis of the causes of the recent banking crisis, which points to many of the same factors that the Committee identifies.

The paper also sets out the Government’s proposals for addressing these problems, by strengthening regulation, improving monitoring and management of systemic risk, improving corporate governance and ensuring a competitive and fair market for consumers. Many of these proposals build on the recommendations of the Review of Lord Turner, chairman of the FSA, published on 18 March 2009.

To date, building societies have generally been shown to have operated a safer business model. Certain features of the building society model, including the comparatively low reliance on wholesale funding and the focus on the protection of members rather than the service of shareholders, have left building societies better equipped to defend against the shockwaves of the current crisis. We heard evidence that establishing new building societies was now harder than it was when the Ecology Building Society was started in 1981. The Government should examine, with the sector, whether any legislative or regulatory changes are required to facilitate building society start-ups and remutualisation. (Paragraph 63)

The Government notes the Committee’s comments. The Government welcomes the contribution of the mutuals sector to the UK economy and communities, and as set out in “Reforming Financial Markets”, believes that the mutual sector has an important role.

The mutual sector has not been immune to the pressures caused by the contraction of global credit markets and the crisis that has ensued, particularly those firms diversifying into new and high-risk lending products. The Government has brought forward measures to promote the ongoing stability of the sector including measures to enhance the legislative framework for, and operational effectiveness of building societies, and will continue to consider how it can best do this in future.

The Government support schemes remain open to building societies, subject to satisfying the relevant terms of entry, and it will shortly consult on measures to enable building

societies to make it easier to raise money from Treasury bills or other securities issued by a central bank.

The Government believes that recent secondary legislation (The Mutual Societies (Transfers) Order 2009) made under The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007, which enables the business of building societies to be transferred to the subsidiary of another type of mutual, provides societies with additional opportunities for corporate restructuring, as an alternative to straightforward demutualization and should assist significantly in ensuring the stability of the mutual model. This power will allow the merger agreed between Britannia Building Society and Co-operative Financial Services to take place.

The FSCS deserves praise for the way in which it fundamentally increased its response to the unprecedented compensation claims arising from the default of five banks in just a few months. We are particularly impressed with the variety of innovative solutions deployed by the FSCS to suit the particular challenges facing them. (Paragraph 88)

We think that there should be a limit to the level of deposit protection offered by the FSCS to mirror arrangements in Europe in order to avoid a competitive disadvantage for UK banks. Once financial stability has returned and there has been clear communication about the scope of protection, it should be made clear that the new £50,000 limit will be applied. This would reintroduce the depositor's obligation to consider matters other than the bald interest rate in choosing where to locate their investments, and thus ensure that the banks had a disincentive to be reckless. The FSA should think now about a strategy for shifting the expectations of the banking consumer from one of total protection, to a partial protection basis. This strategy should be developed sufficiently to be readily deployed by the time that immediate concerns about bank safety have been calmed. One measure we would like to see adopted would be a requirement for all savings institutions to publish all relevant documentation and advertising, and also within branches, notice of the £50,000 deposit ceiling. We renew our recent recommendation that the FSA should carry on its website a list of all banking products covered by the deposit protection scheme. (Paragraph 90)

The Government welcomes the Committee's recognition of the important role the FSCS played in dealing with last year's events. As set out in "Reforming Financial Markets", the Government intends to legislate to expand the remit of the FSCS. In addition, the Government will also bring forward proposals regarding the governance and accountability of the FSCS to ensure it is best able to respond to the challenges that its new roles and responsibilities, and the changed environment for financial stability, will bring.

Rules on FSCS compensation limits, their disclosure and consumer awareness are matters for the FSA. The FSA published a consultation paper in January 2009 which covered among other things, "raising consumer awareness of the FSCS" and proposed rule changes to ensure firms provide information on FSCS compensation arrangements and use of trading names.

We also think that financial institutions must make clear to their customers where they are subsidiaries of other institutions where this is relevant in terms of deposit

protection. Ideally, we would like to see each brand holding a separate banking licence. (Paragraph 91)

We are very sympathetic to the plight of building societies in funding more than their share of the FSCS burden and call on the FSA to review the situation with urgency. It is entirely inappropriate that institutions that are recognised as having a safer funding model, indeed have such a funding model enshrined in legislation in order to protect their depositors, should be required to contribute more to the industry's insurance scheme than competitors with funding models that have failed in the current crisis. The principle seems to have been that the riskier the business model, the less that is paid. The absurdity of this serves to reinforce our previous recommendation that levies be charged according to risk, and we renew that recommendation in this Report. (Paragraph 96)

The detailed rules on the levies for the FSCS are a matter for the FSA. However, the Government has always been clear that the costs of the FSCS should be met by the financial services industry. All parts of the industry, including building societies, benefit from the extra confidence which the existence of the scheme gives consumers—so all should contribute to FSCS levies. If a building society were to default, building society depositors would be protected by the FSCS. The FSCS will be required to contribute to costs arising from the closure of Dunfermline Building Society.

What has been the Government response?

The Government's initial policy of requiring Northern Rock to run down its loan book immediately after nationalisation stood in clear contradiction to its public exhortations to other banks to increase lending levels to small firms and individuals. Given the economic downturn and the need to maintain overall lending levels, we welcome the Government's decision to reverse this policy and allow Northern Rock to expand lending. We ask the Government to set out how this change of policy will also change the timescale over which the taxpayer loans to Northern Rock will be fully repaid and, in turn, the timescale over which a new ownership structure, whether by trade sale, privatisation or remutualisation, could be achieved. (Paragraph 111)

The Government notes the Committee's recommendation. The Government's policy is to encourage and support a well functioning mortgage market, where lenders lend responsibly, and borrowers have access to a wide range of mortgages that they can afford to repay. Northern Rock will therefore undertake new lending of about £5bn per annum in 2009, and £3-9bn from 2010 onwards, subject to market demand.

To enable Northern Rock to fulfil the new lending proposition, the company is being restructured so that back book of mortgages is managed separately to its other business. This new strategy should help the company to build a high quality mortgage book and create a viable bank for return to the private sector in the longer term. The Government will increase the loan to Northern Rock and extend the repayment schedule. It is working with Northern Rock to finalise the details of future loan repayments and will make a further announcement on this. Implementation of Northern Rock's new business plan is subject to receiving state aid approval from the European Commission.

The decision to support the March 2008 business plan was based on a full assessment of the value for money case. The Government continues to follow the objectives it set at an early stage: to protect the taxpayers' interest, to protect retail depositors and maintain wider financial stability.

