HOUSE OF COMMONS

HOUSE OF LORDS

ORAL EVIDENCE

TAKEN BEFORE THE

PARLIAMENTARY COMMISSION ON BANKING STANDARDS

BANKING STANDARDS

MONDAY 29 OCTOBER 2012

PROFESSOR JOHN KAY

Evidence heard in Public Questions 288 - 354

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Oral Evidence

Taken before the Joint Committee

on Monday 29 October 2012

Members present:

Mr Andrew Tyrie (Chair)
The Lord Bishop of Durham
Mark Garnier
Baroness Kramer
Lord Lawson of Blaby
Mr Andrew Love
Mr Pat McFadden
Lord McFall of Alcluith
John Thurso
Lord Turnbull

Examination of Witness

Witness: **Professor John Kay**, Visiting Professor of Economics, London School of Economics, and Fellow of St John's College, Oxford, gave evidence.

Q288 Chair: Professor Kay, thank you very much for coming in this afternoon. You produced a report just at the beginning of our work, on decision making in equities. In there, you said that one of your aims was to "Shift regulatory philosophy and practice towards support for market structures which create appropriate incentives, rather than seeking to counter inappropriate incentives through the elaboration of detailed rules of conduct". Do you think that getting incentives in better shape will improve banking standards?

Professor Kay: Yes, I do, although we need to be a bit careful about what we mean by incentives, because I have noticed that when I talk about incentives, people think I am talking about bonus structures. I am talking about that, but not only about that. I am talking about the whole industrial structure and environment within which people work and what moulds their behaviour.

Q289 Chair: Can you elaborate a little on what you mean by incentives, maybe under a few headings?

Professor Kay: Yes. Economists talk a lot about incentives. When they do, it tends to be monetary incentives, and obviously monetary incentives play a part in determining what people do, but actually people's behaviour is very much moulded by the environment in which they operate. They behave like the people who are around them, and the values of the organisation in which they function and the kind of expectations that people in it have form a large part of what they do. That is why I think what is really important about getting financial services right is both getting the structure of the industry right and influencing the kind of

ways people are encouraged to behave, or not to behave, within the organisation. Again, that is partly a matter of financial incentives, but it is certainly not just a matter of financial incentives.

Q290 Chair: You mentioned structure. I want to ask you about the proposals that are in play at the moment. There is Vickers. There is Liikanen. Of course, there is the Volcker rule, and you yourself published a detailed set of proposals entitled "Narrow Banking". Do you think that any of these will make a major contribution to improving standards?

Professor Kay: They will make a contribution. We are moving in the right direction. Everything you have described—the Volcker rule, the Vickers recommendations and Liikanen—is starting to address the issue that the problems are to do with the structure of the industry, rather than creating more rules about how people will behave. They are all fairly modest, for a start. How large an effect any of them will have in the particular form in which they are now proposed is an open question.

Q291 Chair: Will you have a stab at answering the open question? After all, it does seem pretty important to an inquiry into banking standards.

Professor Kay: I think that is right. There are two different groups of issues that we are trying to address. One is the misalignment of incentives that follows from the way in which in effect the taxpayer-backed deposit base could be used as security for the wider activities of a conglomerate financial institution. That was a problem that was really at the heart of at least why we had to respond to the crisis of 2008 in the way in which we did.

The second is the broader cultural issue and, to my mind, the incompatibility between the culture that is required to run the kind of retail bank that depends on processing millions of rather routine transactions every day with a really high degree of accuracy and the trading culture that depends on buccaneering individuals who do not respond very well to bureaucratic structures. Whatever we do in terms of ring-fencing or the like, it will not really address that cultural issue, which is part of what has created the problem in a much broader sense.

Q292 Mr McFadden: When you gave evidence to the Treasury Select Committee almost exactly a year ago, shortly after publication of the Vickers report, you said, "I would have preferred full separation, but I think 98% of a loaf is pretty good and I am fairly happy with that." Thinking about what has happened over the past year, is that still your judgment of Vickers—that it represents 98% of what you would like to see—or have things moved on in any material way in terms of your judgment of it?

Professor Kay: If I said 98% then—I am sure, since you quote me, I did—I was probably in a fairly optimistic mood at the time. But certainly I have taken the view that at least half, or more than half, a loaf is better than no bread. A problem that has always concerned me is that even that half loaf would have crumbs knocked off it as a result of lobbying and the passage of time before it actually came into effect. There is certainly nothing that has happened since then that would have alleviated that particular worry.

Q293 Mr McFadden: Do you think the Government's version of the Vickers reforms and the changes made, such as the applicability of capital ratios or the way that they propose to deal with the bail-in debt proposals, are important departures, or departures of detail that do not really alter the substance of it?

Professor Kay: I think they are departures of details. I do not think they are hitting at the fundamental principle. There is a very real difficulty of getting definitions first of all precise enough of the ring fence and, secondly, of blocking attempts to get round it. Whatever behavioural rules of that kind we employ, we know that there will be a lot of pressure to do things that have the same economic effect, even if they have a slightly different form. We have to watch those issues all the time. The reason I wrote the "Narrow Banking" pamphlet in the terms that I did, was that I had concluded that it was incredibly difficult to write rules that would make a ring fence water-tight—though that is the wrong metaphor—a ring fence sufficiently robust.

Q294 Mr McFadden: When Paul Volcker came before us a couple of weeks ago, I think it is fair to say that he was quite sceptical about the concept of a ring fence, either the Liikanen or the Vickers version. He thought it would be permeable over time, and that it did not deal with the cultural problem, which he described as the transactional—and you called the buccaneering—culture "infecting" the retail banks. That was his word, not mine. When it comes to it, what do you think are the pros and cons of full separation in the Glass-Steagall or Glass-Steagall II sense, and this ring-fence concept?

Professor Kay: We are talking about Glass-Steagall II, because Glass-Steagall as it was in the 1933 legislation does not really get the distinction you want to make. It is very difficult to do this. I have written about my experience at Halifax, where I thought that the road to nemesis essentially began at the point at which it was decided that the treasury operations of the bank should be a profit centre rather than a service activity for the business of deposit taking and mortgage lending.

