



House of Commons Treasury Committee

Banking Crisis: regulation and supervision

Fourteenth Report of Session 2008–09

*Report, together with formal minutes, oral and
written evidence*

*Ordered by the House of Commons
to be printed 21 July 2009*

HC 767

Published on 31 July 2009
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Treasury Committee

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

Current membership

Rt Hon John McFall MP (*Labour, West Dunbartonshire*) (Chairman)
Nick Ainger MP (*Labour, Carmarthen West & South Pembrokeshire*)
Mr Graham Brady MP (*Conservative, Altrincham and Sale West*)
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)
Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)
Mr Michael Fallon MP (*Conservative, Sevenoaks*) (Chairman, Sub-Committee)
Ms Sally Keeble MP (*Labour, Northampton North*)
Mr Andrew Love MP (*Labour, Edmonton*)
John Mann MP (*Labour, Bassetlaw*)
Mr James Plaskitt MP (*Labour, Warwick and Leamington*)
John Thurso MP (*Liberal Democrat, Caithness, Sutherland and Easter Ross*)
Mr Mark Todd MP (*Labour, South Derbyshire*)
Mr Andrew Tyrie MP (*Conservative, Chichester*)
Sir Peter Viggers MP (*Conservative, Gosport*)

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

Powers

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

Publications

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

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

Committee staff

The current staff of the Committee are Dr John Benger (Clerk), 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).

Contacts

All correspondence should be addressed to the Clerks of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.

Contents

Report	<i>Page</i>
Summary	3
1 Introduction	5
2 The FSA's regulation of banking	8
Northern Rock—a catalyst for change	8
The regulatory philosophy of the FSA	10
Fit and proper persons	13
Danger of regulatory badging	15
3 Systemically significant banks	18
Introduction	18
Bank size	18
Narrow banks	20
Complex banks	23
Regulating complexity	24
Product regulation	25
Off-balance sheet vehicles	26
Bank resolution	27
4 Macroprudential supervision	30
Introduction	30
The Basel capital rules	31
Higher bank capital	32
Counter-cyclical capital requirements	33
Introduction	33
Rules or discretion?	34
Calling the cycle	35
Conclusions	35
Liquidity regulation	36
Loan-to-value ratios	37
5 Reform to the institutional framework of financial stability	38
The case for change	38
The Bank of England—responsibility without power?	39
Council for Financial Stability	40
The Government White Paper and co-operation between the Tripartite bodies	42
6 International dimensions	44
Global initiatives	44
Europe	44
Regulating cross-border firms	46
The future of the City of London	48

7 The way forward	50
Generating ideas and maintaining momentum	50
The role of the Treasury Committee	51
Conclusions and recommendations	54
Formal minutes	60
Witnesses	61
List of written evidence	61
Reports from the Treasury Committee during the current Parliament	62

Summary

This Report is the last to be published under the Committee's Banking Crisis inquiry.

By any measure the FSA has failed dreadfully in its supervision of the banking sector, but it has already begun to rectify its mistakes. The first chapter considers the steps already taken by the FSA to improve its regulation of banks in response to the failings exhibited in its handling of Northern Rock. We welcome the Supervisory Enhancement Programme (SEP) and the increased intensity of supervision which it will bring to bear on the financial services sector. The SEP is a necessary but not sufficient reform.

We note that the regulatory philosophy of the FSA has changed. It has less faith in market forces than before; it is more willing to challenge firms' business decisions; it now considers the competence of new bank directors and appears more willing to remove 'the punchbowl from the party'. All of this is good, but all of this is also fashionable. The FSA must develop the confidence to take unpopular decisions when the economic boom begins again, in the face of both industry and the political class.

Many banks are systemically significant because they are too big, they conduct many types of business, or they are too complex and interconnected. This Report addresses each of these issues in turn. We believe it to be unlikely that all banks could be shrunk to a size where they posed no systemic risk, but the Government can and should still act. First, it should ensure that there are no banks which are 'too big to save'. It should review the wisdom of allowing a banking market to be dominated by firms whose balance sheets are larger than the national economy. Second, banks must not operate under any incentive to grow large just in order to benefit from the status of being 'too big to fail'. We suggest that this market failure be addressed through a 'tax on size' administered through the capital requirements regime.

We conclude that it would be intolerable if banks took advantage of the implicit Government guarantee for deposits to take risky bets on proprietary trading. We urge the FSA not to rule out a prohibition on proprietary trading by deposit-taking banks at this early stage in the debate.

We conclude that the more complex and interconnected a bank is, the higher its capital requirements should be, reflecting the greater impact they would have on the wider financial markets and real economy if they were to fail.

Substantial reforms to capital and liquidity regulations are now required. The Basel capital rules did not work in preventing the financial crisis. Arguably they made things worse by distracting the attention of leading experts. We therefore support the introduction of a leverage ratio, to complement the more risk-sensitive minimum requirements under the Basel II capital accords. We also support an element of counter-cyclicality in capital regulation. These requirements should be based, as far as possible, on simple rules with a more limited role for discretionary judgements by the prudential supervisor.

We believe the reforms to the institutional structure of the Tripartite Committee announced in the Treasury's recent White Paper to be largely cosmetic. Merely re-branding the Tripartite Standing Committee will do little in itself. This Report reiterates our concerns expressed after our inquiry into Northern Rock that the division of responsibility for financial stability is unclear. Clarity over existing responsibilities remains a problem, but no new responsibilities should be allocated until a decision is made about the precise tools needed for macroprudential supervision. For this reason, this Report does not advocate substantial change to the Tripartite framework. When that decision is made however, responsibilities need to be crystal clear.

Now that immediate concerns over bank stability appear to be subsiding the temptation to relax must be avoided. Whilst there may not be an urgent need for new rules at the moment, there is an urgent need for momentum to be maintained towards the design of a better framework. We expect further announcements by the Tripartite bodies in the autumn, and look forward to reviewing their progress towards the establishment of safer, calmer, banking supervision.

1 Introduction

1. For more than a year the Treasury Committee has been engaged in a series of related inquiries looking into the causes and consequences of the banking crisis and examining possible solutions to the problems currently being faced.¹ In our Ninth Report of the present session we examined possible reforms to corporate governance and pay in the City. We pointed to failings of corporate governance, remuneration practices which encouraged excessive risk-taking, the failure of institutional shareholders to scrutinise the decisions of boards, the role of the media in holding the City to account, and the extent to which credit rating agencies, accountants and auditors influenced events.²

2. That report suggested ways forward for reform of corporate governance in the private sector. But private regulation and self-restraint on the part of banks will not in itself be sufficient to mitigate the risk of future banking crises. And indeed evidence already points to the return of some worrying trends in respect of the payment of huge bonuses to City employees. Even against the background of Sir David Walker's review for HM Treasury into the corporate governance of the UK banking industry there have been suggestions that a "business as usual" mentality is once more becoming entrenched.³

3. The Governor of the Bank of England was not convinced of the gains that would automatically be made as a consequence of the reform of corporate governance, believing that undue faith in the capacity of non-executive directors was likely to be misplaced:

In the end I think any well run company is bound to have to accept that it is the executive that runs it and what matters are the incentives facing the executive, and if we create a financial system in which the incentives for the executive and the shareholders are to take lots of risks because that is the profitable thing to do for shareholders, it is very hard to see how you should expect non-executives to prevent that.⁴

4. Private regulatory mechanisms alone are unlikely to be a sufficient response. Given the scale of rewards that prevails in the financial sector there will always be incentives for firms to challenge the regulatory framework. Lord Turner of Ecchinswell, the Chairman of the Financial Services Authority, suggested that the current crisis showed that markets could not be relied upon to be self-equilibrating.⁵ So great, he asserted, was the scale of the crisis

1 Fifth Report from the Treasury Committee, Session 2008-09, *Banking Crisis: The impact of the failure of the Icelandic banks*, HC 402; Seventh Report from the Treasury Committee, Session 2008-09, *Banking Crisis: dealing with the failure of the UK banks*, HC 416; Eleventh Report from the Treasury Committee, Session 2008-09, *Banking Crisis: International Dimensions*, HC 615

2 Ninth Report from the Treasury Committee, Session 2008-09, *Banking Crisis: reforming corporate governance and pay in the City*, HC 519

3 Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities*, 16 July 2009

4 Q 142

5 Q 55

that it offered a unique opportunity for a strong and effective response.⁶ He noted that public regulatory authorities had a key part to play, telling us:

it is highly likely that in our regulatory response we need to be able to identify a relatively small number of high-impact levers which will really make a major difference.⁷

5. Our report examines what some of these high-impact levers might be. It builds not only on our earlier reports on the banking crisis but also on further oral and written evidence taken subsequent to those inquiries, additional oral evidence taken from our inquiry into the international dimension of the banking crisis,⁸ and our recent visit to New York and Washington where we met many of the leading US regulators.

6. The Governor of the Bank of England gave a very clear exposition of the benefits that effective regulation of the banking sector could bring, and of the dangers of leaving events to take their course without intervention:

We will never get rid of financial crises—a bank is inherently a dangerous institution that will generate crises from time to time—but what we ought to be really concerned about is that the impact of these crises and their frequency is not diminishing over time. We get used to the idea that aeroplane crashes are less frequent and that we make passenger transport more safe over time. In the financial sector it seems to be the other way round, and that is why we cannot, I think, just put the issue to one side and say practical people who understand the world know there is nothing you can do about it. That is a counsel of despair, and we cannot afford a counsel of despair given the damage that has been wreaked on the rest of the economy by the problems in the financial sector.⁹

7. Governments and regulators throughout the world are taking steps to counter such a ‘counsel of despair’. Within the UK, Lord Turner has conducted his review, *A regulatory response to the global banking crisis*,¹⁰ which was tasked with reviewing the causes of the current crisis, and making recommendations on “the changes in regulation and supervisory approach needed to create a more robust banking system for the future”.¹¹ The Government published a White Paper entitled *Reforming financial markets* in July 2009 which endorsed the Turner Review, and also addressed issues surrounding competition in banking and financial capability.¹² At a European level, Jacques de Larosi  re was charged by the European Commission with setting out a framework for a new regulatory agenda, stronger co-ordinated supervision and effective crisis management procedures, producing

6 Q 55

7 Q 51

8 Published in Eleventh Report from the Treasury Committee, Session 2008-09, *Banking Crisis: International Dimensions*, HC 615 (hereafter *Banking Crisis: International Dimensions*).

9 Q 137

10 Financial Services Authority, *The Turner Review: A regulatory response to the global banking crisis*, March 2009

11 *Ibid.*, p 5

12 HM Treasury, *Reforming financial markets*, Cm 7667, July 2009

a report in February 2009.¹³ The United Nations Conference on the World Financial and Economic Crisis and its Impact on Development in June 2009 prompted a report of a Commission of Experts which examined macro-issues and the role of global economic regulation.¹⁴

8. This Report begins by examining the FSA's model of banking supervision before the financial crisis, and how that model has subsequently evolved. The vexing question of how to regulate big, complex, universal banks is considered in Chapter 3. In Chapters 4 and 5 respectively, we consider how the authorities should look beyond their scrutiny of individual firms to prevent the build-up of systemic risks, and whether any changes to the institutional framework might be required. The Report next comments on the raft of developments being taken forward at the global and European level before ending with a short section on the next steps that need to be taken by regulatory authorities.

13 The High-level Group on Financial Supervision in the EU, *Report*, 25 February 2009

14 United Nations Conference on the World Financial and Economic Crisis and its Impact on Development, *Report of the Commission of Experts*, June 2009

2 The FSA's regulation of banking

Northern Rock—a catalyst for change

9. We were extremely critical of the FSA's supervision of Northern Rock in our report *The Run on the Rock*, where we concluded that the FSA had “systematically failed in its duty as a regulator”.¹⁵ Our report was soon followed by another conducted by the FSA's own internal audit function, which was also critical of the Authority's arrangements for supervising high-impact large firms. In response the FSA launched the Supervisory Enhancement Programme (SEP) aimed at correcting some of the failings identified. Some 218 additional staff were recruited to work on “relationship management” in the supervision of large financial institutions. By November 2008, some 38% of those vacancies had been filled.¹⁶ In June 2009 the FSA recorded it was “90% or so there”.¹⁷ Not only were the FSA taking on more staff, commented Lord Turner, they were also improving the quality of staff, with a new induction programme for all new supervisors, and a training and competence scheme for existing supervisors.¹⁸ And the staff were doing “fundamentally different things”:

For instance, we are much more involved in a very detailed analysis of the assets of banks; the accounting approaches of banks. In the past, we have not really challenged the way that accounting is done; the accounting judgments being made on the market in trading books. We are involved in detailed discussions now with auditors in a way that we were not before, and we are also using stress testing in a far more intense fashion than we were previously doing. We are also gathering far more detail on the liquidity and we have a new liquidity regime. I think that it is a very major change in the intensity of supervision, with an increase in the scale of resources but also a change in the nature of the questions that we are asking and a greater willingness to challenge business models. There are some bits that we still have to get in place and which the Board was discussing recently. We said that we would get better at doing sectoral analysis; at understanding peer reviews across sectors; at identifying where banks and insurance companies were making their money and what that means for the risks.¹⁹

10. Lord Turner claimed that the SEP was having a “huge” impact, and in conjunction with the FSA's other initiatives would make a big difference.²⁰ Mr Rod Kent, the former Chairman of Bradford & Bingley, urged us not to under-estimate the “step-change” in the FSA's supervision of Bradford & Bingley immediately after the Northern Rock affair, from October 2007:

15 Fifth Report from the Treasury Committee, Session 2007-08, *The run on the Rock*, HC 56-I, p 34

16 Treasury Committee, *Banking Crisis: Oral evidence*, HC 144-I (hereafter *Banking Crisis: Oral evidence*), Qq 51-52

17 Q 53

18 *Banking Crisis: Oral evidence*, Q 53

19 Q 53

20 Q 52

At many times we were reporting on a daily basis to them, particularly in respect of liquidity, and we were discussing a whole different range of items, mainly to do with funding and liquidity funding, rather than the normal processes of ARROW which is a risk determination, and Basel II, which had been a large piece of work for us and all other banks.²¹

11. Lord Turner was adamant that the FSA had learnt the lessons from Northern Rock, and that the subsequent failures of British banks such as HBOS and RBS had arisen from an entirely different problem. He explained that the FSA had hitherto been supervising all banks in accordance with a particular regulatory philosophy which, in retrospect, was “wrong”. In the case of HBOS, for instance, he characterised the FSA’s supervision as “a competent execution of a style of regulation, and a philosophy of regulation which was, in retrospect, mistaken”.²²

12. When we asked the chief executives of the major British banks how the FSA’s supervision had changed since Northern Rock, their responses chimed with Lord Turner’s view. Sir Tom McKillop, the former Chairman of RBS, explained that the FSA had supervised his firm in a “close and continuous” way,²³ and Santander, Lloyds Banking Group, Barclays and HSBC all agreed that the FSA had increased its engagement with them following the collapse of Northern Rock.²⁴ Mr John Varley, for Barclays, confirmed that the sort of micro-prudential failings identified in the FSA’s supervision of Northern Rock were not apparent in its supervision of Barclays, but added that what the FSA had missed altogether was the build up of systemic risks in the financial sector:

the big miss, was the absence to spot the systemic risk that existed. I think one of the learning points for me as I think about this is that we need to create the wherewithal and the structures in regulatory supervision going forward that ensure that it is the explicit obligation of a member of the regulatory body to be looking out for the big systemic risks because I think it is a failure of systemic risk that characterises the history of the last two years.²⁵

13. We welcome the speed of progress made by the FSA under the Supervisory Enhancement Programme in recruiting staff, and boosting training, in order to improve its scrutiny of UK banks. Although it is difficult, and too early, to tell what impact the SEP has had on the banks’ behaviour, we are encouraged by the fact that the financial services sector has clearly noticed a change in approach. The SEP is a necessary, but not sufficient, response to the problems of the financial crisis.