We are concerned that Northern Rock is suffering a 'first starter' disadvantage because it was one of the first European banks to request public funds. Northern Rock is paying a relatively high rate of interest on its Government loans whilst banks which have subsequently entered public ownership are paying lower charges in comparable circumstances. We recommend that the Government ensures consistent rates on loans made to banks in receipt of public funds or explains the justification for continuing discrepancies in such rates. (Paragraph 112)

The Government disagrees with the Committee's comments that Northern Rock is suffering a "first starter" disadvantage. The Government has maintained a constructive and cooperative dialogue with the European Commission on Northern Rock since it was taken into public ownership in February 2008. It submitted an updated notification to the Commission in April 2009.

The Government ensures that terms of financial support provided to each bank is consistent with its stated objectives and with state aid rules in particular the Commission's reference rates for providing loans, and is based on commercial principles.

We strongly recommend that the Government assesses the impact on the buy-to-let mortgage market of its share of that market, and how it proposes to use the influence it has. (Paragraph 119)

The Government notes the Committee's recommendations. Throughout this period of challenging financial conditions it has remained committed to protecting depositors, maintaining financial stability, and protecting the interests of the general taxpayer. In light of these objectives the Government is committed to an orderly wind-down of Bradford & Bingley's balance sheet.

Bradford & Bingley (B&B) published the Executive Summary of its business plan in March this year. B&B's over-arching objectives are to repay HM Treasury and the Financial Services Compensation Scheme (FSCS) as soon as market conditions allow, and protect taxpayers, whilst also treating customers and creditors fairly. The business plan sets out how B&B intends to run down its balance sheet in an orderly fashion over a number of years, and repay its liabilities, including approximately £18 billion provided by the FSCS and HM Treasury in order to transfer B&B's retail deposits to Abbey.

The merger between Lloyds and HBOS has been described in some quarters as a 'shotgun wedding'. Lloyds Group Chief Executive Eric Daniels conceded that the merger proceeded swiftly on the basis of relatively little due diligence and that the Government was involved to the extent that it offered to waive the competition rules. We also note that the merger may have prevented the collapse of HBOS with the consequent loss of many thousands of jobs and also avoided the outright nationalisation of the company. Nevertheless, from the evidence we received, if the merger has had injurious consequences for Lloyds TSB we consider that the responsibility for this lies primarily with the Lloyds Board. (Paragraph 128)

The merger between HBOS and Lloyds TSB was a decision that lay with their respective boards and shareholders. The Government's role in the Lloyds-HBOS merger was in amending competition law to allow financial stability issues to be considered alongside competition considerations.

Lloyds TSB and HBOS shareholders voted overwhelmingly in favour of the merger. This was after the Boards of both banks recommended to shareholders that they approve the merger. Moreover, as recognised by the Committee, if HBOS had not merged with Lloyds TSB, HBOS would have required significant financial support and may not have been able to continue as an independent financial institution.

If HBOS had been allowed to fail it would have had a very negative impact on taxpayers—depositors, business and families. It was right, and in the taxpayers' interest, that the Government allowed the financial stability implications of the merger to be considered.

Bank recapitalisation was necessary to maintain confidence in the UK banking sector. Given prevailing market conditions it was clear that some UK banks would have collapsed without taxpayer support. We therefore support the decision to implement a recapitalisation programme and the Government's support in return for stakes in banks that were unable to raise additional capital through the private sector. The unavoidable speed of implementation did, however, mean that the implications for both banks and Government were neither fully understood nor worked out. (Paragraph 146)

We welcome the fact that the Government has attached conditions to those banks in receipt of public funds for the purpose of recapitalisation. This is despite the fact that such conditionality may have discouraged other banks from applying for Government support. It is important that Government intervention does not undercut the competitive position of sound banks. Such conditionality should help provide assurances to the public that the banks face a quid pro quo in return for Government money and have not received a cost-free bail-out. The Government's priority now must be to ensure that these conditions—in particular those relating to remuneration and lending levels—are adhered to. We will consider remuneration policy in the part-nationalised banks in a later report. (Paragraph 154)

That said, we are concerned about the contradictions of the Government's objectives for the banking sector especially with regard to the part-nationalised banks. For example, there is an inherent conflict between ensuring that the banks maintain high capital ratios, protecting the taxpayer interest and wanting the banks to increase lending levels. This tension was demonstrated by the Government's initial decision to charge a 12% coupon on its preference shares which may have adversely impacted on the ability of the part-nationalised banks to increase lending levels. To this end, there is a pressing need for the Government to clarify its strategic objectives and priorities with respect to the part-nationalised banks as well as towards other banks who are also facing conflicting pressures from Government. (Paragraph 155)

The Government welcomes the Committee's finding that it was right to take decisive action in response to the exceptional instability in financial markets. The package announced in October 2008 was designed to increase liquidity in the short term through

extending and expanding the Bank of England's Special Liquidity Scheme; maintain funding in the medium term through credit guarantees; and make new capital available to banks to enable them to restructure their finances while supporting the UK economy.

As part of the Bank Recapitalisation Scheme, the Royal Bank of Scotland (RBS) received a capital injection of £20bn in the form of £15bn of ordinary shares and £5bn of preference shares. Subject to the Lloyds-HBOS merger, Lloyds TSB received an injection of £4.5bn in ordinary shares and £3.5bn in preference shares and HBOS received an injection of £8.5bn in ordinary shares and £3.5bn in preference shares. The preference shares carried the right to a dividend of 12 per cent per annum. The terms of the deal were based on market conditions at the time, and the need for the terms to be sufficiently competitive to achieve a return for the taxpayer and state aid approval.

The Government's strategy was successful in preventing the collapse of the banking system, ensuring that no retail depositors in UK banks lost money and safeguarding the interests of the taxpayer. However the intensification of stress in global credit markets from autumn 2008 triggered a steep and synchronised global downturn, exposing system-wide vulnerabilities in financial institutions around the world. This included RBS, which announced on 19 January 2009 an estimated annual loss for the 2008 financial year of between £7bn and £8bn, before exceptional goodwill impairments.

The Government announced on the same day that it would restructure its investments in RBS by converting its preference shares to ordinary shares, in order to ensure that the bank had sufficient Core Tier 1 capital to absorb expected losses. This was completed on 14 April. The Government converted its preference shares in Lloyds Banking Group on 8 June. This action to strengthen the capital base of the banks was achieved with no additional outlay by taxpayers. Whilst the Government will no longer receive its coupon payments from the preference shares, taxpayers will realise the value of their investment in the future when the Government's shares are sold. Ordinary shares also offer taxpayers the opportunity to share in any equity upside. This action enabled the Government to satisfy its objectives to ensure the bank remained sufficiently capitalised, whilst securing a potential return for the taxpayer.