If you are to say that that is an activity that is capable of bringing about the destruction of the whole operation—and it was an activity that ultimately contributed to the destruction of that whole operation—you have to have a very tight and narrow definition of a ring fence, and what you mean by deposit-taking bank, in order to achieve what we should be trying to achieve with it. Everyone would have thought that Halifax, as it was in the late 1990s, was a retail bank in the ordinary sense, but in the sense that is relevant to us there was an important respect in which it was not.

Q295 Lord Lawson of Blaby: May I probe this area a bit more, as it is important? Correct me if I am wrong, but you have said that almost at the heart of the problem is the cultural incompatibility—your term—between the prudent culture appropriate for retail banking, particularly when there are taxpayer guaranteed deposits, and the buccaneering culture of trading and the risk that goes on in investment banking. It may be very important and interesting but it is a different culture.

Your fear is that the ring fence cannot work, because you cannot have two incompatible cultures in one organisation, so you propose your narrow banking idea. Would you agree that the important thing is the complete separation between the two organisations, rather than the precise place where you put the separation in your narrow banking? You may put it in the right place but some people might put it differently. The important thing is not precisely where you put this separation but that there is this separation.

Professor Kay: No, I think that is absolutely at the heart of the matter. In that pamphlet I wrote a particular version of the separation, in order to answer the question that this couldn't work. I set out a model in which I believe it plainly could work. It is certainly not the only model that might work. The issue that Vickers addressed directly, which is that of cross-subsidy, is important, but the cultural issue is a fundamental one.

The cultural issue has been with us since the big bang. In the 1980s, what we saw in Britain was the retail banks taking over most of the other activities in the City, as jobbers, brokers and the like were acquired by retail banks. Those mergers technically did not work, because at that time the retail bankers were running the show and the traders would not be run by the retail bankers. Then there was the second round, which we have seen in the past 10 to 15 years, which worked the opposite way round, in that it was the investment bankers who took over the entire conglomerates and the retail banking activities were subordinated, essentially, to them. Until Diamond was removed at Barclays, we had essentially reached a position in which the top positions at British banks had been taken by people who had spent large amounts of time on the investment banking side of the business.

Q296 Lord Turnbull: I am clear about your proposal on narrow banking, but I am very unclear about what your proposals really are for the rest. The rest is not a residual; it is mortgages, lending to industry, working capital for SMEs and lending for commercial property, as well as dealing with issues such as providing hedging in derivatives that companies need. In your world, who looks after that bit, which is not simply the residual bit but the heart of what industry and society need to function?

Professor Kay: Well, it is the heart of what industry and society need to function, but it is not really the heart of what these institutions do. If we look at what the balance sheets of UK banks are, we are talking about aggregate balance sheets that amount to something like £7 trillion, but in terms of lending to the real economy, by far the largest element in it is residential mortgages. Residential mortgages are something like £1.4 billion or £1.5 billion. That is a big number, and it is much the biggest number in terms of banks' contribution.

Q297 Lord Turnbull: So, £1.4 trillion?

Professor Kay: Sorry, £7 trillion, and £1.4 trillion are the mortgages. My view is that we know how to do residential mortgages. We did them pretty well in the '90s, I think, and there was an argument probably then that Britain had in some ways the mortgage market of all the major countries that was working best.

Lending to real non-financial business is a very small part of the total. It is £200 billion or so. It is a very important part, and it is being done very badly at the moment, and I believe that we are going to have to reconstruct institutions that are capable of doing that particular business in a way that we would like the banking system to do it. In large part, there are still elements within the banks as they operate today that have the capability to do that, but it is something that they have been diminishing over a couple of decades, as they have centralised and mechanised the process of doing that kind of lending.

Q298 Lord Turnbull: Where do the SMEs get their working capital from?

Professor Kay: That is where they get it from.

Q299 Lord Turnbull: And what are these institutions that perhaps exist at present but are not doing this function?

Professor Kay: They are business banks, and there are elements of business banks in this sense within—

Q300 Lord Turnbull: So you are saying that we have to create a series of institutions that do not exist at present, as opposed to taking the institutions we have and modifying them.

Professor Kay: They would be stripped out. The embryos of them would, I think, be stripped out of our existing institutions. One of the missed opportunities of Royal Bank of Scotland, for example, was that I am fairly confident there were quite good small business lending bankers within that institution. Pulling these people together and making an institution focused on business lending would have been a strong part of the proper reconstruction of Royal Bank of Scotland and, indeed, we could have done the same with the other semi-nationalised bank as well.

Q301 Lord Turnbull: We have a Bill coming through in the next Session on restructuring banking. It seems to me quite an ask to say it should be based upon the creation of a series of institutions that don't yet exist.

Professor Kay: Well, we cannot put that into legislation. That is why near nationalising Royal Bank of Scotland was an opportunity because it gave us as policy makers, or potential policy makers, the opportunity to reconstruct one institution in a way that could be the basis for the sort of developments we want. If one works through the implications of what I would like to achieve, you would end up with a very radical reconstruction of the financial system. I have no doubt about that. But I think it needs to be taken step by step. Probably the first step is the effective separation step.

Q302 Lord Turnbull: "We" is a tricky word. Who is the "we" who do this? Is it the banks themselves or are you basically saying that the state has to do this?

Professor Kay: I am sorry. When I say "we" I am referring to the public policy objectives in this sector. That is what I mean.

Q303 Lord Turnbull: Coming back to narrow banking, you are saying that the deposits should be secure in Government securities—Baroness Kramer may have some questions on that—but they can lend on the basis of wholesale funding. This is surely the Northern Rock model, isn't it?

Professor Kay: Yes.

Q304 Lord Turnbull: And it went badly wrong?

Professor Kay: Yes.

Q305 Lord Turnbull: So how do you stop a Northern Rock type failure?

Professor Kay: Under the kind of thing I propose Northern Rock could not have happened. Northern Rock could not have happened if there had been what there obviously should have been, which was priority for depositors and/or the financial services compensation scheme in the break-up or liquidation of an organisation. Then you would have situation where the combination of securitised mortgages and the protected retail deposits would have been such a large part of that institution's balance sheet that it could never have raised the money on wholesale money markets which were the source of its ultimate demise.