21 *Banking Crisis: Oral evidence*, Q 330

22 *Ibid.*, Q 2144

23 *Ibid.*, Qq 1821-2

24 *Ibid.*, Qq 2098-2101

25 *Ibid.*, Q 2098

The regulatory philosophy of the FSA

14. Mr David Pitt-Watson, of Hermes, accused regulators of occupying wormholes, in which they could only observe a single part of the overall financial system. He urged them to oversee the whole chain of regulation, rather than specific aspects in isolation, “because right now it does not fit together”.²⁶ Professor Alan Morrison, of Oxford University, agreed with this sentiment, alleging that the FSA focused excessively on risks at the level of the individual firm, rather than the aggregate picture, as well as placing an over-emphasis on conduct-of-business regulation rather than its prudential responsibilities.²⁷ Lord Turner admitted that the FSA’s “most important failure” was not seeing the build-up of systemic risk,²⁸ but argued that this failure was shared by many economists, central bankers and finance ministries around the world:

up until 2006 and even into 2007 the world was awash with erudite, authoritative arguments put forward not just by bankers who had a self-interest in it but by theoretical economists who thought that they were looking at this in a disinterested fashion, who were arguing that the world, as a result of the development of structured credit and derivatives, had become less risky. That is there in the IMF global financial stability report; that is there in documents produced by Chicago School economists, etc, etc.²⁹

Lord Turner said that better regulation (such as that which would hopefully result from the FSA’s Supervisory Enhancement Programme) itself was not enough and he quoted a non-executive director of the FSA who had commented to him that:

On Northern Rock we made a complete hash of it. If we had done it perfectly within the same structure of regulation, it would have made almost no difference to the development of the financial crisis.³⁰

15. Lord Turner told us that it was important to understand that the ability to fix the problems of the financial crisis by more intense supervision, by having the correct meetings, by having the correct procedures, but without a different overall philosophy of regulation was “very limited indeed”.³¹ The Treasury also concluded that “regulators and central banks ... underestimated the risks that were building up in the financial system”.³²

16. The FSA’s supervision of banks has until recently concentrated on organisational structures, processes, systems, and whether reporting lines were correct. The FSA explicitly stated, according to Lord Turner, that it was not the function of the regulator to cast questions over the overall business strategy of firms. Lord Turner himself, upon arrival at

²⁶ *Banking Crisis: Oral evidence*, Q 1045

²⁷ Q 2

²⁸ *Banking Crisis: Oral evidence*, Q 2143

²⁹ *Ibid.*, Q 2142

³⁰ Q 50

³¹ *Ibid.*

³² *Reforming financial markets*, p 4

the FSA, found this approach “surprising”.³³ He attributed this approach to a global philosophy of regulation which “was based upon too extreme a form of confidence in markets and confidence in the ideas that markets were self-correcting”. This in turn had led to a belief that firms themselves could be left to make fundamentally sensible decisions.³⁴

17. Lord Turner argued that such a regulatory philosophy was rooted within a political philosophy where the pressure was on the FSA *not* to scrutinise more closely the business models of firms. Indeed, Lord Turner pointed out that the FSA had been criticised prior to the financial crisis for being too “heavy and intrusive” and was under pressure to become even more “light touch”.³⁵ This political philosophy, Lord Turner said, was “expressed in speeches on both sides of the House of Commons”.³⁶ For example, Lord Turner argued, if the FSA had attempted aggressively to challenge the mortgage banks to rein in lending in 2004, “the predominant reaction of many people, including perhaps many people in this House [of Commons], would have been to be telling us that we should not be holding back the extension of mortgage credit to ordinary people; that we were preventing the democratisation of home ownership”.³⁷

18. Professor Charles Goodhart, of the London School of Economics, spoke of the difficulty that any regulator had in supervising in a way which ‘leans against the wind’ during an economic boom:

in a boom everyone loves it and the idea that you are going to have a regulator saying, “I am sorry, we are not going to have 100% or 125% loan to value ratios; Northern Rock, you are not allowed to behave that way, you are not allowed to do sub-prime mortgages based on nothing except the expectation that housing prices will go on rising, you are not allowed to do that,” runs counter to the wishes of the lenders, the borrowers, and virtually every politician at the time during the boom, so what you are asking regulators to do is effectively to take the punch bowl away when the party is going, and that is not a popular activity.³⁸

Professor Willem Buiter, also of the London School of Economics, took a similar view, arguing that there had been “universal capture of the regulators and the political process by the financial sector”:

Who argues with success? People who take home \$50 million a year must be doing something right. It is very hard to interrupt that spiral until it is done by brute force through an implosion of the bubble. There is no willingness among the regulators or among the political classes to interfere with an asset boom or a credit boom.³⁹

33 *Banking Crisis: Oral evidence*, Q 2145

34 *Ibid.*, Qq 2156, 2165

35 *Ibid.*, Qq 2145, 2165

36 *Ibid.*, Qq 2159-60

37 *Ibid.*, Q 2168

38 *Ibid.*, Q 694

39 *Ibid.*, Q 694

19. The Governor similarly doubted the ability of regulators to lean against the wind: “The lesson I would draw from this is not to expect too much from regulators”. If the FSA had tried to rein in the optimism of the City of London before 2007, it would have faced overwhelming resistance from the banks, and an inability to prove the counterfactual that if banks did not reform, then they could find themselves in difficulty:

The people in the banks would have said, “Well, who are you to say we are taking too big risks? We have got far brighter and more qualified risk assessors than you have got. We have made massive profits every year for almost ten years. We have paid big bonuses. The City is the most successful part of the UK economy. How dare you tell us that we should stop taking such risks? Can you prove to us that the risks we are taking will necessarily end in tears?” and of course [the FSA] could not ... Any bank that had been threatened by a regulator because it was taking excessive risks would have had PR machines out in full force, Westminster and the Government would have been lobbied, it would have been a pretty lonely job being a regulator.⁴⁰

20. But Lord Turner seemed prepared to be that ‘lonely’ figure, urging against despair at the FSA’s ability to lean “against the winds of exuberance” in future:

I think we have a fundamental issue here rooted in human nature and institutional cultures whereby, if we leave the leaning against the wind entirely to boards of directors and management, it will not happen to sufficient extent. I think that human nature and institutional cultures do have a tendency for, as it were, the animal spirits of capitalism to get out of hand and be self-reinforcing, and I think that is our job ... to take away the punchbowl before the party gets out of hand.⁴¹

21. Lord Turner was “absolutely determined” that, whilst he was at the helm, the FSA would be “independent” from political pressure, adding that, because there had been such a huge shock to the world economy, regulators would find it easier to be more independent.⁴² He recognised the need, however, for a culture to develop in which the regulator did not get swept along on the tide of an economic boom: “the crucial challenge ... is to try at least to take the opportunity of this crisis to reinforce institutional mechanisms so that we do not, in ten to 15 years’ time, do it all over again”.⁴³ The Governor agreed that the FSA would find it much easier over the next ten years to supervise more intrusively, but warned that eventually banks would forget this episode and get themselves “back into a state of mind where everyone starts to think that it is acceptable to take more risks and then we will go back in the cycle again”. The real challenge, he suggested, was to build into the system an institutional memory of the dangers of relaxing regulation too much, and of not having a framework which builds in some sand in the wheels of a rapid rate of credit expansion.⁴⁴ Mechanisms for injecting sand in the wheels of

⁴⁰ *Banking Crisis: Oral evidence*, Q 2354

⁴¹ *Ibid.*, Q 2210

⁴² *Ibid.*, Q 2165

⁴³ *Ibid.*, Q 2319

⁴⁴ *Ibid.*, Q 2363

financial sector expansion needed to be “simple” and “very robust”.⁴⁵ We consider proposals for such mechanisms in Chapter 4. Dr Alexander believed that the FSA were “on the right track” towards improving bank supervision, but eventual success would depend critically on political support.⁴⁶

22. By any measure the FSA has failed dreadfully in its supervision of the banking sector. But this Report is about the future not the past, and we welcome Lord Turner’s candid approach to recognising the failures of the FSA and his willingness to address these failings. The arrival of Lord Turner has already had a very noticeable impact on the approach to regulation taken by the FSA.

23. Lord Turner’s analysis of a faulty regulatory philosophy of bank supervision, as part of a wider political philosophy is an interesting one, and seems to us plausible. But whether or not such a political philosophy had emerged, the FSA was and is an independent body, established in statute, and did not need permission from politicians to regulate financial institutions properly. Effective regulation can (and often must) require unpopular decisions in periods of economic growth, which appear at the time merely to restrain profitable activity. It is easy now for the FSA to promise to be more invasive in its supervision, because public and political opinion has swung behind such an approach. However we firmly believe that it is not the job of the supervisor to be popular and merely follow political fads. The FSA must develop sufficient self-reliance to stick to its guns in the face of criticism from industry or politicians, because ultimately, the job of the FSA may be to make unpopular decisions from time to time.

24. In addition to the FSA developing the confidence to make unpopular judgements and act on the basis of them, we are in favour of the supervisor receiving some automatic tools to put sand in the wheels of financial expansion, without having to prove beyond all doubt that its actions are necessary in the face of resistant firms. In Chapter 4 we will turn to the question of how rules-based counter-cyclical supervisory tools might be developed that make it easier for the supervisor to lean against the wind by the time the next economic boom commences.

Fit and proper persons

25. The FSA’s oversight of the ‘fit and proper persons regime’ for senior appointments in the financial services sector encapsulates much of what was wrong with its previous approach, whilst proving instructive in how the FSA’s new philosophy of regulation will seek to rectify its failings.

26. The Financial Services and Markets Act 2000 (FSMA) made provision for the FSA to require individuals performing certain roles to seek approval to perform a ‘controlled function’, including senior management posts, at banks. There are three possible outcomes in respect of such applications: approval; refusal; or withdrawal of the application. Since the FSA’s inception in December 2001, it has received approximately 51,700 applications.

⁴⁵ *Banking Crisis: Oral evidence*, Q 2355

⁴⁶ Q 34

Some 616 of these were identified as requiring detailed investigation because of adverse information, and were subject to close scrutiny. Of those 616, only four applications were refused, with a further 75 being withdrawn by the applicant.⁴⁷

27. Hector Sants, the FSA's Chief Executive, told us that historically the FSA's "fit-and-proper" process "was primarily focused on probity", and there was no competence remit. The view taken by the FSA was that it was for the firms themselves to determine whether candidates were competent for the role applied for. This position, he explained, followed "a very extensive debate" between the industry and the regulators, in which the industry was "very, very clear" that competence was a matter of judgement best left to the individual firm.⁴⁸ However, this approach was not one with which either Lord Turner or Mr Sants were comfortable, and so the FSA has already reformed the fit-and-proper process to include an assessment of competence, which, for senior bank appointments included an interview.⁴⁹

28. When asked what "competence" would look like Mr Sants said this was a difficult question involving much judgement. The FSA was still working up its proposals in this area, but it would "certainly need to look for technical competence in respect of risk management, the ability to understand the data, the types of accounts ... and understand the fundamentals and to apply that practically to the role in question".⁵⁰

29. With a view to setting a minimum benchmark of competence, we recommended, in our Report *The run on the Rock*, that senior bankers should possess a relevant qualification for their role.⁵¹ The chairmen and chief executives of RBS and HBOS had a mixed range of qualifications: Sir Tom McKillop had no formal banking qualifications, but he had studied advanced mathematics and had chaired, or served on the board of, banks and other firms.⁵² Sir Fred Goodwin had qualified as a chartered accountant, Mr Andy Hornby had an MBA degree focused on finance, and Lord Stevenson had been an entrepreneur, prior to their involvement in running banks.⁵³ A number of other RBS board members, we were told, had banking qualifications.⁵⁴ Lord Stevenson suspected that all the board members of HBOS had banking qualifications.⁵⁵ Lord Turner observed that there was little or no difference between the formal financial qualifications held by the top executives of HBOS and RBS, from those of, say, HSBC and Standard Chartered, which had fared much better in the financial crisis.⁵⁶

47 Treasury Committee, *Banking Crisis: Written evidence*, Volume I, HC 144-II, Ev 569

48 *Banking Crisis: Oral evidence*, Q 2170

49 *Ibid.*, Qq 2170-2

50 *Ibid.*, Q 2173

51 *The run on the Rock*, p 33

52 *Banking Crisis: Oral evidence*, Qq 1661, 1800

53 *Ibid.*, Q 1661

54 *Ibid.*, Qq 1733-4

55 *Ibid.*, Q 1740

56 *Ibid.*, Q 2145

30. Mr Miles Templeman, for the Institute of Directors, was “nervous” about any blanket requirement that all bank directors should have relevant qualifications, but argued that such a qualification “should be set up as good practice”.⁵⁷

31. The FSA’s assessment of whether senior bankers were fit and proper for their posts appears to have been little more than a tick-box formality, unless the applicant had a criminal record or gave some other evidence of a shady past. That bar was demonstrably set too low. We welcome the acknowledgement from the FSA that a candidate’s competence, as well as their probity, will now be thoroughly reviewed before taking up a senior post in a bank. We recognise that there may be some dangers in the FSA assessing competence, not least because the FSA will become exposed to accusations of incompetence itself, if it makes a wrong judgement. We discuss these dangers in the next section.

32. We recommend that the FSA assess whether bank executives should possess relevant qualifications. We would like to see banking qualifications become one of the core indicators against which the FSA can assess a candidate’s competence. If a candidate has no relevant qualifications, the onus should be on them to prove to the FSA that they have relevant compensatory experience. To this end we recommend that the FSA work with the British Banker’s Association to draw up a list of relevant qualifications, and perhaps even work to encourage academic institutes to design new qualifications tailored towards the skills required of banks’ senior management.