Improved confidence and capacity to lend for businesses and households is important as we move towards economic recovery. This is why the Government has reached agreement with certain institutions, in particular the specific and quantified lending commitments with RBS and Lloyds Banking Group, to increase the flow of lending to homeowners and institutions in return for Government support. But the agreements are clear that the banks will lend on commercial terms, which means that their lending will be priced competitively.

The January 2009 package

Whilst welcoming the approach taken in the Asset Protection Scheme, we are concerned about the need for greater clarity over the possible impact on the public purse, and urge the Government to complete the due diligence on assets in the scheme as quickly as possible, to make public the proportion of assets, by value, in each category covered by the scheme, and to disclose as soon as possible the mechanism for

determining and the projected timeline for the crystallisation of any losses. (Paragraph 172)

We are mindful of the Governor of the Bank of England's comments that identifying the toxic assets on the balance sheets of banks is a task that will take many months. Dealing with so-called toxic or bad assets is a priority if confidence in the banking sector is to be restored and a prerequisite for this is establishing a clear and comprehensive picture of exactly what is on the balance sheet of the banks. To this end, we support the due diligence on assets of banks participating in the scheme currently being conducted by the Treasury. The Government has decided to tackle this problem through the establishment of an Asset Protection Scheme, which will provide guarantees on 'toxic' assets held by banks as well as other assets they retain that may suffer losses during the economic downturn. However, it is unclear at this stage whether the APS is a precursor or an alternative to the introduction of a so-called bad bank and we would welcome clarity as to the Government's intention in this area. We note that the exact value of the assets that the taxpayer will be guaranteeing has yet to be determined and that the eventual cost to the taxpayer of this arrangement is unknown. In hindsight, there were clear signs of an impending financial crisis since the summer of 2007. We question whether more analysis should have been instituted by the regulators earlier to clarify the nature and value of assets on which banks were relying. We would welcome transparency regarding the methods used to calculate the fee charged for participation in the Asset Protection Scheme and the relationship between the fee charged and the degree of risk. It is also as yet unclear how the Office for National Statistics will classify the potential liabilities assumed. (Paragraph 178)

The Government agrees with the Committee that clarity about the fiscal impact of the Asset Protection Scheme (APS) is important. However, it is inherently difficult to produce a robust estimate of the scale and profile of losses over time for the APS, in current market conditions. The inability of the market to value certain assets forms part of the background as to why the Scheme was established.

However, the Government is committed to reporting on the fiscal position to enhance public scrutiny of fiscal policy-making. In Budget 2009 the Government provisionally estimated that net losses from the Government's financial sector interventions may lie within a potential range from £20 billion to £50 billion (1½ to 3½ per cent of GDP). This estimate covers all the Government's interventions to ensure the stability of the financial system and restore the flow of credit, and therefore includes the APS. This provisional estimate is a prudent judgment, made for fiscal policy purposes. It is not an estimate of scheme-by-scheme losses over time, as it is impossible to set out accurate overall costs for certain at this point. The Government will continue to develop estimates of losses as schemes are finalised, and as market conditions normalise. It will update its estimates of unrealised losses in subsequent Budget and Pre-Budget Reports as new and better information becomes available. The Treasury accounts—to be published this month—will contain information in relation to expenditure and income on some of the Government's financial sector interventions, including the APS.

The Government agrees that it is important to complete due diligence on assets in the APS. The Treasury and its advisers are continuing to work on this. Further detailed information

will be provided when participating banks have signed the Accession Agreements to the APS.

With respect to the fees for the APS, these are determined with reference to a number of factors, including the nature of the assets that each of the participating banks is proposing to put into the APS, potential losses on these assets in a range of different scenarios, the first losses being taken by the banks, the capital position of each of the banks, the impact of the APS on their risk weighted assets and the need to ensure that the banks continue to lend to creditworthy borrowers through the recession. These factors differ between the participant banks, and so it is to be expected that the fees charged to them will also differ. Other relevant differences between the banks include the characteristics of the "B shares" that each will use to pay the fee and the fact that the agreement with RBS includes a tax undertaking from the bank.

The Committee asked for clarification of whether the APS is a precursor or an alternative to a bad bank solution. The APS is aimed at tackling the root cause of the problems facing the participating banks: uncertainty around the value of their assets. It is therefore aimed at tackling a similar problem to that which a "good bank/bad bank" scheme would tackle, and requires much the same process in the first instance, in terms of identification of assets. However, the Government chose the APS as the best approach for RBS and Lloyds Banking Group for a number of reasons. First, it enables the banks to remain substantially in the private sector—where they belong. Second, it ensures that the most distressed assets are ring-fenced, capping the banks' losses and freeing up the banks to increase lending. Third, it ensures that the banks properly share the burden of losses with the taxpayer, and is structured with incentives to minimise those losses, so reducing the taxpayers' exposure. Fourth, it has all the ring-fencing virtues of a bad bank approach, while leaving open the option that the covered assets can be reintegrated when they are no longer distressed. Most importantly this model allowed the Government to act quickly and decisively. In the current climate, speed has been shown to be essential to restore confidence. As noted in the statement on 19 January 2009, assets included in the Scheme will continue to be managed by the institution and will remain on its balance sheet but will be required to be "ring-fenced" by the institution so that actions in relation to them, including enforcement and disposal, will be subject to appropriate Treasury controls.

But this does not mean that the Government has rejected "good bank/bad bank" approaches in all circumstances. Indeed, the Government's approach to the resolution of Dunfermline Building Society was effectively a variation on a good bank/bad bank strategy. In order to stabilise the business, Dunfermline's retail and wholesale deposits, branches, head office and originated residential mortgages (other than social housing loans and related deposits) were separated out and, following a competitive process conducted by the Bank of England, transferred to Nationwide. These can be seen as "good bank" assets and liabilities. The social housing loans of Dunfermline's customers were transferred temporarily to a bridge bank, owned by the Bank of England, and have now been transferred to Nationwide. The remainder of Dunfermline's assets and liabilities—the bad bank—including commercial loans, high-risk mortgages and subordinated debt were put into administration to be managed and wound down over a period of time.

Further detailed information on the APS will be provided after final contracts are signed with the participant banks.