Q306 Lord Turnbull: You are separating credit and lending activities from deposits. You are also separating them organisationally.

Professor Kay: I would be quite happy to do that. That was a model I proposed in the narrow banking pamphlet. I would equally be happy to have a narrow banking organisation

which lent on a very strictly defined range of categories. I was concerned about the issue which I mentioned earlier in which the Treasury operation of what was then a building society, which became a mortgage bank, ultimately metamorphosed into what was essentially a trading activity within that organisation.

Q307 Lord Turnbull: My brief research into HBOS tells me that it was in the commercial lending and the property lending that the fall begun.

Professor Kay: That was not the heart in the end of the HBOS problem. No, that is absolutely right, but it was the heart of the problem at other banks, and it is capable of being the heart of the problem at any bank.

Q308 Lord Turnbull: I think my summary is the contrast between the clarity of the definition of the narrow bit and the vagueness of definition of everything else in your set of proposals—

Professor Kay: I think in the pamphlet you are describing that is perfectly fair. I am in the process at the moment of writing a book in which I want to spell out the set of other financial institutions that one would need to create if one were to have a financial sector that served better the needs of the real economy. But I did not put it all in that pamphlet; I had not thought of it all at that time. I am not sure I have thought of it all even now.

Q309 Mr Love: Andrew Haldane, in a recent speech, suggested that the "too big to fail" problem was becoming hard-wired into the structure of the banking industry. Are the proposals that the Government have brought forward for resolution regimes and structural change adequate for the task of dealing with "too big to fail"?

Professor Kay: No. I would be slightly surprised if anyone really thought they were.

Q310 Mr Love: So what needs to be done? Obviously, your narrow bank proposals, partially, but where are the shortcomings of what the Government are proposing, first of all?

Professor Kay: I do not much believe in the effectiveness of the proposed resolution procedures, for a variety of reasons. One is that if the resolution procedures were to be real, they would have to entail massive simplification of the corporate structure of these organisations, which does not appear to be in progress. Although we do not know the details of the resolution proposals, that is a reason for an outsider to be rather surprised at the suggestion that they might deal with a problem. In any event, an outsider sees that they appear to be directed to the gradual winding down of institutions, which seems not to be the kind of problems with which we are characteristically faced in the present world.

As we understand it, the Chancellor of the Exchequer was given a few hours' notice that the banks that the Government supported with very large amounts of money were about to run out of cash. At the point at which you, as the Chancellor, are given that ultimatum, you have absolutely no choice but to say "How much money do you need?" That is what we did. Your reaction the day after is to say, "How do we make sure this will never happen again?" but that is the question that does not seem to have been asked.

We need to address a mix of the structural issues that we have been describing, and also to ask whether we simply need to have more, smaller and more diverse institutions in order to remedy the "too big to fail" problem. I suspect if we dealt with the first of these issues properly we would not have to give so much attention to the second—whether these institutions are too big. The truth is that for most of the 20th century in Britain the situation of

having some very large but very conservatively managed banks worked perfectly well and can probably manage perfectly well again. I would like to see more diversity of institutions in the financial sector, but primarily for other reasons. My basic view is that “too big to fail” is a doctrine that is unacceptable both for reasons of economic dynamism and because democracies cannot have private sector organisations that are too big to fail. That means that Governments can be blackmailed, in effect, in precisely the way in which they were.

Q311 Mr Love: I think Andrew Haldane shares your scepticism. He suggests that when push comes to shove, exactly as you outlined, a Government will step in. Are you suggesting that only the very narrow banking structure that you put forward will deal with that, or are there any other structures? Looking at the plethora of options available to us at the present time, are any of them likely to lead to the market accepting that we are dealing with the “too big to fail” problem?

Professor Kay: I think we can move there. I think the basic principle we should be moving towards is saying that the only thing that the taxpayer will stand behind is retail deposit-taking institutions. We need to extricate ourselves from either implicit or explicit support for any other financial institution. That does not mean that you might not sometimes want to go for, as it were, the General Motors solution, where you put in Government funding to promote an orderly wind-up and reconstruction of the organisation, but you are quite clear that those are the terms on which you are doing it. It is to enable the winding down of the activities to take place in an orderly manner rather than to enable it to try to get back to business as it was before.

Q312 Mr Love: You were somewhat sceptical about the impermeability of the ring fence. Andrew Haldane, in his speech, said that you would need “entirely separate governance, risk and balance sheet management on either side of the ring fence.” In other words, they would need to be almost entirely separate entities. Would that measure up to the impermeability that is required in these circumstances?

Professor Kay: I think if there was entirely separate governance, that certainly would do it. Actually, entirely separate governance amounts to separation. You could imagine that being done within the context of a single holding company that owned both, but only if the holding company was essentially a purely passive investor in the two institutions and did not attempt to influence their policy. You could conceive of that structure, but it is far-fetched and it is hard to understand why anyone would want to do that. I have thought, and in some ways I continue to think, that the effectiveness of ring-fencing would be demonstrated by whether Barclays wanted to split itself up. If the ring fence were really effective, they would have little reason to want to maintain that structure. In that world, the interest that certainly the previous management of Barclays would have in the retail side of the activities would probably be rather small.

Q313 Mr Love: You are echoing comments made to us by Mr Volcker, who said he had never heard of complete separation. He said that it had not occurred to him that it was at all possible and that the net effect would be that they would go for complete separation, because that would be the impact of what has been suggested as the impermeable ring fence.

Professor Kay: I have been very conscious of analogous developments in the case of various utilities—gas, electricity, telecoms and so on—in some of which we instituted separation, and in others of which we tried to create ring fences of various kinds. In the end,

in most cases both the institutions themselves and the regulators went down the route of separation.

Q314 Mr Love: Perhaps the most radical thing in Andrew Haldane's speech, which was about being the right size, was his suggestion that once allowance is made for an implicit subsidy there is no evidence of economies of scale from sheer size and that the optimum size would be around $100 billion deposits. Do you have any sympathy for the size argument? How would we get there if that was suggested?