Danger of regulatory badging

33. Dr Andrew Lilico, of Europe Economics, brought to our attention one potential consequence of the FSA’s new approach to more intensive supervision: the idea of “regulatory badging”.⁵⁸ Regulatory badging is where the usual due diligence conducted by potential investors in financial institutions begins to get crowded out by the actions of the regulator. For example, market participants might assume that, because the FSA was becoming more invasive in its questioning of firms’ business models and risk management, or indeed in its assessment of the competence of a candidate for a senior post in a bank, then they no longer needed to undertake such work themselves. If that situation were to become a reality rather than a theoretical concern, the FSA would increasingly become the single source of assurance about firms’ solvency and liquidity, in the stead of the complex web of assurance currently provided by shareholders, bondholders, non-executive directors, auditors, credit ratings agencies and the media. As we observed in *Banking Crisis: reforming corporate governance and pay in the City*,⁵⁹ this web features many faults and inadequacies, but nevertheless provides a useful impediment to imprudent decisions by management. Over-reliance on one single point of failure, in the shape of the FSA, could

57 *Banking Crisis: Oral evidence*, Q 635

58 Q 4

59 *Banking Crisis: reforming corporate governance and pay in the City*, p 6

prove to be catastrophic if the FSA were to bungle its supervision. Lord Turner accepted that this was a theoretical possibility, but thought it unlikely in practice.⁶⁰

34. We put to Lord Turner that, rather than taking on a greater role in making judgements about firms' financial health, the FSA should expend its effort on correcting market failures and improving transparency, to enable others to make better-informed decisions. He described the debate about the extent to which financial system stability would depend on greater transparency, disclosure and more effective market discipline, vis-à-vis the greater willingness of the supervisor to make discretionary judgments, or of the macroprudential authorities to pull macroprudential levers, as being an "important philosophical" one. But he doubted that the market itself could provide adequate discipline:

Back in spring 2007, I think it was a reasonable thing to believe that the level of risk within the financial system was increasing—given the scale of the increase of a credit extension, given what we already knew about sub-prime mortgages in the US, et cetera; and yet aggregate, on average, bank CDS [credit default swap] spreads, rather than going up, continued to fall, to reach pretty much an all-time low in about June 2007. Therefore, the thing which is meant to give us a forward indicator of risk failed almost entirely. I do think that we have a problem of the fundamental nature of financial markets. The concept of market discipline in response to transparent information depends crucially on the idea that market prices will reflect all of the available information rather than reflect herd and momentum effects. I think that to a significant extent they reflect herd and momentum effects.⁶¹

35. Lord Turner's lack of faith in the ability of the market to set appropriate prices led him to suggest a three-pronged solution to the problem of market irrationality. He admitted that there was a role for improving market transparency in the hope that the effectiveness of market discipline might improve, although he was not hopeful that it would. Secondly, the supervisory and macro-prudential authorities would need to show a greater willingness to make judgements, at an individual institution level or macro level respectively, which "leant against the wind of irrational exuberance". Lord Turner accepted that such judgements could never be perfect, but "we have to be willing to attempt to do that". The third defence against irrationality was higher capital buffers:

if you believe that market discipline will always be ineffective and subject to herd and momentum effects, if you believe that regulators are also imperfect human beings—which I undoubtedly agree with—and will get things wrong, then what we have to do is put more buffers into the system. We just have to accept that both of those other corners of the triangle are uncertain and we have to have a system which, in the face of inevitable volatility, simply has more shock absorbers to absorb that inevitable volatility and irrational exuberance, followed by irrational despair.⁶²

60 Q 104

61 Q 59

62 Q 60

The investors of that capital buffer, the shareholders in particular, would still have an incentive to ensure that management acted prudently. After all, the responsibility of the FSA is to defend creditors, but not equity holders.⁶³ Lord Turner stressed that equity holders were there to absorb risk, and that the FSA could carry out its supervision of a firm in a way which maintained systemic stability but still produced a “pretty bad” result for shareholders, something which would undoubtedly “concentrate the minds of management and boards”.⁶⁴

36. There are obvious potential benefits to the FSA becoming more inquisitive, and starting to ask more searching questions about firms’ business models and management decisions. It is quite right that, where the taxpayer is exposed to the risk of bank failure, the regulator should adopt a proactive approach to ensuring that risks borne by banks are not excessive. However, there is a potential downside to this approach, which is that the FSA start to crowd out the due diligence of private agents. It would be extremely dangerous if the FSA were to become the single point responsible for the identification of failure. It is important that investors and others conduct due diligence and necessary scrutiny of banks. The solution lies in making sure that the regulator does enough to insulate the taxpayer and small depositor from the impact of a firm’s failure whilst avoiding treading on the toes of those with a responsibility for a firm’s stewardship. It is right that shareholders should feel the pain if their firm fails, and equally it is good that small depositors are protected by deposit insurance and an active regulator. Currently bondholders and other creditors are also substantially protected from loss, because it is most unlikely that a large bank would ever end up entering administration. A balance needs to be struck by the FSA which places sufficient incentive on them to perform satisfactory due diligence. We recommend that the FSA outlines its thinking on the appropriate level of protection for creditors of banks and how it proposes to do this.

63 Q 104

64 *Ibid.*

3 Systemically significant banks

Introduction

37. Some market commentators have argued that large, complex firms are more likely to fail,⁶⁵ due to the difficulties inherent in risk management and supervision; when they do fail, the consequences are more severe; and that these firms enjoy an implicit Government guarantee that the firm would not be allowed to go bust, in order to protect depositors and maintain broader financial stability. In his Mansion House speech, the Governor observed that:

It is not sensible to allow large banks to combine high street retail banking with risky investment banking or funding strategies, and then provide an implicit state guarantee against failure. Something must give. Either those guarantees to retail depositors should be limited to banks that make a narrower range of investments, or banks which pose greater risks to taxpayers and the economy in the event of failure should face higher capital requirements, or we must develop resolution powers such that large and complex financial institutions can be wound down in an orderly manner. Or, perhaps, an element of all three. Privately owned and managed institutions that are too big to fail sit oddly with a market economy.⁶⁶

In oral evidence to us, the Governor reiterated that it was “very important” that policy makers focused on the issues associated with the size and complexity of modern banks:

if you want to reduce the likely frequency and severity of future crises, it is almost impossible to avoid dealing with that issue.⁶⁷

Lord Turner agreed that this was a “crucial issue” but one that needed to be broken down into its constituent problems.⁶⁸ In this chapter we first consider bank size, before looking at narrow banks and bank complexity.

Bank size

38. Until now regulatory capital and liquidity requirements have focused on the likelihood of failure, rather than the potential cost of failure. Consequently large banks are not ‘handicapped’ by higher proportionate capital charges than their smaller competitors. Further, banks may actually have an inappropriate incentive to become larger, because the bigger the bank, the more certain it can be of a Government bail-out in the event of failure. One result of the financial crisis has been that the UK banking market is now more concentrated than before. LloydsTSB has merged with HBOS, Santander has taken over Alliance & Leicester and Abbey (plus parts of Bradford & Bingley), and several building

65 A ‘failed’ bank here is defined as a bank that would go bankrupt in the absence of public sector intervention.

66 Speech by Mervyn King, Governor of the Bank of England at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June 2009

67 Q 135

68 Q 89

societies have merged with larger competitors. For those calling for bank size to be limited the issue has never been more pertinent. The Governor has recently observed that “if some banks are thought to be too big to fail, then ... they are too big”.⁶⁹

39. The Treasury did not support calls for the introduction of formal limits on the size of banks, because the financial crisis “has shown that banks can fail whether they are big or small”.⁷⁰ Furthermore, the White Paper argued that it “is clearly not the case” that there is an absolute size below which a firm can be safely be left to fail and that, essentially, all financial institutions were systemic to some extent:

Financial institutions of all sizes and functions can have knock-on effects for the entire system.⁷¹

40. Lord Turner agreed that “in order to make that figure small enough that you could be really sure that, when it went down, it was not systemically important, you would probably have to make it very small—much smaller than the present level, not just a little bit smaller”.⁷² And even if banks could be reduced to such a size, other systemic problems would arise.⁷³ Therefore, Lord Turner suspected that banks which were too big to fail would always exist.⁷⁴

41. Professor Morrison set out the market-distorting impact of having banks which were ‘too big to fail’:

The critical effect of being too big to fail is that the people who finance you anticipate bail-out and your cost of capital reduces. There may be an argument for becoming very big because that makes you very effective, you are able to give better support to customers and ... you can do things efficiently ..., but there is also an argument about becoming too big because, when you become too big, your funding becomes cheaper.⁷⁵

Professor Morrison explained that the bank’s cost of capital reduces because some funding costs are transferred to the taxpayer or the deposit insurance scheme—a clear case of market failure.⁷⁶ Dr Lilico went as far to say that banks might even decide to merge in order to become too big to fail, and thus “game the taxpayer” and that this possibility should be considered in merger law.⁷⁷

69 Speech by Mervyn King, Governor of the Bank of England at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June 2009

70 *Reforming financial markets*, p 14

71 *Ibid*, p 69

72 Q 89

73 Q 90

74 *Ibid*.

75 Q 35

76 *Ibid*. In the UK, deposit protection is provided by the Financial Services Compensation Scheme.

77 Q 37

42. One way of correcting that market failure would be to make it more costly for banks to become so big that they were able to reduce their funding costs due to implicit insurance from the public sector. According to Professor Morrison, proportionately higher capital requirements for bigger banks, for example, “would probably mean” that many banks shrunk and those that remained large would be operating under the right incentives (because their funding costs subsidy would be offset by the higher capital charges).⁷⁸ The Government agreed that, rather than limit the size of banks through rules, it would be more efficient to do so through a price instrument, such as higher capital requirements, thus internalising the higher costs of failure associated with large banks.⁷⁹ Lord Turner was in favour of the idea of a “tax on size”.⁸⁰

43. It is probably a fact of life that many banks will remain ‘too big to fail’, and will never be allowed to go bust. But there are areas where the authorities must take action. First, we are concerned that some banks would be ‘too big to save’ and the recent consolidation in the UK banking sector has only exacerbated this problem. Quite apart from competition considerations, the Government should review how prudent it is to have a banking market dominated by several banks with global balance sheets larger than the national economy.

44. Second, those banks which are too big to fail must no longer be able to take advantage of that fact for private gain. Market discipline must be reintroduced in order to realign the incentives of bank investors and managers. We welcome the ideas put forward regarding a ‘tax on size’ administered through the capital regime.

45. Capital requirements must tackle any incentives that banks have to grow or merge merely for the sake of becoming ‘too big to fail’. Further, and admittedly more difficult, since capital requirements are a form of insurance, they should ideally be calculated on an expected loss basis, taking into account both the probability of a bank’s failure and the potential costs of such an event occurring.

Narrow banks

46. Some commentators have contended that the presence of a government guarantee for deposit-taking business enables firms to cross-subsidise their non-guaranteed business, which is higher risk but tends to generate higher reward. In other words, banks can play at a high-stakes casino table with the taxpayers’ chips. The bank gets the rewards of a successful bet; the taxpayer comes to the rescue if the bet fails. The Governor saw this as a “very important issue ... much too important to sweep under the carpet and say, ‘Oh, no, it is too difficult, we cannot do it’”, because the enormous expansion of risk-taking through proprietary trading by institutions in receipt of taxpayer-financed insurance, was “asking

78 Q 35

79 *Reforming financial markets*, p 71

80 Q 91

for trouble”.⁸¹ He quoted a recent speech by Paul Volcker, a former Chairman of the US Federal Reserve, in support of his position:

Deposit insurance from central bank liquidity facilities are properly confined to deposit-taking institutions ... In my view, it is unwarranted that those same institutions, funded in substantial part by taxpayer protected deposits, be engaged in substantial risk-prone proprietary trading and speculative activities that may also raise questions of virtually unmanageable conflicts of interest.⁸²

47. The Governor said that the authorities could not simply accept a situation of banks taking risks with taxpayer support, and set out three potential solutions to the problem:

- legal barriers to the range of activities to which deposit insurance applies;
- higher capital requirements on banks that take part in risky activities; and
- ensuring adequate arrangements for large and complex banks to be wound down.⁸³

48. Lord Turner fully accepted that some banks, benefiting from an implicit Government guarantee, used that status to undertake risky proprietary trades, a situation he regarded as intolerable.⁸⁴ But he was firmly against the imposition of a legal division between commercial and investment banking. He pointed out that many of the problems that had led to bank failures in the recent financial crisis were failures of traditional banking activities, such as the provision of credit and the trading of syndicated loans or credit derivatives. These had been, and remained, legitimate activities for commercial banks to engage in, and the problems arose because of “the scale on which they [the banks] did it, not that they did it”.⁸⁵ It followed therefore, that a price-based instrument rather than a legal division instrument was needed to limit bank’s activities.⁸⁶

49. The Treasury shared Lord Turner’s distaste for formal limits on the activities of financial firms, because the financial crisis had “shown that banks can fail whether they are ... simple or complex”.⁸⁷ They had found no evidence that insulating the deposit-taking business of banks from other activities (particularly trading) would have made them less likely to fail during the recent crisis, or that the systemic impact of any failure would have been reduced. They pointed out that some failed institutions engaged solely in commercial lending or investment banking, and did not mix the two. Additionally, in the view of the Treasury, “there would almost certainly be losses in efficiency as well as significant

81 Qq 113, 136

82 Q 113, the Governor was referring to Paul Volcker’s address at the institute of International Finance, 11 June 2009.

83 *Ibid.*

84 Q 94

85 Q 93

86 *Ibid.*

87 *Reforming financial markets*, p 14

difficulties in implementing and enforcing workable limits, both domestically and internationally”.⁸⁸

50. The Governor was not so quick to dismiss a legal separation of investment banking from commercial banking, but downplayed the differences of view between the Tripartite bodies:

[Lord Turner has] come round to advocating ... the idea of using capital requirements to make it more expensive to combine these activities. That is only a matter of degree different from saying, if you make it expensive enough, you might as well prohibit it. So it depends on the size of the tax. That, in the limit, is the same as prohibiting it, and if there are difficulties in defining the activities on which to base a prohibition, there are also going to be difficulties in defining activities on which to calculate the tax base. So I do not think these things are quite as different, and I do not have strong views about which way we should go at all, but what I do think is that we should not rule any of these things out at this stage; we should discuss it, debate it, learn from people with experience, talk to them and say, “What is the right way forward?”, and let us have a debate.⁸⁹

51. Lord Turner told us that the “crucial issue” here revolved around where in the capital structure investors suffered loss:

Is it only the equity holders? Is it also the subordinated debt holders? Is it, under certain circumstances, senior creditors? Who suffers loss? That is the real issue...⁹⁰

In view of this, the FSA approach, supported by the Treasury, is to revise the capital requirements of those banks which have over-indulged in risky activities such as proprietary trading. By significantly increasing trading book capital requirements, the FSA would discourage, rather than ban, proprietary trading by banks. Those that continued with proprietary trading would be obliged to create a large buffer of investor capital. This, in turn, should act to reduce the moral hazard problem by removing the incentive to become systemically significant.