Bank lending

Whilst noting some positive signs, we are very concerned about the availability and terms of credit to the small business sector, and the slow movement on this issue by the banks. We regret the reports of sharp increases in bank charges and arrangement fees which can often be more damaging to businesses than higher interest rates. We deplore the behaviour of a number of those banks who have received so much public money and behaved in such an insensitive manner particularly to established customers. We ask the Lending Panel to set up a unit to monitor and investigate such practices, which seem to work against the letter and the spirit of the signed agreement. We invite the banks and Government to report back to us on progress in this area on a quarterly basis. (Paragraph 189)

The Government notes the Committee's concern on the availability and terms of credit to the small business sector.

At the 2008 Pre-Budget Report, the Government announced a new Lending Panel (made up of lenders, trade and consumer bodies, the Government, regulators and the Bank of England) to monitor lending. As part of this new monitoring approach, the Bank is publishing a new monthly report—"Trends in Lending"—which presents the Bank's assessment of latest developments in lending to the UK economy. The third report was published on 18 June. It highlighted the current weak levels of lending to business. The Bank of England's "Credit Conditions Survey" for the second quarter of 2009 reported on 2 July that increases in the availability of credit for businesses and households over the three months to mid-June 2009 and lender expectations of a further increase in the third quarter of 2009.

There are currently a number of Government schemes aimed at encouraging lending by the banks. However, it is difficult to form an overall picture of how effective those efforts are, and how well they are working together. We recommend that the Government, via the Lending Panel, ensure that there is published a clear overall strategy, with each of the schemes outlined, indicating its aim and progress to date. At present, the approach seems to be piecemeal and disjointed. The Lending Panel has not provided detailed information on how the lending level targets set when negotiating the recapitalisation and asset protection schemes have been met. The relevant data should be published. Meanwhile there is an unresolved inconsistency between, on the one hand bankers' assurances that they are increasing their lending and, on the other hand the widespread complaints of business that credit is difficult to obtain and increasingly expensive. This information should be published now, and on a quarterly basis in future. (Paragraph 201)

The Government notes the Committee's recommendation that the Government set out its strategy to support lending. Budget 2009 sets out the Government's strategy to ensure financial stability and support lending in the UK economy, including the measures announced in October and January.

As part of this strategy, the Government has agreed legally binding lending commitments with Lloyds Banking Group and RBS as conditions for accessing the Asset Protection Scheme. These commitments will see Lloyds lend an additional £14billion, and RBS an

additional £25 billion,—on commercial terms, and subject to market demand—over the 12 months from March 2009. The Government will report annually to Parliament on the delivery of these commitments.

As set out above, the Bank of England is publishing a new monthly report—“Trends in Lending”—which presents the Bank's assessment of latest developments in lending to the UK economy.

We are concerned about the arrangements for monitoring lending levels, which reverted from UKFI to the Treasury with the announcement of the January 2009 package. We feel that annual reporting of the lending levels, as announced by the Government to Parliament, is inadequate, and recommend that the quarterly figures reported to the Treasury by the banks should be made public. (Paragraph 202)

As set out above, the Government has agreed lending commitments with Lloyds Banking Group and RBS for the 12 months from March 2009. The Government recognises the importance of transparency of these agreements, and HM Treasury will report to Parliament annually on these commitments. Annual reporting is appropriate because these commitments have been made for a period of 12 months.

The Government notes the importance of regular monitoring across the wider lending market, and so has established a Lending Panel to monitor lending to businesses and households. As part of this new monitoring approach, the Bank of England publishes “Trends in Lending” on a monthly basis. In addition, the Bank publishes its “Credit Conditions Survey” on a quarterly basis, the FSA publishes mortgage market data on a quarterly basis, and industry bodies publish monthly data on mortgages and lending to SMEs.

UKFI

UKFI is managing billions of pounds of taxpayer money but at this stage too little of its activities are in the public domain. UKFI's website, for example, is almost devoid of content. Its Framework Document was published on 2 March 2009, four months after UKFI was set up, and the Investment Mandate is still not in place. We urge the Treasury to complete this document expeditiously, and to publish it. We consider it important that the public, the markets and Parliament understands the full details of UKFI's objectives with respect to its investee banks. The Government must publish a strategy for UKFI addressing how it will use its control of the investee companies, and what role it envisages for UKFI in promoting change within the banking sector more generally. We recommend that this should be done within the next three months. We do not think it is in the national interest for UKFI to remain so enigmatic a body. (Paragraph 212)

The Government notes the Committee's comments around the level of information publicly available on UK Financial Investments Ltd (UKFI), and its role, and agrees with the Committee on the importance of ensuring the market, and Parliament, has clarity on these issues. The Framework Document between HM Treasury and UKFI, published in March, sets out UKFI's objectives and the relationship between HM Treasury and UKFI. UKFI has also committed to sharing its Business Plan with the Committee in due course,

which will contain further information about UKFI's budget, and about how it will run itself. It has published an annual report and strategy for market investments on 13 July, which includes details on its work and strategy going forward.

The Government does not believe that it would be appropriate for the Investment Mandate to be published, given its commercial nature. The Government has set out its long-term vision for the banking sector in "Reforming Financial Markets", on 8 July 2009, and, as mentioned above, UKFI published its annual report and strategy for market investments including details of its work and strategy going forward.

In owning a majority stake in both RBS and Lloyds Banking Group, UKFI is in a strong position to influence banking remuneration structures across the entire banking sector, and should use this opportunity to fundamentally change the bonus culture provided by current banking remuneration practices. In a forthcoming report we will discuss in detail the contribution of remuneration practices to the banking crisis and how banking pay could be better structured. (Paragraph 217)

The Government notes the Committee's comments on UKFI's role in relation to remuneration in the banking sector. UKFI has been overseeing the remuneration conditions attached to subscribing to the Government's recapitalisation fund, and the Treasury's Asset Protection Scheme, within RBS and Lloyds, and has worked to ensure management incentivisation based on long-term, sustainable performance and no rewards for failure, in order to protect the interest of the taxpayer as a shareholder.