Professor Kay: I do not have much sympathy for the size argument. There clearly are some economies of scale in banking, but I think they are largely exhausted at a pretty low level. To the extent that they are not exhausted they are mainly on the technological side. Now, as we were reminded in the last few months, bank technologies are in many ways in a rather unsatisfactory state because they have had old systems which they have added more and more to over the years. It is quite interesting to look at the credit card and plastic payment market, which is the newer development on the technological side. The reality is that the technology is very largely operated by a very small number of specialist firms, firms we have barely heard of like First Data and so on. That name is not on any of the credit cards in your wallet, but what is has been the name of a bank who is essentially the front for this back-office technology which is being provided by specialists. I rather suspect, although I have not gone into the issue in detail, that that may well be the road ahead for banking as well. You have technology platforms that are supplied and developed by specialist firms, and banks buy them in to meet their needs.

Q315 Mr Love: But if you don't think there are economies of scale from just sheer size, would it be sensible to try for a period of time to get the industry to conform to the idea of a smaller size of bank as one way to try to resolve these issues of being too big to fail?

Professor Kay: It would, but in the retail banking sector, almost all banks are going to be too big to fail. We introduced deposit insurance relatively recently in the UK. Most countries had deposit insurance much earlier than we did. Until the 1980s people got deposit insurance in the UK from their belief that banks were too big to fail. But we have introduced deposit insurance and I am sure deposit insurance is the right route ahead, whether €100,000 is the right limit to put it at is another matter. But once you have that in place as the main Government mechanism for guaranteeing retail deposits, it changes a lot of other elements of the equation.

Q316 John Thurso: Professor Kay, I want to ask you about corporate governance but before I do that can I just for a brief clarification on two answers that you have already given? One was in relation to Lord Turnbull who pointed out that much of HBOS's failure was in corporate property lending. Is it the case that the common denominator between all the failures was an attempt by those who caused those failures to emulate the culture of bullish trading and that is the common thread throughout the banking crisis?

Professor Kay: I think there is quite a lot in that. I have also thought of it as being another issue, that almost none of the banks that failed did so as a result of failures in what was their mainstream business. The example you take is probably the closest to one that did and it is not very close. The largest part of the business for that bank was essentially mortgage lending. It was not mortgage lending that pulled them down. But if you take RBS or AIG as extreme examples, what destroyed them was relatively minor in relation to where the bulk of their people worked and the bulk of their profits were derived and so on.

Q317 John Thurso: The reason I ask is because I wonder whether in your work you did anything to look at what is nowadays called human resources—when I started out in the world it was called the personnel department—and the manner in which people are hired and how they look for those people. Did you look at that at all in your work?

Professor Kay: I have not and that is my particular strength or specialism.

Q318 John Thurso: The reason I ask is that I have been told that a number of banks do personality tests and deliberately look for what is known as the alpha male, the one whose testosterone is at the highest level between 7 am and 10 am, which is why so many bank meetings take place at that time. They deliberately seek them because they are the aggressive people who do deals. Those people have now permeated into the top culture and that explains some of the culture. Is that something you have looked at?

Professor Kay: I have not looked at that. I think you would be aware that there are now a number of psychologists and neurologists who are looking at the character of people attracted to employment in the financial sector. That may be a very interesting line for you to pursue in the discussion.

Q319 John Thurso: Let me move on to variable pay. In your review there is a paragraph that broadly says—I am paraphrasing—that you dislike the concept, that you are not very keen on variable pay at board level. However, as it seems to be here to stay the best we can hope for is to try to control it. Is that an accurate reflection?

Professor Kay: That is a pretty accurate paraphrase of what I said, yes.

Q320 John Thurso: Would you accept that there are a number of activities in any organisation and in banks where variable pay is quite an important element, but one of the ways you get control and governance of that is that the people managing them do not partake in the variable pay? On that basis, do you not think that you have sold yourself short? Because actually boards of banks with variable pay are aligning themselves with the variable pay activities of the people who do need it, rather than being the stewards and guardians of what they ought to be doing.

Professor Kay: Yes, I think that is true. I was compromising with the reality, as it were, by saying that if there were to be bonuses paid to people on boards, those bonuses should be paid in shares, which should only fully vest after the person employed had left or retired from that organisation.

Q321 John Thurso: If we were looking at that and—though I don’t suggest for a moment that we are going to get there—if an option to look at was one that executives on boards should not necessarily have variable pay, that would be something that you would find a reasonable proposition for us to inquire into.

Professor Kay: I think you should inquire into it. You could look at it in a different way. It is perfectly clear that trading activities are going to be rewarded in the traditional way—you share a part of the upside activity. I think the logic of what you have been saying is that those activities do not fit well into banks that do all the other things that we want banks to do.

If you ask where they were traditionally conducted, they were traditionally conducted by partnerships where the people at the top of the organisation shared both the upside and the

downside. As a result of that they kept rather a tight watch on each other and tight control of the people who worked for them.

My view is that there is a role for this kind of risk-taking activity in the financial sector. It probably ought to be a lot smaller role than it has today, but there is role for it. Models of the kind we are describing—either the traditional partnerships or the hedge fund with a relatively small number of sophisticated investors keeping a close eye on what people engaged in trading activities are doing—are the right vehicles to conduct the risk-taking activities of the financial sector. The mainstream banking part of the financial sector should be concerned with the traditional roles of taking in savings and finding borrowers to whom they can appropriately and profitably lend.

Q322 John Thurso: In the short time available, could you fill in two short parts of the equation? First, on the shareholders, you have some very interesting ideas about the shareholder forum. Evidence came in from some people who suggested that shareholders should be able to elect non-execs, and so on. Leaving that aside, and looking at the shareholders, is it really possible to envisage a world, even where the long-only traditional fund managers are the investors—other than sovereign wealth, but virtually everybody else—is it really practical to consider them capable of having an input, given the fractional size of their shareholding compared with the totality of the business? Are not the shares simply a commodity that is traded?

Professor Kay: Not as things are presently constituted. Few fund managers have either the competence or the scale of shareholding to do that. I think that is something we need to start addressing. That is what the discussion we are having on the structure of the banking industry has very much in common with the discussion in the equity market review of the structure of intermediation in the fund management industry. I think intermediation is about people placing savings with intermediaries in whom they have trust and confidence, and those intermediaries in turn placing the funds they are raising from small savers with companies in which they have trust and confidence. In each case, you need to have the kind of relationship that enables you to generate that trust and confidence. What we have done right across the board has been to replace those relationships with trading and transactions.