52. Professor Morrison was in “no doubt” that trading book capital requirements were too low. He explained that the rationale for the low capital requirements to date was that banks would be able to sell trading books’ assets rapidly and so did not require much capital. What the financial crisis had shown however, was that at the time when a rapid sale of such assets is most needed, nobody else wants to buy them.⁹¹ Over the next year, the Basel Committee on Banking Supervision is conducting a thorough review of the definition of risk in trading books. But Lord Turner told us that the FSA had proposals to increase

88 *Reforming financial markets*, pp 14, 75

89 Q 137

90 Q 90

91 Q 15

substantially trading book capital requirements without international agreement by the end of next year.⁹²

53. It has been alleged that some large banks took advantage of the implicit government guarantee backing up deposits, to cross-subsidise more lucrative trading activities. In such a scenario, rewards would be pocketed by the banks, whilst risks would be largely borne by the taxpayer. Such an outcome would be intolerable. We see the debate about narrow banking as being not so much about reducing the risk of failure, or even the impact of potential failure, but more about the incentives confronting bankers. These incentives are skewed dramatically by implicit government guarantees. The FSA proposals to subject proprietary trading activities carried out by retail banks to much higher capital requirements is welcome, and the bare minimum given the failure of the concept of ‘liquidity through marketability’ that previously underpinned the relatively low capital requirements of trading books. Calculating how swingeing those capital requirements ought to be is a tricky balancing act. As they get tougher, their impact will get closer and closer to that of a prohibition on proprietary trading. A ban may not be necessary if firms are given sufficient incentive to separate their trading units from their retail banking activities of their own accord, but a ban should not be ruled out by the FSA as an option at this early stage.

Complex banks

54. The Treasury admitted in its White Paper that a recent increase in the complexity of banking may have contributed to financial instability.⁹³ Paul Tucker, the Deputy Governor of the Bank of England, has argued that “complex structures rendering a bank unsupervisable must not be permitted”.⁹⁴ And the Governor bemoaned the lack of attention paid in the UK to the problem of complex banks. He argued that the degree of interconnectedness between banks was a very good way of measuring the risks they posed to the system as a whole. For this reason, the Governor wanted to see capital requirements varying according to the interconnectedness of a bank.⁹⁵

55. We agree with the Governor of the Bank of England that highly complex, interconnected banks should face higher capital charges than simpler banks, because they impose a greater risk on the financial system as a whole. In order to inform such flexing of the capital regulations, we recommend that the FSA initiate work to increase its understanding of the extent and nature of the interconnections between financial firms.

92 Q 99

93 *Reforming financial markets*, p 40

94 Speech by Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the British Bankers' Association Annual International Banking Conference, 30 June 2009

95 Qq 127, 146

Regulating complexity

56. One aspect of the complexity debate features innovative financial firms constantly striving to keep one step ahead of the regulator. The odds tend to be stacked against the FSA, because City firms usually have the means to pay higher wages than the public sector regulator (at least in a boom), and so attract the top talent. Mr Jon Moulton, of Alchemy Partners, labelled innovation in the banking system “a disease”⁹⁶ and did not believe that regulators could keep pace with financial innovation, arguing that a large bank “with 30 or 40 business lines and huge books of derivatives”, was simply too complex. In some cases, he observed, products were “simply incapable of being analysed by the vast majority of people out there”:

Northern Rock’s last capital issue, an off balance sheet vehicle is on their website—11 layers of debt, three currencies, interest rate swaps, currency swaps, 415 pages of prospectus—nobody understood it.⁹⁷

57. Professor Buiter commented that there had been an enormous amount of financial innovation that had been pointless and even actively harmful. But there had also been innovation which had been useful for the real economy. Because regulators would always struggle to foresee all possible consequences of financial innovation, he suggested testing financial innovations in something akin to a ‘laboratory setting’ (in the same way pharmaceutical drugs are tested) prior to being let loose on financial markets.⁹⁸ In Professor Buiter’s view, Credit Default Swaps (CDS), for example, had “become a deeply destabilising instrument that should be regulated to within an inch of its life”.⁹⁹ Dr Lilico did not go as far as labelling innovation “a disease” but he did explain why innovation in the financial sector might not be as beneficial as in other sectors. He maintained that because banks did not have the ultimate fear of going bust if an innovation flopped, innovation risk was essentially one-sided, so this was unlikely to be efficient.¹⁰⁰ Professor Morrison agreed that innovation needed to be closely examined:

One needs to be careful in financial markets to distinguish ... between innovation which is there to encourage the efficient use of capital and the efficient deployment of resources, which is what we would like financial markets to accomplish, and innovation that is there to get round regulation.¹⁰¹

58. His view was that a good deal of financial innovation such as structured investment vehicles (SIVs) “was about getting round regulation” and was a response to “poorly designed regulation”.¹⁰² Professor Morrison also observed that some of the banks’ models were “very elegant and very clever” but had “very little economic content; they were

96 *Banking Crisis: Oral evidence*, Q 780

97 *Ibid.*, Qq 737, 740

98 Evidence published in *Banking Crisis: International Dimensions*, Q 103

99 *Ibid.*, Q 104

100 Q 48

101 Q 49

102 *Ibid.*

essentially physics rather than economics”. Their fundamental weakness, he explained, was that they wrongly assumed certain economic variables to be constant, rather than numbers which were subject to behaviour and expectations of market participants.¹⁰³

59. Lord Myners told us that the FSA had been charged with a new requirement to advise the Chancellor twice a year on new areas of innovation and their consequences for systemic risk, and any statutory changes that would be required to take account of that.¹⁰⁴

We recommend that the FSA’s advice to the Chancellor on new areas of innovation and their consequences for systematic risk should be published.

Product regulation

60. The Turner Review acknowledged that there may be a case for regulators to consider the direct regulation (or prohibition) of products identified as having potentially adverse financial stability effects. The Review listed the pros and cons of banning one possible contender, the Credit Default Swap (CDS), concluding that it was a topic that needed much more debate. More generally, the Review found that “Regulators should not treat it as a given that direct product regulation is by definition inappropriate, but should be willing to consider over time whether particular markets have characteristics sufficiently harmful, and benefits sufficiently slight, as to justify intervention.”¹⁰⁵

61. Professor Mark Taylor, of Warwick Business School, argued that it was not products themselves which generated the problems of the financial crisis, but the behaviour of bankers and the use to which they put those products. As he observed, some banks had run into serious difficulty with, for example, simple mortgages. The focus of regulation ought to be on the “appropriate recognition of the different kinds of risks that prevail in financial markets”, rather than on trying to regulate individual products—not least because market participants were skilled at inventing new products that were genetically similar to the one subject to strong regulation.¹⁰⁶ A further argument is that almost all financial instruments do have some legitimate uses, even if they have been manipulated for other, less worthy, purposes: a CDS, for example, is a useful hedging instrument for investors with long credit positions to hedge exposures that may have arisen through direct lending between the parties involved.

62. Dr Kern Alexander, of Cambridge University, argued that it should be unacceptable for banks to engage in activities which they or the regulator did not fully understand. Under the Basel II accord, banks must submit their risk models to regulatory review for approval and Dr Alexander’s view was that regulators should simply not approve these models if the bank concerned was unable adequately to explain the model. He argued that it should not be the regulator’s task to figure out what the model was saying; rather the onus had to be on the bank to prove that it was reasonable.¹⁰⁷ **The FSA should only permit banking**

¹⁰³ Qq 46-47

¹⁰⁴ Q 221

¹⁰⁵ *The Turner Review*, p 110

¹⁰⁶ Evidence published in *Banking Crisis: International Dimensions*, Q 105

¹⁰⁷ Qq 44-45

activities that it understands, and that it has confidence that the bank concerned understands.

63. Lord Turner's view was that there were parts of the wholesale financial services industry—in particular, those relating to structured credit, credit derivatives and fixed income trading—which “simply grew beyond their socially useful size”. They were “indulging in innovation which was not socially useful ... but either regulatory arbitrage ... tax arbitrage ... or rent extraction. As long as that occurs on a more-than-useful scale, he continued, some people would end up “being paid very large amounts of money for things which are not terribly useful”. The solution, he contended, was likely to lie in adjusting capital requirements rather than banning entire products.¹⁰⁸

64. We are instinctively wary of placing too much reliance on product regulation, because it tends to be a blunt instrument. Typically it creates new opportunities for the identification and abuse of loopholes and work-arounds, and restricts some legitimate uses of the product concerned. We believe however, like the FSA, that regulators should keep an open mind and look at each product on its own merits. If, for example, a particular product has some legitimate uses and benefits, but these are significantly outweighed by inappropriate uses, the FSA should look very closely at restricting their use.

Off-balance sheet vehicles

65. The Treasury's White Paper observed that regulators and central banks failed to appreciate “the full implications of activities outside the regulatory boundary, in particular the build-up by banks of large exposures to off-balance sheet financing vehicles, and the lack of transparency that accompanied them”.¹⁰⁹ As Professor Morrison explained, many banks built up large exposures to structured investment vehicles (SIVs) that were treated as off-balance sheet (so not used in calculating regulatory capital requirements), but which in many cases were taken back on to the balance sheet when the wholesale funding markets' liquidity dried up, despite the fact that banks' lines of credit were not legally binding. Banks found “it very hard to walk away” from their related SIVs and, hence, had a liquidity exposure that was not recognised by the regulatory framework.¹¹⁰

66. It was not clear to Lord Turner that SIVs were necessary or useful things, and he admitted that the FSA had been “over-tolerant” of off-balance-sheet vehicles:

There are some circumstances in which they usefully separate away risk, and that can be legitimate; but often they are forms of regulatory arbitrage and tax arbitrage, and I think that we need to be much more aggressive in the future at spotting them.¹¹¹

108 Q 56

109 *Reforming financial markets*, p 4

110 Q 46

111 Q 102

67. Lord Turner's solution was simple—regulate things according to economic substance not legal form. So if a bank established an off-balance vehicle for regulatory arbitrage purposes only, and its exposure to risks remained the same as if the vehicle had not been set up at all, then that vehicle would be regarded as on-balance sheet.¹¹² The Government's view is that a firm's exposure to related entities such as SIVs should be reflected in regulatory capital and liquidity requirements. At the international level, the Basel Committee on Banking Supervision has issued consultation proposals to strengthen the Basel II framework in this regard, and the International Accounting Standards Board is inviting public comment on proposed accounting changes for the consolidation of off-balance sheet vehicles.¹¹³

68. We endorse the approach of the FSA that the focus of regulation should be based on economic substance rather than legal form.

Bank resolution

69. However well-managed banks become—and however well-regulated—there will remain a chance, albeit a small one, that banks will fail. After all, banking is an inherently risky business, and peculiarly dependent on the confidence of its customers and investors. That confidence can disappear in the blink of an eye, so there is a clear need for having mechanisms to be in place to 'resolve' a failed bank—to deal with bank failure in a way that protects depositors and limits the risks to financial stability.

70. In February 2008 the enactment of the Banking (Special Provisions) Act 2008 provided temporary powers to enable the Government to deal with failing banks, which were used to resolve Northern Rock, Bradford & Bingley and the UK subsidiaries of two Icelandic banks. These powers, which were taken on an emergency basis, were limited to a year.

71. The Government, Bank of England and FSA co-authored several consultation papers in 2008 about the establishment of a permanent 'Special Resolution Regime' (SRR) to deal with failing banks.¹¹⁴ In September 2008, we reported on these proposals.¹¹⁵ The Banking Act 2009, which came into force in February 2009 was drafted to replace the expiring powers under the Banking (Special Provisions) Act, and established in statute the SRR. The Act gives the authorities permanent powers to intervene when the likely failure of a bank or other deposit-taking institution threatens financial stability, the protection of depositors' money, or the interests of the taxpayer. Once the FSA has determined that a bank is failing, the Bank of England can use new powers to take the lead in resolving it. These include a power to facilitate private sector purchase, a power to set up a 'Bridge Bank', a power of

112 Q 103

113 *Reforming financial markets*, p 83

114 *Financial stability and depositor protection: strengthening the framework*, Cm 7308, January 2008; *Financial stability and depositor protection: further consultation*, Cm 7436, July 2008; *Financial stability and depositor protection: special resolution regime*, Cm 7459, July 2008

115 Seventeenth Report from the Treasury Committee, Session 2007-08, *Banking Reform*, HC 1008

temporary national ownership and new insolvency and administration powers. The Act was used for the first time to resolve the Dunfermline Building Society in March 2009.¹¹⁶

72. The Dunfermline Building Society was a relatively simple organisation to resolve, because it had largely stuck to lending mortgages to residential and commercial customers and taking deposits.¹¹⁷ The SRR could be applied quickly and resolution could be achieved in short order. But it would be a very different proposition should a major global bank enter into the SRR. Some large banks have thousands of legal entities, across dozens of national jurisdictions and offshore financial centres. Many have links of some kind to off-balance sheet vehicles where risk exposures are opaque. The Bank of England would face an extraordinarily difficult challenge in resolving such an institution in a short timeframe.