It is right that the Government's investments in UK banks should be managed at arm's length and it is important to retain a clear division of responsibility between UKFI's role as an institutional investor, and any other public policy objectives that the Government may pursue. However, we think it important that "arm's length" in this instance is clearly defined so that what is appropriate behaviour can be clearly discerned. Certain aspects of UKFI's institutional arrangements do lead us to wonder just how "arm's length" UKFI actually is from the Treasury: it shares a building and support staff such as IT and HR professionals, while the Chief Executive and several other staff are Treasury secondees. Whilst we acknowledge the cost savings that might be made through the collocation of UKFI with the Treasury, the effectiveness and independence of UKFI should not be compromised for the sake of relatively inconsequential sums of money, especially bearing in mind the onerous responsibility placed on UKFI. To this end, we recommend that UKFI consider moving out of the Treasury building, even if that means elsewhere on the Government estate. The Treasury has constrained UKFI's discretion by introducing a power of direction to be used if UKFI strays too far from the Treasury's wishes. The existence of this power, even if it is a nuclear option, undermines the "arms length" nature of UKFI's engagement with the investee companies. We invite the Treasury to set out clearly the precise circumstances in which it envisages this power being used. (Paragraph 222)

The Government welcomes the Committee's focus on the importance of Government shares in financial institutions being managed at arms' length and on a commercial basis, and notes the Committee's recommendation that UKFI should consider moving out of the HM Treasury building and be established on a statutory basis to ensure this.

The Government's view is that the organisational structures that have been established will effectively allow UKFI to deliver its objectives at arms' length, but notes the Committee's view on the other options available for ensuring that this is the case. With regard to UKFI's location in the HM Treasury building, this is a matter for UKFI, and is covered in its response to the TSC report.

It is not possible to set out the precise circumstances in which HM Treasury may be required to use the power of direction given to it under the Framework Agreement. As set out at UKFI's establishment, the Government's position is that its investments in financial institutions should be managed at arms' length on a commercial basis, and the Framework Agreement sets out how this is to be delivered in practice within the key areas of UKFI's responsibility. However, it is not possible, or indeed sensible, to try to predict every possible future circumstance and set out details in the Framework Agreement about how that circumstance should be managed. The power of direction is in place to provide a way of dealing with that as necessary.

Given the importance of the task entrusted to it and the vast sums of public money involved, we believe that UKFI should be established, at the earliest opportunity on a proper statutory basis. While the current ad hoc administrative arrangements persist we have no confidence that UKFI will have the real operational independence that is necessary. (Paragraph 223)

We appreciate that UKFI has many urgent priorities to consider at the moment, but shaping an exit strategy must be one of them. We think it vital for investor confidence that, even at this early stage of ownership, preconditions for UKFI's exit should be outlined, and a strategy for achieving exit devised. It is clear that setting out an exit strategy has advantages and disadvantages for banking system stability and UK economic recovery. The taxpayers must be satisfied that any exit strategy will maximise the direct financial benefits and minimise the risks to them. This precondition for any exit from the results of recapitalisation must be clearly set out. The existence of an exit strategy would greatly improve the clarity of UKFI's mission, and enable more effective scrutiny of UKFI's performance. We recommend that the Treasury provides details of an exit strategy for the taxpayer's investment in the banking sector. This strategy should include an analysis of the pros and cons of selling the Government's stake in tranches rather than as a whole. (Paragraph 229)

The Government also notes the Committee's request that the Government sets out an exit strategy for the Government's investments in financial institutions. UKFI's strategy for market investments, which was published on 13 July, includes information on UKFI's strategy going forward.

The future of the banking sector

The rebuilding of consumer trust is closely wound up in depositors having faith in the safety of their deposits, and the stability of payment systems and other utility aspects of banking. In our view, depositor reassurance can in the short term best be provided through improving and strengthening the regulatory regime for all types of bank. We do not lightly dismiss the Governor of the Bank of England's instinct that a separation of retail from investment banking functions is "very attractive". We believe that this is a

live issue which requires further debate, and one to which we will return.. (Paragraph 245)

The Government does not believe that breaking up large banks or requiring a Glass Steagall-style split between investment and narrow banking is the correct approach to managing such risks in the UK. Further information is set out in "Reforming Financial Markets".

We are concerned about the lack of transparency inherent in over-the-counter trading. One of the many reasons why "toxic" assets had such a devastating impact was that institutions had only a shaky grasp on where they were, what they comprised and what their value was. Their judgment was further clouded by the strong correlation between complexity and profitability. Looking to the future it is desirable that such obscurity is avoided. We recommend that the FSA takes steps to encourage trading through clearing houses and where appropriate on exchanges. The international nature of finance means that unilateral action by the UK would be ineffective. Nevertheless, the UK's central role in world finance makes it a key player in moving forward this agenda. (Paragraph 258)

The Government welcomes the Committee's interest in this area. The Government agrees that it is important to enhance the robustness and functioning of key derivatives markets, including the greater use of central counterparties (CCPs). "Reforming Financial Markets" sets out the Government's approach in this area.

It is widely accepted that the Government has been obliged to intervene very heavily in the banking sector to ensure its survival and maintain economic stability. In doing so, competition concerns have not been a priority. However the benefit of free competition in this area remains important and we recommend that the Government address this issue during the next two years. (Paragraph 272)

The Government believes that competition is vital in ensuring efficiency in financial markets and in protecting the consumer's interests. Choice can be an important element of competition and is a vital aspect of decision-making by users of services. As set out in "Reforming Financial Markets", the Government: is committed to encouraging new entrants into financial services in the UK; will seek to strengthen the ability of mutual societies to compete in future; and recognises the need to intervene to help in areas where markets cannot provide solutions, such as in its ambition to create a Social Investment Wholesale Bank. The Government remains committed to maintaining competitive markets in the UK.

Some banks' management and boards have failed their shareholders and created concerns for their customers and this failure has had devastating consequences for the UK's private and public finances. The consequences of this are being felt by individuals and households around the UK, and by UK businesses. Enormous effort will be needed on the part of financial institutions to restore public confidence in them. Moreover such is the sophistication of current (and no doubt future) banking operations that a different intensity of supervision may be needed to protect lenders, investors and other participants. We look forward to contributing to discussions on this issue. (Paragraph 282)

As set out in 'Reforming Financial Markets', the Government agrees that it is necessary to strengthen supervision and regulation of the financial sector. Lord Turner, in his recent Review, outlined the FSA's supervisory enhancement programme, which the Government supports, which will implement more intrusive and systemic regulation of financial institutions.

Much of the attention in the public debate around the financial crisis has focused on the role of regulatory authorities around the world, and their failure to predict and pre-empt the crisis. This is an important and valid debate, and one with which the Government's strategy engages head-on. However, it is also important to note that, alongside failures of regulation, the actions (or, in many cases, inaction) of market participants themselves were also highly significant. In a number of important respects, market discipline failed, leading to distortions and inefficiencies, which contributed to or exacerbated the crisis. It will therefore be incumbent on participants to work to address these failures, and to re-establish appropriate mechanisms for market discipline. While this is, in the first instance, the responsibility of market participants themselves, the Government will also take action to support this important aspect of renewal.