Q323 John Thurso: I could not agree with you more, and I completely get that from your report. My question is really whether that is possible with very large companies, which all financial institutions tend to be. You take a small end company—most of the institutions are 5% or 6% and you can get 70% of your shareholders in the top-10 of your shareholder list—and those shareholders can follow the company and do exactly what you said. There seems to be a point at which the sheer scale of a company, and therefore the very fractional nature of even quite substantial holdings, means that it is very difficult to have the kind of influence that you are talking about.

Professor Kay: That is probably true. If we are talking about companies such as BP—

Q324 John Thurso: The FTSE 100.

Professor Kay: Probably not as many as the FTSE 100.

Q325 John Thurso: The top 20?

Professor Kay: Certainly the top 20.

Q326 John Thurso: Does it not, therefore, follow that if one is looking for a practical solution, one cannot just simply say, “Well, it would be very nice if shareholders took more interest”? We are going to have to look at the construction of boards to ensure the stewardship you are after actually exists before that nirvana, if I may put it like that, is created. That is what our task should be.

Professor Kay: Yes, we are. I think that is right. I am trying to describe a world that would be quite radically different from the one we are in today, because I do not believe that small tweaks in the world we are in today will make much difference. In some ways, such tweaks are more likely to make things worse. Equally, one has to be realistic and accept that we can only get to a different kind of environment step by step. What we have to do is think about practical steps that will take us in the right direction, while at the same time making the kind of philosophical leaps that are needed to take us to the world we would like.

Q327 Baroness Kramer: I have a couple of stray questions, for which I apologise in advance. On the issue of stewardship that John was just talking about and that you were addressing, can you help me understand why, if we are placing a significant emphasis on intelligent stewardship by the shareholder—whether that is intermediated by an asset manager, advised by an analyst, or whatever mechanism—that can be compatible with less frequent corporate reporting? I come to this as someone who was originally an American commercial banker. The quarterly numbers, from my perspective, were always far more useful than the annual ones, which are incredibly manipulated, as you will know—customers, suppliers, other banks and so on. It seems that less frequency, and therefore less transparency, creates this potential for real delay at a time of incipient crisis, and I am just trying to understand how those can fit together.

Professor Kay: I am surprised that you say that you thought annual data were subject to more manipulation that quarterly data.

Baroness Kramer: Far more.

Professor Kay: The extent to which companies have now put themselves into a position of managing quarterly data, which for a large number of companies have no relevance at all to what is really happening in their business, is considerable. But what I am trying to get at, and this is almost a symbolic recommendation in relation to that, is that I think we have emphasised comparability between companies at the expense of relevance in our reporting structures, and I would like to see far more of, as it were, user-need-driven information provision, and that goes with the more concentrated, more focused, less fragmented shareholding that I would also like to see. The provision of information is in large part negotiated between the large shareholders and the company, rather than prescribed by regulators on a standard template for all companies. That is the shift we are trying to move to.

Q328 Baroness Kramer: Fit for purpose.

Professor Kay: That is exactly right.

Q329 Baroness Kramer: That’s really helpful.

On a completely different topic, there is something else that bothered me as I worked through this—I have found very helpful all the work you have put before us—and that is narrow banking. The underlying concept of narrow banking is that the depositor is safe because the institution is able to invest in only the safest securities—I think you give an example of Government securities—and, indeed, you go on to suggest that under those circumstances deposit insurance could be withdrawn and it could be a stand-alone

arrangement. But as we look around the world today and take a look at what is happening with Government securities, are we just fooling ourselves with the idea that it is possible to identify a single category of safe securities and, consequently, is there not some benefit to enabling diversification? One of the advantages, perhaps, of doing ring-fencing rather than separation—an interesting one—is the potential for the bail-in, if you like, from the outside, of the resources for more diversified business activity, if the investments prove to be riskier than anticipated.

Professor Kay: Yes, I think that that is probably right. When I wrote that pamphlet back in early 2009, I remember writing in one draft that it should be British Government securities, to which someone pointed out, "Well, surely it has to be EU Government securities", to which I reacted, "Okay, all right then." I do not think I would react in quite that way today. I would be less inclined now to write about a safe banking sector based on Government securities than I would have been three years ago, and I think that is just a warning as to how careful we need to be in thinking about all of this.

Q330 Baroness Kramer: My point almost is: can we ever identify a category, or are we likely to become very complacent, and say "That's no risk" and wait until events prove us wrong without diversification, or without possible recourse to another source? What we have done, in fact, is to expose our deposits to a very high-risk investment profile.

Professor Kay: No, I think that is right. I have written in various places that there is no such thing as a safe asset, and I think that historical experience has demonstrated that. The greatest security you get is from diversification, but it is not from diversification into things you don't know very much about, which is the diversification we've seen a lot of in the financial sector.

Q331 The Lord Bishop of Durham: One of the things we are seeing is the range of objectives—under the Financial Services Bill, for example—that are set for the regulators, and generally more and more things that are being demanded of regulators. Andrew Haldane has commented that much of the regulation was perfectly effective, but just missed the point of where the banks were going wrong. The other thing we are seeing—in hearing evidence, particularly from Mr. Volcker— has been the whole issue around culture and practice. Do you have any examples in your mind, or can you think of ways in which either regulation has changed banking culture, or structure might change banking culture, for the better? Would your narrow banking proposal alter the culture of those banks?

Professor Kay: It may seem not be answering your question, but I think the key issue for me is to move away from the idea that the nature of regulation is detailed prescription of rather complex rules about the appropriate behaviour of these organisations, because that is the regulation that does affect culture, and it affects culture in seriously negative ways, in my view. If you go into financial institution after financial institution, you will see firstly that regulation is regarded unequivocally as a nuisance, and, secondly, that regulation is largely entrusted to a department whose job it is to deal with regulation, and that department is itself regarded as a nuisance.