73. In order to make the Bank of England's job a little easier, the Governor has suggested that an important practical step would be to require each bank to produce a plan of how an orderly wind down of its activities might be conducted in the event of failure: "Making a will should be as much a part of good housekeeping for banks as it is for the rest of us".¹¹⁸ The Governor told us that bank complexity had reached a point where "institutions that seem to people, in life, to be one business entity, when problems occur, in death, turn out to be a very large number of separate entities".¹¹⁹ In his view, allowing banks to have become so complex, with numerous different entities under the same umbrella organisation—many of which are off-shore—was a recipe for creating an institution that was inherently difficult to wind down, despite the desirability of such a course of action in certain circumstances.¹²⁰

74. The Treasury agreed with the Governor that all firms should have detailed, practical resolution plans for dealing with their own failure, with the FSA paying particular attention to "high impact" firms' plans. Such plans would be proportionate to the size and complexity of the bank in question, and should include an assessment of how difficult it would be to resolve. Constructing such a plan would involve, for large complex firms, ensuring that their legal structure would facilitate resolution in the case of failure of the firm as a whole. This could involve making revisions to corporate structures of some firms, creating clear lines between deposit-taking and other banking operations, so that the depositor book could be easily sold to a competitor at the point of failure with minimal disruption to depositors. The Bank of England would also have a role in the evaluation of resolution plans. The Treasury argued that the quality of a bank's resolution plan should have a direct bearing on the FSA's overall assessment of the prudential risks borne by the firm, including, if necessary, by feeding into regulatory capital and/or liquidity requirements.¹²¹

116 *Reforming financial markets*, pp 5, 64

117 The Scottish Affairs Committee will publish its report, *Dunfermline Building Society* as HC 548 on 30 July 2009.

118 Speech by Mervyn King, Governor of the Bank of England at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June 2009

119 Q 138

120 Q 139

121 *Reforming financial markets*, pp 13, 72-73

75. Although the best solution would be international agreement on the creation of ‘living wills’ for global banks, the Governor advised us that the UK ought not wait for that:

I know the Chancellor is very keen to push this forward at the G20 and to see whether we cannot work with our international colleagues to do more here, but I do not think we can say that if they do not do anything we should abandon it. It is too important to simply say without international agreement we can do nothing. We cannot afford to do that. We have got to take action ourselves irrespective of whether others do or not.¹²²

The Governor believed that if global banks currently domiciled in the UK decided to leave for another country as a result of such changes, then that would be a price worth paying.¹²³ He said that the UK should not be “blackmailed” by the big banks threatening to go elsewhere, and anyway felt that they would have few places to go, because the major economies were in agreement on this point.¹²⁴

76. Improving bank resolution mechanisms is a vital component of financial services sector reform. Currently, the fact that there is no means by which large, complex banks can be resolved encourages complacency in these banks, contributing to the moral hazard dangers discussed above. The Special Resolution Regime is an important mechanism, but its usefulness is reduced somewhat by its inability to cope effectively with the resolution of a large, complex bank. That weakness derives from a lack of information about how major banks are internally structured, an issue which must be addressed. We fully support the proposal of each bank writing a ‘will’ and subjecting that will to regular evaluation by the Bank of England. Banks may not like it, they may even threaten to domicile elsewhere, but in our opinion this is a reform that is clearly needed.

122 Qq 139

123 Q 140

124 Q 150

4 Macroprudential supervision

Introduction

77. Financial markets have proven vulnerable to the collective temptation to lend too freely when times are good, only to rein in lending unduly when the economic cycle turns. This amplifies the economic cycle and is described as pro-cyclicality. There is also another problem, succinctly summarised by the Deputy Governor of the Bank of England, Paul Tucker:

A bank may consider a course of action it wishes to take to be acceptable — as it may well be in a limited context. But the same course might, if widely copied by other banks, have unfortunate effects on the banking system as a whole. It is part of the supervisor's job to take the wider, systemic view and sometimes to curb practices which even prudent banks might, if left to themselves, regard as safe.¹²⁵

78. Because market participants cannot manage systemic risks if left to their own devices, there is a need for Government intervention to correct market failure. Dr Alexander told us that one of the major failures in regulation over the last ten years had been that regulation had focused on the individual institution, rather than the level of risk or leverage building up in the total financial system:

The regulator thought that, if individual firms were okay and seemed to be managing the risk appropriately, then everything was fine ... Micro-prudential regulation is fine, but it needs to be linked with a robust macro-prudential framework.¹²⁶

79. So measures are needed to arm the authorities with tools to prevent the building up of systemic risks. These tools are sometimes known as 'macroprudential instruments'. An international consensus is building that such tools are needed, but there is little agreement on the precise form that these should take. The Government's White Paper gave no strong views, but set out three sets of tools which were "under examination":

- International rules which require additional capital to be set aside during periods of strong growth;
- Discretionary variations of regulatory requirements by national authorities; and
- Particular restrictions on loan products—for example, maximum loan to value ratios for mortgages.¹²⁷

80. The Bank of England helpfully sent us a memorandum which set out the issues regarding the rationale and objectives of macro-prudential policy, and the design, and practical implementation problems of macroprudential instruments.¹²⁸

¹²⁵ Speech by Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the British Bankers' Association Annual International Banking Conference, 30 June 2009

¹²⁶ Q 3

¹²⁷ *Reforming financial markets*, p 15

81. Lord Turner agreed that the choice of appropriate macroprudential instruments was a “very complicated” issue, but was clear that the most important lever would be the varying of bank capital requirements, even if the supervisor’s armoury contained other instruments. The former was “an almost definite”, whereas the benefits of the latter were more debatable.¹²⁹ The Governor thought it would not be easy to identify a single macroprudential policy instrument, and the toolkit would be more likely to contain a range of instruments for different scenarios.¹³⁰

82. Because many large banks operate across national boundaries and are relatively geographically mobile, there is a clear need for international agreement on the way forward for macroprudential supervision. However, seeking international agreement will not be easy, as economic cycles differ significantly across countries, as do the nature and size of banking sectors.

The Basel capital rules

83. The current capital rules in Europe are based around the Basel II framework, drawn up by the Basel Committee for Banking Supervision. Basel II was only introduced to the EU in early 2008, so the genesis of the credit crunch occurred under the regime of the less risk-sensitive 1988 Basel Accord (Basel I). The Basel capital requirements set minimum levels of capital for banks across most of the developed world. Arguably, the extent of losses suffered by banks during the financial crisis would suggest that Basel capital requirements were inadequate. Andrew Crockett, former General Manager of the Bank for International Settlements, took the view that capital and liquidity requirements was “an area of unique importance” which, in his view, should be “the principal focus of regulatory reform efforts”:

Hitherto, regulatory capital requirements have been based on “Risk-weighted Assets” under Basel I and Basel II. I believe this formulation is incomplete as it does not give sufficient weight to (a) macroprudential risks, and (b) liquidity risk. Inadequate attention is paid to the possibility of generalized financial stress, in which market dynamics can lead to a downward spiral of asset valuations. The risk of such stress generally increases during periods of benign credit conditions, as market participants bid up values and financial imbalances accumulate. It would therefore be good to adjust capital ratios to take account of factors which signal the build-up of macroprudential risk. Specifically, it is for consideration whether regulatory risk-weighted capital ratios should be adjusted to take account of both the speed with which credit has been expanded, and changes in leverage at financial institutions.¹³¹

128 Ev 50

129 Q 78

130 Q 133

131 *Banking Crisis: Written evidence*, Volume II, Ev 295

84. The Governor argued that the Basel capital framework “achieved nothing because it was wildly too complicated”.¹³² The bulk of this chapter considers possible reforms to improve capital regulation.

Higher bank capital

85. In the run up to the financial crisis, the leverage of UK banks increased significantly. The Basel II capital requirements offered no brake on this trend because requirements were calculated on risk-weighted assets, the value of which tended to rise during the boom. These risk-based models systematically underestimated the risks being built up.

86. In the view of Mr Andrew Haldane, the Bank of England’s Executive Director for Financial Stability, determining the optimal level of capital for a bank was an area “which has been chronically, and perhaps surprisingly, under-researched” and one which policy makers had “repeatedly ducked”.¹³³ Lord Turner explained that in the 12 years of discussion leading up to the Basel II capital regime, there was intense consideration of the relative weight of capital charged against different asset classes, but almost no discussion of what the aggregate level of capital should be. Instead, Basel II merely maintained the status quo of overall capital requirements inherited from Basel I. He observed that this was “slightly odd, in retrospect”. So what is the optimal level of capital? Lord Turner said it was very difficult to derive a complete theory of the optimal level, but “there was a reasonable argument that it should be higher”.¹³⁴ However much regulators improved in their capacity to foresee future problems, they would never achieve perfection. Accordingly there needed to be shock absorbers built into the system, and “the shock absorbers in the banking system are ultimately the capital requirements”.¹³⁵ He added that it was an issue which needed much more debate amongst policy makers, a debate which the FSA would encourage, but that in the meantime, a global consensus was proceeding on the basis that more, and higher-quality, capital was required.¹³⁶

87. Dr Lilico anticipated that banks would hold significantly more capital than in the past, but suggested that this would happen with or without regulation. He advocated waiting to see what the market reaction would be before reacting with new regulation.¹³⁷ Dr Alexander drew our attention to the inconsistent application of capital definitions across Europe, with each country interpreting the Basel rules differently. Capital, in his view, should be defined as the ability to absorb losses.¹³⁸ The Government is working with EU partners to agree a common definition and level of high quality regulatory capital and ensure a more consistent adoption of the Basel standards.¹³⁹

132 *Banking Crisis: Oral evidence*, Q 2355

133 Speech by Andrew Haldane at the Federal Reserve Bank of Chicago 45th Annual Conference, 8 May 2009

134 Q 63

135 Q 51

136 Q 63

137 Q 10

138 Q 14

139 *Reforming financial markets*, p 54

88. The FSA and Government have proposed introducing a leverage ratio ‘backstop’ to ensure minimum capital levels are maintained, whatever the risk-based calculations of the Basel II framework computation. On its own, a leverage ratio could create undesirable incentives for banks to invest in risky assets, but the Treasury’s position is that a leverage ratio would complement, not replace, risk-based systems.¹⁴⁰ The Governor was “all in favour” of a leverage ratio, believing it would be good to reintroduce some simple measure to the cocktail of complex capital rules:

A vast amount of effort, untold expenses and manpower went into designing these [Basel] regulations, and in normal times the calculations, I am sure, were much more sophisticated than before, but in normal times it did not matter a great deal. When it really mattered, then the models that were used to estimate the risk were pretty worthless. So this was a very good example, I think, where you need to be careful not to be so complicated and sophisticated and actually miss the big picture, and I think leverage ratios clearly have a role to play there.¹⁴¹

The Basel Committee is taking forward work to consider the implementation of leverage ratios which would supplement risk-based capital requirements.¹⁴²

89. The Basel capital rules are the result of over a decade of negotiations and planning. Unfortunately they do not work, or at least do not work in a crisis, which is precisely when they are most needed. Arguably they have made things worse by distracting the attention of leading experts, and have had the effect of driving much financial activity off balance sheet altogether. There may be a place for risk-based capital requirements, but there is also undeniably a need for a minimum level of capital based on a bank’s size. We welcome the steps being taken in the UK and in the international arena to introduce a leverage ratio as a backstop measure to prevent banks being able to reduce their capital levels to an unacceptable level.

Counter-cyclical capital requirements

Introduction

90. The Government believes that capital regulation should encourage firms to build up buffers of resources during economic expansion periods in order to absorb losses without triggering or amplifying an economic downturn. A “leading option” would be dynamic provisioning, which involves estimating long-run expected losses on assets rather than actual current loan losses. This would mean banks in effect holding higher reserves in the good times when actual losses are below the long run average. The Government believes that such rules should be primarily introduced through adjustments to prudential regulation rather than accounting standards, supporting Lord Turner’s proposals that buffers be held in the form of non-distributable reserves, set by the prudential regulator, which would be transparently disclosed in the published accounts. “This would aim to

¹⁴⁰ *Reforming financial markets*, p 86

¹⁴¹ Q 134

¹⁴² *Reforming financial markets*, p 86

ensure the building of counter-cyclical buffers whilst maintain the integrity and transparency of financial statements.¹⁴³

Rules or discretion?

91. The FSA was “strongly favourable”, Lord Turner argued, to some element of “hard-wired counter-cyclical, through something like the Spanish dynamic provisioning approach”.¹⁴⁴ Box A summarises the concept of dynamic provisioning.

Box A: Dynamic provisioning

Dynamic provisioning uses a statistical method to allow for losses inherent within the portfolio which have not yet materialised.

- In economic upswing, it builds up a buffer by requiring provisions higher than recognised by standard ‘incurred loss’ accounting
- In economic downswing, it allows some losses to be met from the accumulated buffer.

Dynamic provisions can be either deducted from published Profit and Loss (P&L), or from regulatory capital, or both.

In June 2000 the Banco de España introduced a dynamic (also known as ‘statistical’) provision for Spanish banks and other credit institutions. It aims to ensure that aggregate annual provisioning—including the dynamic provision—equals average annual net losses suffered by the banking system in the last decade.¹⁴⁵

92. Leaning against the credit cycle might be achieved in part through the implementation of a rules-based system. However financial institutions have proved adept at regulatory arbitrage and innovation, so there may be a case for an element of discretion in the application of rules. Dr Lilico, for example, argued that once an economy hit a “difficult period”, formulaic capital adequacy requirements ought to be abandoned, because it would be impossible to devise a rule which worked well in both the good times and the bad.¹⁴⁶ Professor Morrison agreed that, in a crisis, the regulator should be prepared to relax capital requirements.¹⁴⁷ But, as the White Paper noted, the introduction of discretion can create problems for regulators where they cannot credibly commit in advance to behave consistently.¹⁴⁸ Dr Alexander believed that there needed to be a combination of rules and discretion, and the rules “need to provide reference points or guidelines for regulators”. The fact that policy makers were seeking consistent capital regulation across Europe would mean that all countries would need to be “working from the same playbook”, so a rules-based framework was essential, but this would need to be flexible enough to change as

¹⁴³ *Reforming financial markets*, pp 86-7

¹⁴⁴ Q 78

¹⁴⁵ From *The Turner Review*, p 63

¹⁴⁶ Q 11

¹⁴⁷ Q 13

¹⁴⁸ *Reforming financial markets*, p 88

market conditions changed and innovations occurred.¹⁴⁹ Professor Morrison agreed that there was a need for a focus on rules-based systems—as simple as possible and as hard to bend as possible—because “in times of boom it is incredibly difficult to put the brakes on” in the absence of rules. To the extent that discretion is built into the system, he argued, it was “incredibly important” that those exercising discretion had the right incentives and were accountable, otherwise counter-cyclical regulation would “simply have little effect”.¹⁵⁰ He cast another doubt on the effectiveness of counter-cyclical capital regulation, which was that in a crisis, capital requirements would lack bite, because although the regulator might relax the rules, the market itself would demand “massive levels of core capital”.¹⁵¹

93. Lord Turner thought that the best system would be a combination of rules and discretion. He noted that the more discretion introduced into the system, the greater the overlap with monetary policy, because counter-cyclical capital tools can start to become alternatives to the interest rate as an instrument for controlling inflation.¹⁵²

Calling the cycle

94. In order to have capital requirements varying at different points in the economic cycle, somebody would need to determine the shape and timing of the economic cycle, which is no simple task. The Treasury’s difficulty in calculating the start and end point of economic cycles, for example, has been well documented.¹⁵³ We asked Lord Turner who should perform this role. He argued that counter-cyclical capital rules might not actually need someone to identify the cycle. For example, in a rules-based system, such as the Spanish dynamic provisioning regime, a rule could state that extra capital would be required if credit were to grow at a particular pace. In a discretion-based system, for example, the prudential supervisor might take action when it saw what it believed to be overheating in the credit markets.¹⁵⁴

Conclusions

95. **There is a strong argument in favour of the introduction of a degree of counter-cyclicity in capital regulation. It is important that banks are forced to build up capital reserves in the good years for the inevitable leaner years that will follow. By slowing down credit growth in a boom, counter-cyclical capital rules should also prove a strong tonic to the financial markets’ tendency to amplify the natural economic cycle because of irrational exuberance, which is also very welcome. There is now a burgeoning consensus that counter-cyclical capital requirements are needed; the debate has moved on to what that means in practice. We believe that such requirements should, as much as possible, be based on simple rules. This is first so that banks can know where they**

149 Qq 5-6

150 Q 6

151 Q 13

152 Q 66

153 See, for example, the Treasury Committee’s annual reports on Budgets up to 2008

154 Q 66

stand, benefit from regulatory certainty and plan accordingly. Secondly, a rules-based system would reinforce the regulator's ability to avoid succumbing to industry lobbying for lower capital requirements. Thirdly, a rules-based system could remove the need for any one organisation to call the economic cycle, a task which has proven extremely difficult in the past, and which will doubtless continue to be so. Nevertheless, there is a place for regulatory judgements, so there should be some limited flexibility in the application of the rules.