As a result, the Government announced in February 2009 that Sir David Walker would conduct an independent review to cover the effectiveness of risk management at board level (including the incentives in remuneration policy to manage risk responsibly and the balance of skills, experience and independence required on the boards of UK banking institutions); the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees; the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and whether the UK approach is consistent with international practice and how national and international best practice can be promulgated. In its discussion paper, the Government expanded the terms of reference of the Walker Review to "also identify where its recommendations are applicable to other financial institutions". Sir David Walker will be issuing a consultation paper on 16 July and conclusions in the autumn.

The Financial Reporting Council (FRC) is undertaking a parallel review, in close consultation with the Walker Review, of the Combined Code and will report its findings before the end of 2009. As part of this, the FRC has encouraged boards, and particularly the chairs that are responsible for board leadership, to carry out their own reappraisal of governance and of their application of the Code principles.

Appendix 2: UK Financial Investments Ltd response

UKFI

The Government must publish a strategy for UKFI addressing how it will use its control of the investee companies, and what role it envisages for UKFI in promoting change within the banking sector more generally. We recommend that this should be done within the next three months. We do not think it is in the national interest for UKFI to remain so enigmatic a body. (Paragraph 212)

UKFI agrees with the Committee's recommendation. We attach high importance to accountability to Parliament and to the public as shareholder in our investee banks. We have therefore published a strategy for managing our market investments which includes a UKFI assessment of the impact of the financial crisis on Government investee banks, and our general approach to disposal of Government investments, alongside our Annual Report.

In owning a majority stake in both RBS and Lloyds Banking Group, UKFI is in a strong position to influence banking remuneration structures across the entire banking sector, and should use this opportunity to fundamentally change the bonus culture provided by current banking remuneration practices. (Paragraph 217)

UKFI strongly welcomes the finding in the Committee's report on reforming corporate governance and pay in the city that "unduly strict restrictions on bonuses to staff would result in the banks struggling to recruit and retain talented staff and that this would be to the detriment of the taxpayer." UKFI has worked with both RBS and LBG to implement what are perhaps the most far reaching reforms to remuneration structures of any large banks in the world, in the context of their participation in the Asset Protection Scheme. Both banks have committed to fundamental reviews of their approach to future remuneration, and UKFI will continue to work with them on this, taking account of the forthcoming FSA remuneration code, and the findings of the Walker Review.

It is right that the Government's investments in UK banks should be managed at arm's length and it is important to retain a clear division of responsibility between UKFI's role as an institutional investor, and any other public policy objectives that the Government may pursue. However, we think it important that "arm's length" in this instance is clearly defined so that what is appropriate behaviour can be clearly discerned. Certain aspects of UKFI's institutional arrangements do lead us to wonder just how "arm's length" UKFI actually is from the Treasury: it shares a building and support staff such as IT and HR professionals, while the Chief Executive and several other staff are Treasury secondees. Whilst we acknowledge the cost savings that might be made through the collocation of UKFI with the Treasury, the effectiveness and independence of UKFI should not be compromised for the sake of relatively inconsequential sums of money, especially bearing in mind the onerous responsibility placed on UKFI. To this end, we recommend that UKFI consider moving out of the

Treasury building, even if that means elsewhere on the Government estate. (Paragraph 222)

UKFI welcomes the Committee's focus on the importance of Government shares in financial institutions being managed at arm's length and on a commercial basis, and notes the Committee's recommendation that UKFI should move out of the Treasury building. Whilst our initial establishment in 1 Horse Guards Road represented a very cost effective option and helped ensure that UKFI was up and running quickly, UKFI has an open mind on the most appropriate location, and will keep this under active review.

We appreciate that UKFI has many urgent priorities to consider at the moment, but shaping an exit strategy must be one of them. We think it vital for investor confidence that, even at this early stage of ownership, preconditions for UKFI's exit should be outlined, and a strategy for achieving exit devised. It is clear that setting out an exit strategy has advantages and disadvantages for banking system stability and UK economic recovery. The taxpayers must be satisfied that any exit strategy will maximise the direct financial benefits and minimise the risks to them. This precondition for any exit from the results of recapitalisation must be clearly set out. The existence of an exit strategy would greatly improve the clarity of UKFI's mission, and enable more effective scrutiny of UKFI's performance. We recommend that the Treasury provides details of an exit strategy for the taxpayer's investment in the banking sector. This strategy should include an analysis of the pros and cons of selling the Government's stake in tranches rather than as a whole. (Paragraph 229)

As set out above, UKFI agrees with the Committee's recommendations about increased transparency to the public, Parliament and investors, and we have therefore published a broad strategy for our market investments including our approach to disposals this summer. Detailed plans for individual disposals will clearly depend on market developments, and it would not be in the taxpayer's interest to publish them in advance.

Appendix 3: Financial Services Authority response

We welcome the Committee's Report on the *Banking Crisis: dealing with the failure of the UK banks*. In this memorandum we respond to those detailed conclusions and recommendations which are relevant to the FSA.

The issues raised in the Committee's report are high on the FSA's agenda as we seek to complete the implementation of our Supervisory Enhancement Programme and as we work with other authorities in the UK, the EU and internationally to learn lessons from the financial crisis and improve the regulatory framework for the future. We look forward to continuing to engage with the Committee on these issues, including in the evidence which Lord Turner will give on 23 June.

How did we get here?

To date, building societies have generally been shown to have operated a safer business model. Certain features of the building society model, including the comparatively low reliance on wholesale funding and the focus on the protection of members rather than the service of shareholders, have left building societies better equipped to defend against the shockwaves of the current crisis. We heard evidence that establishing new building societies was now harder than it was when the Ecology Building Society was started in 1981. The Government should examine, with the sector, whether any legislative or regulatory changes are required to facilitate building society start-ups and remutualisation. (Paragraph 63)

Legislative changes are a matter for the government. The current requirements for authorisation of any firm, including a building society, which wishes to conduct regulated activity, are set out in Schedule 6 of the Financial Services and Markets Act 2000 (FSMA). We are always happy to meet anyone who would like to establish a new building society to explain the relevant requirements and to help them in the application process.