What you have done and what you exaggerate every time you add to the volume of regulation is the sense that regulation is something that gets in the way of doing business, which you have to try and get round. That not only undermines the effectiveness of regulation, but it undermines the whole culture of the organisation in relation to the real public objectives that we have for all this.

Q332 The Lord Bishop of Durham: You have very neatly answered my second question, which was precisely—

Professor Kay: Maybe I can come back and answer your first.

Q333 The Lord Bishop of Durham: You have not answered my first one at all. Is there any example or is there any way in which you think that the issues around culture can be constructively helped either through enforced structure through regulation, or through principled or judgment-based or written regulation? So the positive side rather than the negative.

Professor Kay: I think it is through structure primarily that we can do that. It is what people towards the top of the organisation see as the objectives of the organisation and then communicate to people throughout the organisation. That is a matter of the people who are appointed, the nature of the organisational goals that the business typically has, and the overall industry environment within which firms operate.

Q334 The Lord Bishop of Durham: That takes me neatly to the third question. You said in a recent article in the British Academy Review that responses to the crisis are characterised by dual regulatory capture. It seems to me that we have identified very well the issues of regulatory capture, and people are increasingly aware of them, as you have been, but there is another element of risk in regulation, which is regulatory comfort. Regulators on the whole like things as they are and do not want the unexpected coming along, even when the unexpected may be a good thing. In the structure you have been proposing—the narrow banking—is there not a danger that the new banks are regulated comfortably and everything is fine in the way you have described over the past 50 years, but they do not actually do some of the things that we need about financial access, money for SMEs and so on, so we get a really serious negative effect on the economy?

Professor Kay: Yes. There is a very real phenomenon of what you have described as regulatory comfort. At the moment we are in the process of encouraging people to establish new banks, but implicitly and explicitly we say, "If you are going to be a new bank, you have to be pretty similar to an existing bank."

The Lord Bishop of Durham: Precisely.

Professor Kay: That again is an inevitable consequence of regulation that is primarily about prescriptive behaviour, because where could your standards of prescriptive behaviour be derived other than from what you think of as the best practice of the existing institutions?

The Lord Bishop of Durham: Thank you very much indeed.

Q335 Lord McFall of Alcluith: Professor Kay, you mentioned earlier about smaller, more diverse institutions to cater for the "too big to fail" problem. One of the impediments to competition is the payment system. Banks have got more information on us than Tesco and others have. Should we be looking at it as a utility with the payment system being the equivalent of a national good? That way, we can get people into competition but if there is any crisis we can immediately fix it.

Professor Kay: I think that is right. To be honest, when I did the narrow banking piece I had thought very little about the payment system, but understanding a bit more about how the mechanics of banking operated in ways that mattered for that report made me think of that. When I thought of that, I thought, "I have confronted some of these issues before," because I have been engaged in issues with the regulation of other utilities in the way you describe, and

we have learned the appropriate way to regulate these kinds of utilities. We were talking earlier about ring-fencing versus functional separation, and you actually have to separate off the core transmission mechanism—be it gas, electricity or whatever—from the supply, so you have the generation of the product at the one end and the supply of it to consumers at the other. My conclusion was that if that was right for those other utilities, it is right for this one, too.

Q336 Lord McFall of Alcluith: Would it be any more difficult for banking than it has been for, say, water and electricity?

Professor Kay: I do not think so. You will know that one idea that is around is that people's bank accounts should have a number attached to them, which means that they could port them off to another provider. I was at a meeting a year or two ago at which I remember several people from the large banks jumping in and explaining how that would be technically impossible and prohibitively expensive, and I remember thinking, "I have heard this discussion before." I had heard it 20 years ago at a meeting where BT were explaining why number product portability in telecommunications was technically impossible and prohibitively expensive.

In the end, they were told to do it, and it was absolutely essential to the creation of the competitive telecoms market that we have today. I think, "Go ahead and do it" is the same here. A few months before that discussion, I remember someone from another company in the industry coming into my office and saying, "I want to talk to you about telephone numbering." I remember thinking that it would be one of the most boring conversations I had ever had, but it wasn't, actually, because I realised that he was talking about something quite important.

Q337 Lord McFall of Alcluith: So rather than just focusing on current account portability, which is important in itself, we could have a grander project looking at this. The point you made earlier about IT systems has been backed up by my own experience with people in the industry who say that the IT systems are a shambles and they need to be looked at.

Professor Kay: Yes, and this might well help in getting the technology side of the industry sorted.

Q338 Lord McFall of Alcluith: In your article in the *Financial Times* on 18 September, you say, "The only sustainable answer to the issue of systemically important financial institutions is to limit the domain of systemic importance. Until politicians are prepared to face down Wall Street titans on that issue, regulatory reform will not be serious." We could have Wall street, or the City or whatever else. My experience, looking at it as an outsider, is that the more regulation there is the more it is gamed, and therefore it becomes a big game. How do we get appropriate regulation and serve the point that you make in that article?

Professor Kay: The point that we keep coming back to this afternoon is that the appropriate regulation should focus much more on structure and much less on behaviour. I think that is a once-and-for-all battle rather than a continuing one, which is why I framed it in terms of facing down, as it were, Wall street titans.

Q339 Lord McFall of Alcluith: I am trying to get deeper into that. Northern Rock was mentioned earlier. The FSA is on the record as saying it did not look at the business structure

of that or others. When you say structural change, should it be looking at business models and issues like that, rather than coming out with a proliferation of regulations as has been done in the past few years?

Professor Kay: I don't think that the regulator should be looking at business models. I am not very happy about the idea of having a regulator that goes into Northern Rock and starts saying, "Do I think this is a good business model for running a financial institution of this kind?" I think there are at least two big dangers in that. One is, that I do not believe that we are easily going to find people in our regulatory agencies who are competent to do that. Secondly, if they do start doing that, what we will get, as we said earlier about regulatory comfort, is that the business models they will like will be the well-established business models, so that that structure would get in the way of innovation.

As it happens, the funding model, the particular business model of Northern Rock did not work. I do not think that the basic model of a predominantly wholesale-funded mortgage lender is necessarily a bad one. I think it did not work as it was applied in particular instances in the case of Northern Rock. Even there, people say that you are proposing things that would not have stopped Northern Rock going bust. As a matter of fact, they would have stopped Northern Rock going bust.