Liquidity regulation

96. The financial crisis has shown that bank liquidity is just as important an issue as bank capital. Liquidity management is critical to the successful functioning of banking which, after all, makes its money from maturity transformation by lending long and borrowing short. As Paul Tucker has recently commented, “the defining characteristic of banks lies in the liquidity services [they] provide and in the consequent liquidity risks that [they] run”.¹⁵⁵ Surprisingly, liquidity received very little regulatory attention prior to the crisis. The Basel Committee has been tasked by the leaders of the G20 with rectifying this deficiency at an international level.¹⁵⁶ Domestically, the FSA has already published substantial proposals to improve liquidity regulation involving higher requirements for liquid assets, improved transparency and a more comprehensive approach to stress testing.¹⁵⁷

97. Lord Turner has admitted that in the area of liquidity regulation “regulators across the world took their eyes off the ball, focusing too much on the intricacies of capital regulation”.¹⁵⁸ Dr Alexander agreed that there had been an “under-appreciation” of the risk that liquidity problems posed to the financial system. He observed that academics and regulators across the world had wrongly believed that credit risk transfer techniques such as securitisation promoted liquidity:

What we did not count on was the fact that suddenly all the institutional investors could just simply not want to roll over their short-term investments and then the liquidity would dry up. That was something that was not foreseen and it is a major failing, I think, on the part of both academics, policy-makers and of course the risk managers in the banks who should have seen this.¹⁵⁹

98. One of the reasons why liquidity regulation has not received the same degree of attention as capital regulation is because liquidity is a notoriously slippery concept, which, as Professor Morrison said, is a “very hard thing to define”. He told us that many people defined a bank's liquidity in terms of the asset base that it had. A bank with a lot of gilts on its balance sheet was thus regarded as a very liquid institution. However, the problem with liquidity, in Professor Morrison's view, was that liquidity was not a constant, but

¹⁵⁵ Speech by Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the British Bankers' Association Annual International Banking Conference, 30 June 2009

¹⁵⁶ *Reforming financial markets*, p 55

¹⁵⁷ *Ibid.*, p 55

¹⁵⁸ Speech by Lord Turner at the Turner Review press conference, 18 March 2009

¹⁵⁹ Q 41

something that evolved in line with market expectations and the beliefs of market participants—“When market participants stop believing in one another, liquidity dries up”. He suggested that a better way to think about liquidity would be to consider the exposure of a bank to the drying-up of liquidity. This concept could be measured in terms of mismatches of maturities on a bank’s balance sheet, so a bank with unusually high levels of short-term wholesale funding, and also having long-term investments, would be deemed to have relatively high liquidity risk.¹⁶⁰

99. Solutions to the problems of liquidity regulation need to distinguish between idiosyncratic failures of liquidity risk management at specific firms, and widespread liquidity crises caused by the freezing of entire asset markets. In the former case, the regulator’s onus should be on ensuring that financial institutions are given the right incentives to manage the risk, in order to avoid moral hazard. In situations where there is systemic market freezing, liquidity should be viewed as being a public good, and be provided for by the central bank. Analysis of the maturity mismatch between assets and liabilities on a bank’s balance sheet might be one angle from which to approach liquidity regulation in the future, and we would welcome the FSA’s views on this matter.

Loan-to-value ratios

100. Policy proposals have also been floated that would regulate the characteristics of financial products rather than the behaviour of financial institutions. In particular, there have been calls to consider imposing limits on loan-to-value ratios to prevent the emergence of unsustainable growth in house prices. Recent years saw a rise in the proportion of mortgage products with 100 per cent or more loan to values (LTVs).¹⁶¹

101. Professor Morrison speculated that LTV ratio limits were likely to be one of the most effective tools for macroprudential supervision, because the rapid expansion of LTV ratios (as seen in the 7 or 8 years preceding the financial crisis) was the kind of macroeconomic variable that rules could be predicated on.¹⁶² Lord Turner informed us that some countries already use LTV ratio limits, either as a stable prudential limit over time, or as a variable tool to respond to changing circumstances. China, for example, has been using LTV ratios as part of its fiscal stimulus package. But Lord Turner cautioned that LTV ratios was one issue “where we need to think very deeply before deciding to go down that route”.¹⁶³

102. The Government asked the FSA earlier this year to consider the treatment of mortgages of more than 100% of house value. The FSA is due to publish a paper in October that will consider potential options for regulatory reform.¹⁶⁴ **We look forward to examining the FSA’s proposals for regulatory reform in the area of loan-to-value ratios.**

¹⁶⁰ Q 40

¹⁶¹ *Reforming financial markets*, pp 89-90

¹⁶² Q 22

¹⁶³ Q 78

¹⁶⁴ *Reforming financial markets*, p 90

5 Reform to the institutional framework of financial stability

The case for change

103. We were critical of the operation of the Tripartite system established in 1997 in our report on *The run on the Rock*. Although in our Report we concluded that the Tripartite system should be kept, but reformed, others have argued for more radical changes, with some favouring a reversion of banking supervision from the FSA to the Bank of England.

104. The Treasury stressed in its White Paper that the institutional structure of regulation was not so much a problem as the judgements and decisions made by the authorities. The White Paper noted that many different institutional frameworks existed in different countries around the world, “but no model of regulation has been successful in fully insulating a country from the current crisis”.¹⁶⁵ As such, the White Paper made no radical changes to the Tripartite arrangements. Smaller changes were, however, set in motion to strengthen the Tripartite through “increased powers for the Bank and FSA, better coordination between them, and strengthened governance and greater transparency”.¹⁶⁶

105. A further reason for re-evaluating the Tripartite system is that a decision will need to be made in the medium term about which of the Tripartite bodies wields the tool(s) of macroprudential supervision. On the one hand, the Bank of England would seem well placed because it has a responsibility for considering system-wide risks. On the other hand, the FSA is the body with the specific knowledge of individual firms, so might be better placed to implement supervisory judgements. The Treasury argued that it would be “premature” to decide on the institutional responsibility until it became clear what the new tools would be, and how they should be used.¹⁶⁷ This stance was supported strongly by both the Bank and the FSA. The Governor explained that allocating responsibilities at this stage would be putting the cart before the horse:

We have not solved the “too big to fail” problem or worked out how to handle it, we have not sorted out what the macro-prudential policy instrument or instruments, in the plural, would be ... There is a lot of things that need to be thought through before we can decide what are the set of regulatory instruments that need to be available to the authorities, and only then, I think, is it sensible to ask how that should be allocated among the various players.¹⁶⁸

106. The White Paper announced the provision to the FSA of a statutory objective for financial stability, with additional rule-making powers “to give it clearer legal authority to set rules whose purpose is to protect wider financial stability”.¹⁶⁹ The Treasury argued that

¹⁶⁵ *Reforming financial markets*, p 4

¹⁶⁶ *Ibid.*, p 11

¹⁶⁷ *Ibid.*, p 15

¹⁶⁸ Q 125

¹⁶⁹ *Reforming financial markets*, p 11

this would “support greater focus on prudential supervision, enable greater attention to system-wide risks and establish explicit legal authority to support financial stability”.¹⁷⁰

The Bank of England—responsibility without power?

107. The Banking Act 2009 formalised the Bank of England’s existing responsibility for financial stability in statute:

An objective of the Bank shall be to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom.¹⁷¹

Although the Bank had been charged with this new statutory responsibility, the Governor had “not really received any adequate answer” to his question of what the bank was actually expected to do in order to discharge that responsibility.¹⁷² At his earlier Mansion House speech, he noted the limitation of his powers:

To achieve financial stability the powers of the Bank are limited to those of voice and the new resolution powers. The Bank finds itself in a position rather like that of a church whose congregation attends weddings and burials but ignores the sermons in between. Like the church, we cannot promise that bad things won’t happen to our flock—the prevention of all financial crises is in neither our nor anyone else’s power, as a study of history or human nature would reveal. And experience suggests that attempts to encourage a better life through the power of voice is not enough. Warnings are unlikely to be effective when people are being asked to change behaviour which seems to them highly profitable. So it is not entirely clear how the Bank will be able to discharge its new statutory responsibility if we can do no more than issue sermons or organise burials.¹⁷³

The Governor did not, at present, see a clear alignment of the Bank’s responsibility and powers, he acknowledged that the current system was a “mess”, and was adamant that this must change:

[Reports and speeches] are important things, but, in the end, I do not believe that people change their behaviour simply because we publish reports. That is fine by me, I am very happy with that position—if you want us just to publish reports, I am very content with it—but I do want it to be absolutely crystal clear before Parliament that you in Parliament understand that the Bank of England can do no more than publish reports or make speeches. If you are content with that, that is fine by me. What you cannot do is turn round afterwards and say, “But you had the statutory

¹⁷⁰ *Reforming financial markets*, p 51

¹⁷¹ *Banking Act 2009*, section 238(1)

¹⁷² Q 117

¹⁷³ Speech by Mervyn King, Governor of the Bank of England at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June 2009

responsibility. Why did you not do something?”, when there is nothing that we can actually do. All I am saying is just align carefully the powers and responsibilities...¹⁷⁴

108. The Treasury’s White Paper noted that one of the Bank’s existing responsibilities under its financial stability obligation, was to “analyse and warn of emerging risks to financial stability in the UK, principally by means of its Financial Stability Report, published twice-yearly”.¹⁷⁵ But the Treasury are now asking the Bank to be more explicit in its warnings and identify:

- risks to the UK financial sector and the UK economy;
- specific actions which could be taken to counter the systemic risks identified in the Report;
- an assessment of their likely effectiveness; and
- consideration of whether these actions should be implemented by the Bank, the FSA, the Government, or whether they require internationally coordinated action.

Additionally, the Treasury have suggested new arrangements to make the evaluation of risks identified by the Bank, and its proposals for required action, more transparent.¹⁷⁶ The principal mechanism for this would be through the new Council for Financial Stability.¹⁷⁷

109. When we asked the Bank how close their links with financial institutions were now, and what work would need to be done to restore those links should the Bank be granted new powers in an institutional shake-up, the Governor reassured us that the Bank currently had close contact with people in the financial sector. He acknowledged that, prior to 2007, the Bank “made a mistake” in not “treading on the toes” of the FSA, especially with the smaller firms. The Governor was keen to enhance the Bank’s understanding of all financial firms, irrespective of whether the Bank was granted new powers.¹⁷⁸

Council for Financial Stability

110. The Tripartite Standing Committee (composed of The Chancellor of the Exchequer, the Governor of the Bank of England and the Chairman of the Financial Services Authority) currently serves as a forum for discussing and coordinating financial stability work.¹⁷⁹ The Treasury’s White Paper announced that legislation would be brought forward to transform the Standing Committee into a new Council for Financial Stability (CFS), set up on a statutory basis, with a published terms of reference and clearer responsibilities. The CFS would meet regularly to discuss systemic risk issues highlighted by the Bank’s

¹⁷⁴ Qq 117-118, 121-123

¹⁷⁵ *Reforming financial markets*, p 11

¹⁷⁶ *Ibid.*, p 12

¹⁷⁷ *Ibid.*, p 89

¹⁷⁸ Q 144

¹⁷⁹ *Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority*, March 2006

Financial Stability Reports and the FSA's Financial Risk Outlooks, and to consider actions required. It would also meet on an ad hoc basis when particular risks to financial stability arose. Minutes of the CFS would be published quarterly. The key differences between the new CFS and the old Standing Committee are that the CFS operates on a statutory basis, and will have published minutes. The Treasury has also pledged to "consider mechanisms for increasing the democratic accountability of the CFS, through greater Parliamentary scrutiny".¹⁸⁰

111. We sought from Lord Myners an answer to the question which the Governor had posed two weeks earlier, regarding how the Bank could satisfactorily discharge its new financial stability responsibility in the absence of any tools other than the power of words. Lord Myners replied that:

The Governor will discharge his statutory responsibility by participating fully in the process in accordance with the terms of reference that are ultimately set and reflected in legislation for the Council for Financial Stability.¹⁸¹

112. **We cautiously welcome the replacement of the Tripartite Standing Committee by the Council for Financial Stability (CFS) in respect of the publication of clear terms of reference for the new body and the fact that minutes of its meetings will now be published. We look forward to engaging with the CFS over how Parliamentary accountability might be improved. However, we view the change as one which is largely cosmetic. Merely rebranding the Tripartite Standing Committee will achieve little by itself; what is required is an improvement in cooperation amongst its members, and a simplification and clarification of responsibilities for each of its members.**

113. **Devising an appropriate institutional framework for macroprudential supervision is extremely important and should not be rushed. We agree with the argument made by each of the Chancellor, the Governor and the Chairman of the FSA that it is necessary to reach an agreement on the precise instruments needed in the macroprudential toolbox, before considering which organisation should wield those tools.**

114. **Whatever the final outcome of any institutional arrangements it is absolutely imperative that responsibilities are clear. The biggest failings of the Tripartite's handling of Northern Rock were that it was not clear who was in charge, and, because the Tripartite took a minimalist view of their respective responsibilities, necessary actions fell between three stools. We are not confident that this issue has yet been adequately resolved. Where before no-one had a formal responsibility for financial stability, now many do—the Bank of England, the FSA, the Treasury, the Council for Financial Stability and the Bank's Financial Stability Committee. Where responsibility lies for strategic decisions and executive action was, and remains, a muddle. The Treasury's design of the institutional framework for financial stability must bear in mind that, when the dust eventually settles on a new system, the question that we, and others, will ask is "Who gets fired?" if and when the next crisis occurs. It is a blunt**

¹⁸⁰ *Reforming financial markets*, p 12

¹⁸¹ Qq 209-215

question, but one which is necessary. Only if we have such clear responsibilities can we expect good decisions to be made and the right actions to be taken. Once those responsibilities have been clarified, the appropriate powers must be properly aligned.