Remutualisation can occur under the current legislation. For example, in 2005, the Britannia Building Society acquired the retail deposits of Bristol & West: the depositors became shareholding members of Britannia. This transaction was effected under Part VII of FSMA.

On 12 June we announced a new way for building societies to raise additional money, if they choose, to help support their businesses.¹ Building societies will be able to issue a new type of share, called profit participating deferred shares, which can be bought by companies looking to invest, such as insurance companies. This instrument, devised by the FSA, enables building societies to raise core tier one capital which will support them during periods of stress. We believe this will support a strong and vibrant mutual sector for the future.

¹ <http://www.fsa.gov.uk/pages/Library/Communication/Statements/2009/profit.shtml>

The origins of the banking crisis were many and varied, including low real interest rates, a search for yield, apparent excess liquidity and a misplaced faith in financial innovation. These ingredients combined to create an environment rich in over-confidence, over-optimism and the stifling of contrary opinions. Notwithstanding this febrile environment, some of the banks have been the principal authors of their own demise. The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed. Bankers have made an astonishing mess of the financial system. However, this was a failure not only within individual banks but also of the supervisory system designed to protect the public from systemic risk. (Paragraph 84)

As we noted in our memorandum of 16 February 2009 to the Committee, we believe that, in retrospect, one of the crucial policy failures in the years running up to the crisis was not the inadequate supervision of any specific financial institution, but the failure to recognise huge inherent system-wide risks and that the cycle of irrational exuberance was close to reaching a crisis point. It is clear that all concerned—the banks themselves, governments, central banks, international agencies, regulators— must learn lessons from recent events and must see how the behaviour and regulation of the banking sector can be improved.

The regulatory philosophy which we pursued in the past focused on ensuring that firms had the appropriate systems and controls in place and relied on the senior management of firms to make the right judgements. We did not see it as a function of the regulator to question the overall business strategy of the institution or more generally the possibility of risk crystallising in the future.

Our approach has now changed. We now expect firms' management to make decisions knowing they will be judged on the ultimate consequences of those actions. In our supervision we will judge firms on those outcomes and on the consequences of their actions, not on the compliance with particular rules. We will apply this outcomes-based approach through our new intensive supervisory model, which is underpinned by our focus on credible deterrence.

Deposit protection

We think that there should be a limit to the level of deposit protection offered by the FSCS to mirror arrangements in Europe in order to avoid a competitive disadvantage for UK banks. Once financial stability has returned and there has been clear communication about the scope of protection, it should be made clear that the new £50,000 limit will be applied. This would reintroduce the depositor's obligation to consider matters other than the bald interest rate in choosing where to locate their investments, and thus ensure that the banks had a disincentive to be reckless. The FSA should think now about a strategy for shifting the expectations of the banking consumer from one of total protection, to a partial protection basis. This strategy should be developed sufficiently to be readily deployed by the time that immediate concerns about bank safety have been calmed. One measure we would like to see adopted would be a requirement for all savings institutions to publish all relevant documentation and advertising, and also within branches, notice of the £50,000 deposit ceiling. We renew our recent recommendation that the FSA should carry on its website a list of all banking products covered by the deposit protection scheme. (Paragraph 90)

We also think that financial institutions must make clear to their customers where they are subsidiaries of other institutions where this is relevant in terms of deposit protection. Ideally, we would like to see each brand holding a separate banking licence. (Paragraph 91)

We are very sympathetic to the plight of building societies in funding more than their share of the FSCS burden and call on the FSA to review the situation with urgency. It is entirely inappropriate that institutions that are recognised as having a safer funding model, indeed have such a funding model enshrined in legislation in order to protect their depositors, should be required to contribute more to the industry's insurance scheme than competitors with funding models that have failed in the current crisis. The principle seems to have been that the riskier the business model, the less that is paid. The absurdity of this serves to reinforce our previous recommendation that levies be charged according to risk, and we renew that recommendation in this Report. (Paragraph 96)

We agree that there should be a limit to the level of FSCS coverage. The EU Deposit Guarantee Schemes Directive has recently been amended to introduce an EU-wide common deposit protection limit of €100,000 from 31 December 2010. However, this amendment will take effect only if the European Commission reports during 2009 that such a change would be appropriate and financially viable for all Member States. We will continue to engage with the EU in its work on this issue.

Consumer expectations of what might happen when a deposit-taker defaults depends not only on the level of FSCS coverage, but on whether consumers consider that the government might intervene to provide extra protection. It is a matter for the government to consider when to tell consumers that the extra protections which it put in place will no longer be available and that depositors will enjoy protection only up to certain limits. However, at the point the government does this, and also once the long term framework in the EU is clear, we and the FSCS will develop a strategy to communicate the level of partial protection to consumers.

We consulted in January 2009 (*Financial Services Compensation Scheme reform*)² on the need for greater consumer awareness of the FSCS, including the need for better disclosure by banks. We published proposals to require deposit-takers to disclose which brands operate under each banking authorisation held. We will finalise and publish our policy on this later in the year. We agree that firms need to make clearer to their customers where they are subsidiaries of other institutions, where this is relevant in terms of deposit protection. We agree that one banking licence per brand would simplify the situation for consumers.

Deposit-takers currently pay for the level of protection that they receive from the FSCS. So a deposit-taker with more deposits contributes more. We consulted in January on a refinement to the way in which any FSCS levies are apportioned between deposit-takers. On the whole respondents welcomed the proposals, but many building societies also called for further action.

² CP09/3, January 2009, *Financial Services Compensation Scheme reform: Fast payout for depositors and raising consumer awareness*

We undertook a comprehensive review of the FSCS funding model in 2006/07 and considered the possibility of introducing risk-based levies. At that time there was no clear consensus on the merits of risk-based levies. However, the position of some stakeholders has clearly changed and this, along with the understandable concerns about the actual impact that the levy is having on deposit-takers, has led us to commit to start a further review of the funding model which will be published in 2010/11. We expect this review to reconsider, among other things, the merits of risk-based levies.

The future of the banking sector

The rebuilding of consumer trust is closely wound up in depositors having faith in the safety of their deposits, and the stability of payment systems and other utility aspects of banking. In our view, depositor reassurance can in the short term best be provided through improving and strengthening the regulatory regime for all types of bank. We do not lightly dismiss the Governor of the Bank of England's instinct that a separation of retail from investment banking functions is "very attractive". We believe that this is a live issue which requires further debate, and one to which we will return. (Paragraph 245)

We welcome the opportunity for further debate on the separation of retail from investment banking functions. In the run-up to this crisis, several large commercial banks, which perform basic banking functions for companies and households, and whose retail deposits are insured, were extensively involved in risky proprietary trading, which generated large bonuses for individual bankers but produced large losses which taxpayers have subsequently had to underwrite.