However, even if they had not stopped Northern Rock going bust, the idea is not to prevent financial institutions going bust. That would be a really bad idea. It is to ensure that from time to time financial institutions can go bust without the world coming to end as a result. That is where we should be trying to be.

Q340 Lord McFall of Alcluith: I would like to take that further, though we could be running out of time. The point has been made about culture. Shouldn't we be cautious regarding culture and how we look at it? Is it not the case that changing culture will be a long and difficult process because it demands individual buy-in, so we could be taking many years to achieve that cultural change for institutions?

Professor Kay: I think we will actually. I don't think you or your committee have the option of saying, "Well, from 2014 we have legislated a different culture in the banking system. That has fixed it."

Q341 Lord McFall of Alcluith: Should that stop us looking at it?

Professor Kay: It shouldn't stop you looking at it. If we don't aspire to it we will never get there.

Q342 Chair: And we certainly do. What you said about the payment system is music to the ears of the Treasury Committee, because as you know we have been looking at that vigorously for some time. You said that regulation should be focused on structure not behaviour. When you use the word "structure" in that context, are you referring to the formal structure of divisions and ring fences between parts of banking institutions, or are you also referring to the structure of incentives within firms?

Professor Kay: I am talking about both.

Q343 Chair: Okay. They are quite different elements.

Professor Kay: The basic underlying philosophical change is to say we should be asking, what is it that gives people encouragement to engage in inappropriate behaviour, rather than what is the inappropriate behaviour and how do you stop it? That is the

fundamental change that I have in mind when I say let us try and influence structure rather than influence behaviour.

Q344 Mark Garnier: First of all I want to talk about competition but could I just pick up on a point that John Thurso was talking about a little earlier on the involvement of shareholders? We recently had a group of asset managers who came in to speak to us about their shareholder involvement. It was a very interesting conversation. What struck me most about it was that one of the group was a bond holder who ran a bond fund. He talked at great length about the influence of bond holders. Is it not fair to say that when you look at shareholders, although they have a vote as equity or owners, it is bond holders who are more influential for a couple of reasons? First, you are talking in many cases of more money and secondly, as you are renewing bond issues on a fairly regular basis, you have to go and talk to the investors much more frequently than you would with shareholders. Are we not barking up the wrong tree in trying to get shareholders involved in corporate governance? Shouldn't we be looking at bond holders?

Professor Kay: That is a very interesting point. If we look at our banks they are unique among large companies in that the equity shareholders in reality only provide 2% or 3% of the capital of the business in many cases. If you are providing 2% or 3% of the capital of a business, in effect what you have is a call option on the business. People who own call options are probably not the best people to control the risk-taking business. Much of the capital is, as you say, in effect employed by the bond holders. That raises two questions in my mind. One is should we do more to give the bond holders a say? The other is by bailing out bond holders and indicating that we are quite likely to continue bailing them out, are we minimising their incentives to play the role we would like them to play? When I talked about Northern Rock, without giving Northern Rock bond holders any legal veto over what Northern Rock did, they would have prevented Northern Rock from doing what it did, if it had not been in that case that the depositors were in the same pot as they were. It meant that they were less likely to lose money and could reasonably expect, as turned out to be the case, that the Bank of England and the Government would long-stop the organisation.

Q345 Mark Garnier: Thank you. That is very helpful. You have written many articles in the *Financial Times.* In the one on 9 May this year, "Time to end the oligopoly of banking", you talked about the fact that in the 20th century we saw an oligopoly of banking with minimal competition and no new entries and no banking failure of any significance. You then went on to argue that this was not necessarily something that would continue for the future and that there would be a new settlement. Do you have a vision of what that should be and what the future of banking should look like?

Professor Kay: We have been sketching out bits of it. I don't have a complete picture of what it would look like because it is a long way from where we are now. But we have been sketching out bits in the course of the afternoon. It has narrow banks which are not necessarily the particular narrow banks of my pamphlet but are much more like the traditional banks where there was basically a direct connection between the savings of depositors and the loans that were made to companies and people in the non-financial economy. Essentially other financial activities of the bank were simply the minimal ones necessary to ensure that day-to-day mismatches between deposits and loans could be accommodated by the money market. We have talked about reform of a payment system, which I think would be an important part of that, which could both improve the technology that has been used and make it easier for people to enter the industry, and I think we have talked a bit about carving out of the existing banks institutions which could do the small and medium-sized lending and, I would hope,

might get involved in equity investment in small and medium-sized enterprises, as well—at least—to some degree, which would really be new kinds of institutions, even if they were institutions based on people and departments from existing institutions.

Q346 Mark Garnier: To a certain extent, you are describing some banks that already exist, like Seymour and Co, Aldermore capital, Arbuthnot bank, even Metro Bank or Tesco Bank. Yet investigations I have done separate from this, with some of these smaller banks, show that, since the crisis, the regulatory pressures that are now being put on them by the FSA are making their business, in some cases, difficult in terms of incurring costs. Do you see the regulated reaction to the banking crisis as being effectively anti-competition?

Professor Kay: There's a lot in it that is, by its nature, anti-competitive. The regulator's heart is in the right place, as it were, but the actions which are taken are not necessarily appropriate to that. We talked earlier about economies of scale in all of this. Sadly, one of the areas of banking in which there definitely are economies of scale is regulatory activity.

Q347 Mark Garnier: One of the interesting debates that we have had was on perverse incentives that come as a result of paying people performance bonuses, which generates increased risk within an organisation. But the one thing we never talk about are incentives for the regulator. Again, it seems that there is a terrific barrier to entry for new entrants to the market, because it comes down, finally, to an individual at the regulator who has to sign off on a new banking licence. While there is every sign that that if a person signed off a bank that subsequently went bust, his or her career would be destroyed and they would be the focus of the press, and all the rest of it, there is no incentive within the regulator to bring about new entrants to the marketplace. Do you think that is a fair criticism?

Professor Kay: Yes. I mean, the regulatory incentive is not to be blamed for something that went wrong, in large measure—

Q348 Mark Garnier: And therefore the default position is, just don't do anything creative.