The Government White Paper and co-operation between the Tripartite bodies

115. The financial media have been awash with rumours about an emerging rift between the Tripartite bodies, with talk of personality clashes and turf wars. We put this issue directly to the Governor:

Chairman: Is your working relationship beyond repair, as the Sunday newspapers would indicate, or are they just making a mountain out of a molehill?

Mr King: I certainly do not see any relationship between the headlines in the newspapers and the reality. I have a good working relationship with Alistair Darling. That is almost as true now as it was before. We talk often to each other and there is no problem with that working relationship whatsoever.¹⁸²

116. Lord Myners also considered the relationship between the Treasury, Bank and FSA to be very good: “I have seen it at first hand since I became a minister last October in these three bodies coming together to take vital and necessary and confident action both in support of the system and to handle individual institutions which have been experiencing difficulties”.¹⁸³

117. We were therefore surprised when in oral evidence on 24 June the Governor told us that, despite the good relationship he had with the Chancellor, he had not been consulted on the draft Government White Paper, which was to be published on 8 July. He had “no idea” what questions would be asked by the White Paper, nor when it was likely to be published. He believed that the Chancellor would show him the consultation paper prior to its publication, but added that “White Papers tend to get written somewhat faster these days than they used to!”¹⁸⁴

118. That the Treasury failed to consult with the Bank of England is a surprising development. In 2008, the Treasury, Bank of England and FSA not only consulted each other, but actually co-authored a trio of consultation papers on financial stability and depositor protection.¹⁸⁵ In advance of the publication of the *Reforming financial markets* consultation paper, the Governor speculated that the Tripartite Committee would not be bringing forward joint proposals, because it was “not a decision-making body”.¹⁸⁶ But this was equally true of the 2008 consultation papers.

182 Q 112

183 Q 184

184 Qq 168-177

185 *Financial stability and depositor protection: strengthening the framework*, Cm 7308, January 2008; *Financial stability and depositor protection: further consultation*, Cm 7436, July 2008; *Financial stability and depositor protection: special resolution regime*, Cm 7459, July 2008

186 Q 167

119. Lord Myners told us that the White Paper represented the Treasury's proposals for reforming financial markets going forward and was a document which had "been informed by close engagement on a continuous basis with the Bank of England and the Treasury over several months".¹⁸⁷ He ascribed the Governor's comments to the fact that at the time of the Governor's appearance, the White Paper was "still in early stages of preparation".¹⁸⁸ Lord Myners sought to reassure us that there had been "very, very extensive consultation, engagement, discussion, review of possibilities, working with other agencies in the preparation of this document, so this is not the work of the Treasury alone working in isolation or in a vacuum, this represents considered opinions drawing on international bodies including the FSB, the IMF, et cetera".¹⁸⁹ This statement appears to be at variance with the Governor's comment that he had "no idea" what was in the White Paper.¹⁹⁰

120. We are extremely perturbed by the statement by the Governor of the Bank of England that he was kept in the dark over the contents of the Government's White Paper on *Reforming financial markets* to the extent that he had "no idea" what it would contain, or even when it would be published, only a fortnight before publication. The Chancellor must set out why consultation papers on financial reform are now no longer jointly published, or even shared, with his Tripartite colleagues. Failure to do so will only add further cause for concern to those worried about the state of the crucial relationships between the Tripartite principals.

187 Q 184

188 Q 185

189 Q 187

190 Q 175

6 International dimensions

Global initiatives

121. Banking has become increasingly international in recent decades, with many large banks operating across several continents. This globalisation has brought benefits through improving the efficiency with which capital flows are intermediated between customers in different countries, and enabled bank customers to access banking services more easily around the world. But the globalisation of finance also presents enormous challenges for national regulators, central banks and governments. For good economic and historical reasons, finance is regulated very differently in different countries, but banks may have a very multinational business model, be geographically mobile and indeed, in some cases, structured to take advantage of these variances in regulation between countries.

122. We asked Lord Turner what was achievable at the international level in terms of financial supervision. He told us that it was important to recognise what could be done at each of the national, European, and global levels. The ideal was to achieve as much agreement internationally as possible, but Lord Turner recognised that this would not be straightforward and would require a lot of energy and activity. Because none of the global bodies in the realm of financial supervision had any legal powers, progress towards reform has been dependent on consensus, so has tended to be “glacial”. Lord Turner was adamant though that the FSA would do all it could to force the pace of change.¹⁹¹

123. In April 2009, at the London Summit, the G20 agreed principles for dealing globally with impaired assets, repairing the financial system to restore lending, strengthening financial regulation to rebuild trust, and funding and reforming international financial institutions, both to overcome the current crisis and to prevent future crises. In particular, the G20 agreed to establish a new Financial Stability Board with a strengthened mandate and more members, as a successor to the Financial Stability Forum; to extend regulation and oversight to all systemically important financial institutions, instruments and markets; and to strengthen international standards of prudential regulation.¹⁹² Many of these initiatives have to be made through international agreements if the world is to avoid creating new opportunities for regulatory arbitrage by firms.

Europe

124. The Government’s White Paper argued that a “key part” of the new global framework would be agreed at EU level, believing that “Europe’s ability to identify and manage system-wide prudential risks needs to be enhanced” and that “the EU needs to develop the quality and scope of rules applying to firms, and ensure their proper enforcement”. Reforms to financial regulation have been driven forward by the report of the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière. This report, published in February 2009, proposed a new framework for European supervision,

¹⁹¹ Q 98

¹⁹² *Reforming financial markets*, pp 8, 95

including steps to reduce risk and improve risk management, reduce procyclicality, improve systemic shock absorbers, improve financial markets incentives, strengthen the co-ordination of supervision between national authorities and build crisis management procedures. Several of these proposals are now being taken forward by the European bodies. In June 2009 the European Council acted to strengthen the supervisory system and rebuild trust by creating

- a European Systemic Risk Board (ESRB) to assess continuously the stability of the financial system as a whole. Where necessary, it will issue risk warnings and recommendations to policy makers and supervisors, and monitor their follow-up;
- three European supervisory authorities, dealing with the banking, insurance and securities industries, working in a network with national supervisors, inter alia in preparing technical standards, ensuring the consistent application of EU law and resolving disputes between national supervisors.

125. The Governor thought that the ESRB might prove a useful forum for discussion and presented another opportunity for UK policy makers to push their argument at the European level.¹⁹³ However, the tepidity of his enthusiasm for the new body was revealed in a later remark:

Whether this body turns out to be a mere talking shop or a useful talking shop, in terms of an exchange of views and ideas being generated, remains to be seen—that is up to the people who sit on it. We will see. I go to vast numbers of international meetings and I cannot claim that most of them live up to the billing that one would hope. Nevertheless, as I said, hope springs eternal—cautious, moderate hope for this committee—and we will do our best to try and raise the level of debate.¹⁹⁴

126. The three new European Supervisory Authorities, which will replace the existing EU Committees of supervisors, will be charged with ensuring that a “single set of harmonised rules and consistent supervisory practices is applied by national supervisors”.¹⁹⁵ They will not have any fiscal powers over member states, but will have the final say in binding mediation in disputes between national regulators regarding the application of EU regulations such as the Capital Requirements Directive (CRD).¹⁹⁶ Dr Alexander lamented the absence of such a mediator in the past, because different national regulators have had an opportunity to use quite different interpretations of the CRD without any fear of sanction. He argued that it was entirely appropriate to have a European policy input to issues regarding the implementation of EU law.¹⁹⁷ The granting of binding mediation powers to the European Supervisory Authorities does, of course, have implications for the FSA. It could find itself in dispute with another national regulator, and, ultimately, the mediation process could result in a change of approach from the FSA. But Lord Turner

193 Q 154

194 Q 157

195 European Commission press release 10737/09 “2948th Council Meeting Economic and Financial Affairs”, 9 June 2009

196 The Capital Requirements Directive is the instrument through which Basel capital rules have been applied in the EU.

197 Q 19

was unconcerned about this possibility. He told us that the objective of the new bodies was to put pressure on the regulators in small countries to make sure tight standards were being applied, and not to tell regulators in large countries, such as the FSA, what to do. Lord Turner conceded that “under some circumstances” there was a case for binding mediation, as long as it was about a regulator’s general approach rather than its supervision of a particular firm.¹⁹⁸ In fact, binding mediation would be essential to avoid a repeat of a situation developing like the fallout suffered by the UK from the Icelandic banking crisis.¹⁹⁹ Lord Turner was confident that the FSA would be on the right side of any mediation disputes:

Mr Fallon: It is a very British point of view, is it not, to see this as one-way. What would happen if the Icelandic authorities or the Latvian authorities queried a decision that you had taken here?

Lord Turner of Ecchinswell: ... one would have to make sure that one was adequately involved in the process and that the thing was set up sufficiently professionally that one would be sure that that was only occurring if that challenge was reasonable. Of course the challenge has to be both ways; but we will be extensively involved, in detail, in helping create the professional standards and the technical competence of this regulatory authority.²⁰⁰

127. Lord Turner was “absolutely confident” that the supervisory capabilities of the FSA would be extremely unlikely to be challenged, “because we think that we would be setting the standard of what that professionalism is”.²⁰¹ He added that “it would be odd if the supervisor of Europe’s biggest and most important financial centre was not a beacon of high quality supervisory standards and was more likely to be the institution pushing to make sure that there were excellent supervisory standards in all other countries of the European Union, rather than being one which was criticised”.²⁰²

Regulating cross-border firms

128. The Governor recounted a tale from the G7 meeting in 2008 held in Tokyo:

I said around the table to my colleagues, ... “What happens if a named particular large global investment bank one day rang up and said that they were bust? What would we do?” There was laughter round the table because it was unimaginable and we had not got any idea what to do. Now people know that it could happen and we have to have an idea what to do.²⁰³

198 Q 73

199 Qq 67-70

200 Q 71

201 Q 73

202 Q 105

203 Q 151

129. Recently, ‘supervisory colleges’ have been established for the largest cross-border firms which should lead to a better understanding of firm-specific risks, and cross-border crisis management facilities should improve information sharing between national authorities, addressing cross-border spill-overs.²⁰⁴ Dr Jon Danielsson, of the London School of Economics, described the establishment of supervisory colleges as a “positive development”.²⁰⁵ He argued that banks had been able to operate across boundaries without any regulator “really understanding what they were up to”, which clearly needed to be prevented. There was considerable scope, he argued, for regulatory co-operation through supervisory colleges.²⁰⁶

130. The Governor told us that authorities around the world were no longer as clueless as they had been in Tokyo about dealing with cross-border banks, claiming that through the new Financial Stability Board, and through the supervisory colleges for large firms, there was “a real impetus” behind the idea that large international banks cannot be allowed “to wander around the world in a situation where no-one can afford to let them fail but no-one has any idea how to resolve them if they do other than put lots of money in”. The will to tackle that problem was infinitely greater now than it had been 15 months previously.²⁰⁷

131. Lord Turner believed that regulators around the world may have been “too lenient” in accepting the proliferation of legal structures devised by large interconnected cross-border investment banks for tax and regulatory arbitrage reasons.²⁰⁸ In the case of global universal banks such as HSBC and Banco Santander, he saw merit in the idea of requiring each national operation of such banks to be a stand-alone legal entity, prudentially regulated by the host country, rather than the home country. Then, if the global holding company were to fail, national regulators could have the responsibility and power to deal with the problems at a local level.²⁰⁹ The downside to this argument is that there may be efficiency losses from preventing global capital and liquidity management by the banks, but the upside gain would be an improvement in financial stability.

132. The existence of large, complex, cross-border banks brings both benefits and dangers. Such institutions benefit the consumer by simplifying banking transactions and act as a lubricant to global capital flows. However, the risks they present to the global financial system are considerable. As the Governor has said, whilst banks may be global in life, they are national in death, because if such a bank were to fail, the regulator in the bank’s home state would have the responsibility of resolving the firm. Not only would this be an unenviable task for the home state authorities, it would also present problems for host states, as they would have very little control over the fate of the firm’s banking operations within their countries. This makes all the more critical the insistence on a ‘will’ for any bank operating in the UK. Colleges of supervisors are

204 *Reforming financial markets*, p 99

205 *Banking Crisis: International Dimensions*, Q 89

206 *Ibid.*, Q 91

207 Q 151

208 Q 92

209 *Ibid.*

certainly a good idea, as they will provide a forum through which information about large banks can be shared, but we doubt that they are enough on their own. We support the idea that the national banking units of global banks should be obliged to establish as stand-alone subsidiaries of the parent group, regulated and supervised by the host state regulator. The capital of these stand-alone banking units would need to be ring-fenced to prevent the parent group snatching it away upon failure of the global bank. We recommend that the FSA should consider how feasible such a system would be, including whether or not it could be implemented unilaterally without international agreement. Sacrifices to efficiency of global firms in peacetime would be a price worth paying for the reassurance that a possible crisis could be contained within national boundaries if the firm failed.

The future of the City of London

133. Professor Buiter told us that the City of London was likely to be the first victim of an inevitable retrenchment of cross-border banking brought about by regulators seeking more control over banking activities conducted within their jurisdictions. But Dr Danielsson viewed things differently, believing that there would be a “re-emergence of securitisation” from which London would benefit, because it was the most advanced in this field of finance.²¹⁰

134. The financial services sector is one of the UK economy’s most significant industries. It employs more than one million people, accounts for around 8% of UK output and has contributed over £250 billion to the public finances in tax over the last nine years.²¹¹

135. Some have questioned whether the UK financial services sector has actually grown too large.²¹² Mr Andy Haldane, the Bank of England’s Executive Director for Financial Stability, recently made a speech in which he analysed the source of the ‘excess returns’ to finance during the 20 year period up to the financial crisis. Over that period, UK banks’ return on assets had changed little; instead the remarkable increase in UK banks’ return on equity (and subsequent decline in 2008) could be fully accounted for by bank leverage. In other words, the excess returns from banks over the last 20 years were entirely down to “gambler’s luck” rather than skill.²¹³ The Governor of the Bank of England has, on earlier occasions, voiced concern that the City of London appears to be siphoning off too much graduate talent away from other sectors of the economy, as many very able science, maths and engineering graduates opt for a career in the City, rather than manufacturing or other sectors of the economy:

I do think it is rather unattractive that so many young people when contemplating careers look at the compensation packages available in the City and think that these dominate almost any other kind of career—that is not an attractive position to be in. Such a high proportion of our talented young people naturally think of the City as

210 *Banking Crisis: International Dimensions*, Q 92

211 *Reforming financial markets*, p 18

212 See for example *Rebalancing the UK economy: a long time coming*, Ernst & Young ITEM Club, May 2009

213 Speech by Andrew Haldane at the Federal Reserve Bank of Chicago 45th Annual Conference, 8 May 2009

the first place to work in. It should not be. It should be one of the places, but not the only one.²¹⁴

136. But a recent report co-chaired by Sir Win Bischoff, the former Chairman of Citigroup, and the Chancellor of the Exchequer cast aside these concerns, on the grounds that the sector's 8 per cent share of the economy was comparable to that of the USA and other European countries (although in his Mansion House speech the Governor said that the UK banking sector was, as a proportion of GDP, five times greater than that of the US)²¹⁵ significantly less than Hong Kong and Singapore, and significantly less than the UK output share of the manufacturing sector.²¹⁶

137. The White Paper did recognise that, as has become clear over the last two years, financial markets can operate in ways that can have a “negative impact” on the economy. It concluded that a “strong, thriving financial sector can make a positive contribution to the economy”, but its growth will need to be managed in a way that supported sustainability and long-term growth.²¹⁷

138. We believe that the Government should take the issue of over-reliance on financial services much more seriously than it currently does, and should commission a review by an independent figure from outside the financial community to consider the City's impact on the wider economy and public finances. This is not to suggest it is sensible for any Government to decide the right size of an industry as a proportion of the economy, but rather to ensure that the risks as well as the benefits of specialisation are articulated, understood, and prepared for.