However, it is not clear that separating retail from investment banking functions would effectively address the problem, or that a clear and appropriate division of functions is practical in today's complex and global economy. Risky institutions cannot be left to market discipline: Bear Stearns and Lehman Brothers were not deposit-taking banks but were systemically important. Narrow banks doing classic commercial banking can get into trouble just as universal or investment banks doing risky trading can - Northern Rock and Washington Mutual were narrow banks and HBOS's problems stemmed almost entirely from classic banking activities.

For those reasons we did not suggest a new Glass-Steagall in the *Turner Review*, but suggested imposing new capital and liquidity regimes for trading activity.³ The clear objective and likely impact of such regimes would, however, be very similar to those which a Glass-Steagall type separation would attempt to achieve. It would almost certainly result in an increasing number of banks choosing to focus entirely on classic commercial banking activities and it would help ensure that, where commercial banks are significantly involved in trading and market making activities, they should do so as a means of providing services to commercial customers, rather than as a standalone activity.

This question will no doubt be debated further in the UK and internationally. We will develop our thinking further as we take forward our work on reforming capital and liquidity.

³ March 2009, *The Turner Review: A regulatory response to the global banking crisis*

We acknowledge that the toxic shock that major financial institutions have been exposed to by securitisation is likely to result in changed business practices. We expect that one such change will see banks returning to the practice of keeping a greater portion of the loans they originate on their own balance sheets. But we also believe that a regulatory response may be required and recommend that the FSA coordinate efforts with its international counterparts to require that those undertaking securitisation retain a tranche of the commodities they trade. (Paragraph 249)

The financial crisis clearly highlights significant risks arising from the way in which securitisation practices developed. In the banking system as a whole, one of the key problems was that too much risk was retained on banks' balance sheets, rather than being distributed to end investors. As the *Turner Review* explained, the securitised risk model, initially described as an 'originate and distribute' model became an 'acquire and arbitrage' one, as banks which were distributing their own credit risks were also buying those distributed by others.

However, it is also true that problems arose because banks which were originating risk and not distributing it were, in some cases, less concerned than they should have been to ensure sound lending.

The principal problem was not the concept of securitisation itself but that in many cases the originators of risk (that is, the banks) retained risk far greater than was apparent to themselves, investors and regulators. The originators and investors involved failed to carry out proper screening, monitoring and due diligence. One regulatory response to this which has gained the most attention is a requirement for originators to retain an economic interest ('skin in the game') in their securitisation in order to maintain the appropriate incentives to screen and monitor borrowers. In our view, this does not necessarily address the underlying concerns. Any firm acquiring risk must ensure that it is properly understood and managed, and supported by appropriate capital. It is most important that we regulate by focusing on economic substance, as suggested in the *Turner Review*.

The EU Capital Requirements Directive (CRD) has now been amended to require investors subject to the CRD only to invest in a securitisation position if the originator has retained an economic interest of at least 5%. The amendments (which come into force on 31 December 2010) include additional requirements on investors to ensure they undertake effective due diligence and that originators properly disclose relevant information. We fully support and are engaged in work at an international and EU level which seeks to address the weaknesses that have been identified in the securitisation markets.

We are concerned about the lack of transparency inherent in over-the-counter trading. One of the many reasons why "toxic" assets had such a devastating impact was that institutions had only a shaky grasp on where they were, what they comprised and what their value was. Their judgment was further clouded by the strong correlation between complexity and profitability. Looking to the future it is desirable that such obscurity is avoided. We recommend that the FSA takes steps to encourage trading through clearing houses and where appropriate on exchanges. The international nature of finance means that unilateral action by the UK would be ineffective. Nevertheless, the UK's central role in world finance makes it a key player in moving forward this agenda. (Paragraph 258)

We agree that markets need to be appropriately transparent and resilient in order to underpin financial stability, as well as promote efficiency and investor protection. As we noted in the Discussion Paper (DP) which accompanied the *Turner Review*⁴, the crisis has highlighted questions about whether the rules and arrangements which govern the way that markets operate remain appropriate and effective. In this context, a number of dimensions of transparency need to be considered. Chapter 10 of the DP sets out in more detail how we are taking forward each of these elements. These include:

- a) transparency of trading (price and volume etc);
- b) transparency of positions held by market participants; and
- c) transparency about the nature of the product being traded.

Encouraging the increased use of infrastructure, where appropriate, both for trading and clearing, represents an important way in which the transparency and resilience of these markets may be enhanced. We are, in line with the G20 commitments, working with fellow regulators and market participants on a range of initiatives designed to strengthen the infrastructure for over the counter (OTC) derivatives. Currently, the focus is on introducing central counterparty clearing for OTC credit derivatives and encouraging greater use of exchanges and electronic trading platforms for this asset class.

Some banks' management and boards have failed their shareholders and created concerns for their customers and this failure has had devastating consequences for the UK's private and public finances. The consequences of this are being felt by individuals and households around the UK, and by UK businesses. Enormous effort will be needed on the part of financial institutions to restore public confidence in them. Moreover such is the sophistication of current (and no doubt future) banking operations that a different intensity of supervision may be needed to protect lenders, investors and other participants. We look forward to contributing to discussions on this issue. (Paragraph 282)

We fully agree that the crisis illustrates the need for radical change in our supervisory approach, leading to a far more intensive style of supervision. This is being delivered by our Supervisory Enhancement Programme, launched in April 2008; it will be further reinforced as the lessons of the crisis are learned. Our Supervisory Enhancement Programme will result in substantially increased supervisory resources devoted to high-impact firms, more detailed analysis of sector trends and outlier firms, and greater challenge to firms' business models and management judgements.

This does not weaken our fundamental view that firms' senior management carry primary responsibility for their actions and the consequences of those actions. This responsibility is shared with non-executive directors (NEDs), shareholders and auditors. There are limitations to what regulation can achieve and all regulatory judgements carry risks. A key element of successful regulation is to work in partnership with these groups. It is only by doing so that we will effect changes in behaviour.

⁴ DP09/2 March 2009, *A regulatory response to the global banking crisis*

Investors must also take responsibility to be active individually and collectively, to engage with firms' senior management and non-executive directors in companies and question the effectiveness of the composition of their boards. We are keen to encourage greater dialogue in this respect.