Professor Kay: Yes.

Q349 Mark Garnier: My final question is on the requirements for competition, as part of the mandate for the FCA and PRA. There is not a competition objective within the PRA at the moment, although I believe there is at the FCA. Do you think it is important, if not vital, that we have competition as a primary objective for both those regulatory organisations?

Professor Kay: If we are talking about the PRA, it is not obvious to me, given the brief we have given it, that competition should be an objective. As far as the FCA is concerned, it seems to me that there is absolutely no doubt that competition should be a primary objective. We almost all now believe that, in general, the best form of consumer protection is competition. I certainly believe that. And that is as true here as it is everywhere. But it is also important to emphasise that real competition involves diversity in business models. In fact, that is almost the most important part of competition.

We have the paradox in banking at the moment—if you talk to people in Lloyds and HSBC, on the ground, they will describe their business as incredibly competitive, and you sort of see what they mean. But it doesn't look competitive to you and me, because we regard these institutions as being, almost, difficult to distinguish from each other. A way I put in

once was to say that the competition between Tweedledum and Tweedledee matters a lot to Tweedledum and Tweedledee, but not to anyone else.

Q350 Chair: Before I hand over to Nigel Lawson for a final word, would it be a fair criticism of your report that it is stronger on analysis than it is on recommendations? If I look at the list of recommendations—just take the first five—we have proposals for a more expansive form of stewardship, good practice statements, an investors' forum, keeping mergers under careful review and a recommendation that companies consult on major board appointments, which most do already. If I look for the heart of your recommendations, there seem to be—I would like you to tell me whether you think this is fair—three in particular that we might want to pursue further, one or two of which we have touched on. First is fiduciary duty; the second is that regulators should not get into being prescriptive about particular products, risk models and valuation methods; and the third is that there should be long-term alignment of directors' remuneration with the long-term performance of the business—difficult to achieve, but clearly stated as recommendation 15. Have I got that right, or have I missed out something?

Professor Kay: I think what you are saying is perfectly fair, and let me explain why, which starts from the observation that what many people might have expected us to do in that report was to come up with new rafts of regulations to be imposed on everyone involved in the equity investment chain. You can understand from the discussion that we have had this afternoon why I did not think that that was the right way of doing it. What we need is a shift in regulatory philosophy, not more rules. I understand that you as a legislator ask the question "What is there in this that I can legislate?", but if the biggest thing we need is a change in regulatory philosophy on the one hand, and a change in the culture of the industry on the other, then it is quite difficult for you to legislate either of these things. Actually, you can do things as legislators that are helpful to these things, both in the content of the legislation that you do pass and, equally, because the role you have gives you a position that influences how the public at large think about the industry and how the industry thinks about itself, and that is pretty important.

Q351 Chair: But you have not got a radical set of proposals in your back pocket that you could not get past your advisory board team.

Professor Kay: No.

Q352 Lord Lawson of Blaby: On that last point, you have said that you have thought a lot more in the context of the book you are writing, so if you were to send us a note—a short note—about your further thinking and what you are going to put in your book, I am sure that would be helpful and a matter of interest.

Chair: Or just a précis of your book.

Professor Kay: I will see what I can do.

Q353 Lord Lawson of Blaby: Thank you. The question I wish to ask is this. We talked earlier on about the need for complete structural separation, and that this was at the heart of the culture issue, and we have now moved on to the question of regulation, where you think it needs to be much simpler and of a different kind—I do not want to go over the ground again. You are absolutely right—the Basel II system, for example, was palpably absurd. I think everyone now agrees that.

Professor Kay: Not the people who have been constructing Basel III, I think.

Lord Lawson of Blaby: I know. Some people never learn.

Chair: Even longer than Basel II.

Q354 Lord Lawson of Blaby: People never learn. May I ask you whether you think that perhaps there is a kind of connection between these two things? We do not want merely to make regulation and supervision—unlike the energy sector, if I may say so, there was a case for supervision in banking, whereas in the energy sector it is all regulation. Anyhow, leaving that aside, we want to make the system simpler and more effective, and we also want to ease the task of the people who are responsible for the day-to-day business of regulation. Might not separation help in two ways? First, the non-core—precisely where you draw the line, as you say, is a secondary matter, but important because there are various places you could do it. Might not the load of regulation on the non-core part be very much lighter because you are allowing the discipline of the marketplace and the fear of failure to play a larger part, as with the hedge fund example that you quoted when you were giving evidence to us? Then, where you do have to have the regulation—on the narrow bank, the narrow plus mortgage lending or whatever it is—that is a simpler business. Therefore, the task of the regulators and supervisors is more likely to be well done, because you are not asking them to regulate the most complex and difficult of organisations. So in a sense the regulation problem and the structural/cultural problem may come together in that way.

Professor Kay: I agree almost entirely with that. I certainly visualise that one of the benefits of this kind of separation and focusing on the narrow banking of some current-type of activity is that one could loosen the burden of regulation on the others, very considerably, for exactly the reasons you describe—market pressures and competition would do much of the job. One of the lessons of the 2008 crisis was that lots of hedge funds disappeared and it did not matter. That is how it ought to be. It was the hedge funds that were embedded in regulated institutions that were a large part of the problem.

Similarly, I think that the regulation we devise should be realistic about the capacities of the people doing regulation on a day-to-day basis. You will get people in the industry endlessly complaining that, when they have regulatory visits and so on, it is all about box ticking and procedural issues, and that is true, but that is because that is really what the kind of people that we employ in regulatory institutions are capable of doing. We are not going to employ people in regulatory institutions who are capable of running very large, complex financial institutions—it is not clear that anyone is capable of running very large, complex financial institutions, but the people who profess to do it are paid very large amounts of money to do so.

Lord Lawson of Blaby: Thank you.

Chair: Thank you very much for giving evidence this afternoon. It has been very illuminating. You have added some value to your report. We are heartened by but slightly nervous about the prospect of a much longer report, or book, soon to appear on the same subject.

Professor Kay: Not so imminently, unfortunately.

Chair: Two thirds of the way through our process would be too late, but thank you very much for giving evidence, you have been very helpful.

We shall have a five-minute break and then resume in private.