214 Tenth Report from the Treasury Committee, *Re-appointment of Mervyn King as Governor of the Bank of England*, Session 2007-08, HC 524-II, Q 13

215 Speech by Mervyn King, Governor of the Bank of England at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June 2009

216 *UK international financial services—the future: A report from UK based financial services leaders to the Government*, HN Treasury, May 2009, p 19

217 *Reforming financial markets*, p 18

7 The way forward

Generating ideas and maintaining momentum

139. It is evident that policy makers around the world are not yet anywhere near reaching a conclusion on some of the biggest issues discussed in this Report. There appears to be a growing consensus regarding the necessary reforms, but the painstaking task of seeking international agreement on the detailed regulations required has only just begun. For example, in capital regulation there is an agreement that counter-cyclical requirements are a good idea, but different views exist on the extent to which they should be formula-driven rather than based on judgement, who (if anyone) should call the cycle, and the definition of good-quality capital.²¹⁸ The Governor thought that we were “a million miles away” from having translated the broad idea of macroprudential supervision into a clear set of instruments.²¹⁹

140. Until recently Lord Turner and the Governor had both believed that time was on the side of those wishing to reform banking. The Governor argued that “exuberance of either a rational or irrational sort was not in great supply at the moment”, so there would be no rapid return to the risky banking practices which contributed to the financial crisis.²²⁰ But in July, Lord Turner voiced concern that “we may see a more rapid return to risky trading activities than we had anticipated”. It was therefore important, he said, that whilst pursuing the necessary fundamental changes in, for instance, capital regulation, the authorities monitor closely developments already taking place in the marketplace.²²¹ Lord Turner had noticed, for example, that investment banks had already resumed “aggressive hiring” for their trading activities.²²² The Governor was disappointed by the lack of attention displayed by the financial sector itself to reform remuneration practices, commenting that the message had “not yet sunk in” but maybe it would come.²²³ But overall the Governor was sanguine about these developments:

I think the most important thing is not to worry so much what one or two banks are doing now, but we have got to maintain this momentum to have a debate about the form and to put in place a new structure for banking and its regulation ... If we keep our eyes on that, ... then what happens in the short run elsewhere will not matter, but having that approach in the long run is absolutely fundamental.²²⁴

141. Professor Buiter was convinced that two inevitable consequences of the financial crisis would be both over-regulation and wrong regulation—measures designed to win the last

²¹⁸ See, for example, Qq 66, 132

²¹⁹ Qq 127, 130

²²⁰ Referred to by Lord Turner in Q 103

²²¹ Q 103

²²² Q 56

²²³ Q 115

²²⁴ Q 166

war. The way to avoid such a response involved regulators trying to consider risk generically, “rather than at the most recent manifestations of particular kinds of risk”.²²⁵

142. Lord Turner told us that the FSA would be thinking “over the summer” about their point of view on the choice of appropriate macroprudential instruments.²²⁶ In the autumn it would produce a paper on whether loan-to-value or loan-to-income ratio limits should be used for consumer protection or macro-prudential purposes, or, indeed, not used at all.²²⁷ The Governor had also set his sights on the autumn as the time by which the next stage of the debate would move on and said that the Bank was “thinking very hard” on macroprudential instruments.²²⁸ He saw no merit in rushing the debate by the imposition of an arbitrary deadline, because the banking sector was not behaving in a “gung-ho” manner or taking a lot of risk. But whilst finding a solution was not urgent, maintaining momentum towards finding a solution was “crucial”.²²⁹

143. This Report aims to contribute to the very important debate over the future of regulation and supervision of financial services. The debate is currently at a point where agreement is being reached, nationally and internationally, on the reforms that will be needed, but agreement is not particularly close to being reached on the practical implementation of issues such as counter-cyclical capital agreements, liquidity supervision and cross-border handling of global firms. We acknowledge that UK authorities are at the forefront of much of the agenda on the international stage, which is vital given the size of the UK financial sector. Now that immediate concerns over bank stability appear to be subsiding the temptation to relax must be avoided. Whilst there may not be an urgent need for new rules given the banks’ withdrawal from some of the risky business that got the sector into trouble, there is an urgent need for momentum to be maintained towards the design of a better framework. We expect further announcements by the Tripartite bodies in the autumn, and look forward to reviewing their progress towards the establishment of safer, calmer, banking supervision.

The role of the Treasury Committee

144. The White Paper *Reforming financial markets* indicates the important role envisaged for the Treasury Committee in strengthening regulatory institutions in respect of the scrutiny of the new Council for Financial Stability:

The Government will also discuss mechanisms for increasing the democratic accountability of the CFS given its role in public policy making and implementation, possibly through greater, Parliamentary scrutiny. The Government notes the important role that the Treasury Select Committee (TSC) has played throughout the events of the last two years in fulfilling this function ... The Government will consult

²²⁵ *Banking Crisis: International Dimensions*, Q 105

²²⁶ Q 78

²²⁷ *Ibid.*

²²⁸ Q 126

²²⁹ Q 163

on options for broadening and strengthening channels of democratic accountability.²³⁰

145. We are pleased that the Treasury recognizes the important scrutiny function of the Treasury Committee. We would, however, be more convinced that this vote of confidence in the Committee was likely to be backed up by actions if the process of scrutiny of the White Paper itself had not been so flawed.

146. On 22 April, in his Budget speech, the Chancellor promised that he would “shortly” publish his proposals for reform of financial regulation.²³¹ Rumours repeatedly surfaced that publication of the document was ‘imminent’. Such rumours proved ill-founded. Indeed, it has been a serious obstacle to us in pursuing our inquiry to be obliged to await a key document whose production seemed always to be imminent. We had to cancel a scheduled evidence session which was to be devoted to this topic because of the enduring absence of the White Paper.

147. Right up to the last minute the White Paper was held back. We understood that the White Paper would be published on Monday 6 July but it in fact only saw the light of day on Wednesday 8 July, just two hours before we were due to take oral evidence from Lord Myners, Financial Services Secretary, HM Treasury. Lord Myners had not realized that our meetings had been altered to accommodate the publication, apparently assuming that the publication of the White Paper was not directly related to the hearing.²³² When we pointed out to him that it was hardly beneficial for our scrutiny to have a mere two hours’ notice of a complex document occupying 170 pages, he dwelled instead on the benefits to us of having “an opportunity to engage with it very early on and to shape the debate”.²³³

148. As we pointed out to the Minister, the publication of a key document just before our evidence session was not a unique occurrence. On 22 July 2008, Kitty Ussher, the then Economic Secretary to the Treasury, giving evidence on our inquiry into Banking Reform, brought with her to our meeting a consultation paper on the Special Resolution Regime which she announced was simultaneously being placed in the House of Commons Library. We put it to her that this was an unsatisfactory course of action, a point that she conceded.²³⁴

149. We are pleased that the Treasury acknowledges the useful role that the Treasury Committee can play in scrutiny of the future performance of the Council for Financial Stability and pays tribute to our work over the last two years. Such praise, however, will be no more than empty flattery if it is not supported by actions. If we are to offer effective scrutiny this must be based on our considered analysis of the relevant evidence, not on spur of the moment appraisal. We are also unimpressed that the Treasury initially indicated that the White Paper would be issued shortly after the

230 *Reforming financial markets*, p 50

231 H Deb, 22 April 2009, Col. 246

232 Q 180

233 Q 182

234 Seventeenth Report from the Treasury Committee, *Banking Reform*, Session 2007–08, HC 1008, Q 203

Budget but offered no explanation for the lengthy delay leading up to its eventual appearance.

Conclusions and recommendations

The FSA's regulation of banking

1. We welcome the speed of progress made by the FSA under the Supervisory Enhancement Programme in recruiting staff, and boosting training, in order to improve its scrutiny of UK banks. Although it is difficult, and too early, to tell what impact the SEP has had on the banks' behaviour, we are encouraged by the fact that the financial services sector has clearly noticed a change in approach. The SEP is a necessary, but not sufficient, response to the problems of the financial crisis. (Paragraph 13)
2. By any measure the FSA has failed dreadfully in its supervision of the banking sector. But this Report is about the future not the past, and we welcome Lord Turner's candid approach to recognising the failures of the FSA and his willingness to address these failings. The arrival of Lord Turner has already had a very noticeable impact on the approach to regulation taken by the FSA. (Paragraph 22)
3. Lord Turner's analysis of a faulty regulatory philosophy of bank supervision, as part of a wider political philosophy is an interesting one, and seems to us plausible. But whether or not such a political philosophy had emerged, the FSA was and is an independent body, established in statute, and did not need permission from politicians to regulate financial institutions properly. Effective regulation can (and often must) require unpopular decisions in periods of economic growth, which appear at the time merely to restrain profitable activity. It is easy now for the FSA to promise to be more invasive in its supervision, because public and political opinion has swung behind such an approach. However we firmly believe that it is not the job of the supervisor to be popular and merely follow political fads. The FSA must develop sufficient self-reliance to stick to its guns in the face of criticism from industry or politicians, because ultimately, the job of the FSA may be to make unpopular decisions from time to time. (Paragraph 23)
4. In addition to the FSA developing the confidence to make unpopular judgements and act on the basis of them, we are in favour of the supervisor receiving some automatic tools to put sand in the wheels of financial expansion, without having to prove beyond all doubt that its actions are necessary in the face of resistant firms. In Chapter 4 we will turn to the question of how rules-based counter-cyclical supervisory tools might be developed that make it easier for the supervisor to lean against the wind by the time the next economic boom commences. (Paragraph 24)
5. The FSA's assessment of whether senior bankers were fit and proper for their posts appears to have been little more than a tick-box formality, unless the applicant had a criminal record or gave some other evidence of a shady past. That bar was demonstrably set too low. We welcome the acknowledgement from the FSA that a candidate's competence, as well as their probity, will now be thoroughly reviewed before taking up a senior post in a bank. We recognise that there may be some dangers in the FSA assessing competence, not least because the FSA will become exposed to accusations of incompetence itself, if it makes a wrong judgement. We discuss these dangers in the next section. (Paragraph 31)

6. We recommend that the FSA assess whether bank executives should possess relevant qualifications. We would like to see banking qualifications become one of the core indicators against which the FSA can assess a candidate's competence. If a candidate has no relevant qualifications, the onus should be on them to prove to the FSA that they have relevant compensatory experience. To this end we recommend that the FSA work with the British Banker's Association to draw up a list of relevant qualifications, and perhaps even work to encourage academic institutes to design new qualifications tailored towards the skills required of banks' senior management. (Paragraph 32)
7. There are obvious potential benefits to the FSA becoming more inquisitive, and starting to ask more searching questions about firms' business models and management decisions. It is quite right that, where the taxpayer is exposed to the risk of bank failure, the regulator should adopt a proactive approach to ensuring that risks borne by banks are not excessive. However, there is a potential downside to this approach, which is that the FSA start to crowd out the due diligence of private agents. It would be extremely dangerous if the FSA were to become the single point responsible for the identification of failure. It is important that investors and others conduct due diligence and necessary scrutiny of banks. The solution lies in making sure that the regulator does enough to insulate the taxpayer and small depositor from the impact of a firm's failure whilst avoiding treading on the toes of those with a responsibility for a firm's stewardship. It is right that shareholders should feel the pain if their firm fails, and equally it is good that small depositors are protected by deposit insurance and an active regulator. Currently bondholders and other creditors are also substantially protected from loss, because it is most unlikely that a large bank would ever end up entering administration. A balance needs to be struck by the FSA which places sufficient incentive on them to perform satisfactory due diligence. We recommend that the FSA outlines its thinking on the appropriate level of protection for creditors of banks and how it proposes to do this. (Paragraph 36)

Systemically significant banks

8. It is probably a fact of life that many banks will remain 'too big to fail', and will never be allowed to go bust. But there are areas where the authorities must take action. First, we are concerned that some banks would be 'too big to save' and the recent consolidation in the UK banking sector has only exacerbated this problem. Quite apart from competition considerations, the Government should review how prudent it is to have a banking market dominated by several banks with global balance sheets larger than the national economy. (Paragraph 43)
9. Second, those banks which are too big to fail must no longer be able to take advantage of that fact for private gain. Market discipline must be reintroduced in order to realign the incentives of bank investors and managers. We welcome the ideas put forward regarding a 'tax on size' administered through the capital regime. (Paragraph 44)
10. Capital requirements must tackle any incentives that banks have to grow or merge merely for the sake of becoming 'too big to fail'. Further, and admittedly more difficult, since capital requirements are a form of insurance, they should ideally be

calculated on an expected loss basis, taking into account both the probability of a bank's failure and the potential costs of such an event occurring. (Paragraph 45)

11. It has been alleged that some large banks took advantage of the implicit government guarantee backing up deposits, to cross-subsidise more lucrative trading activities. In such a scenario, rewards would be pocketed by the banks, whilst risks would be largely borne by the taxpayer. Such an outcome would be intolerable. We see the debate about narrow banking as being not so much about reducing the risk of failure, or even the impact of potential failure, but more about the incentives confronting bankers. These incentives are skewed dramatically by implicit government guarantees. The FSA proposals to subject proprietary trading activities carried out by retail banks to much higher capital requirements is welcome, and the bare minimum given the failure of the concept of 'liquidity through marketability' that previously underpinned the relatively low capital requirements of trading books. Calculating how swingeing those capital requirements ought to be is a tricky balancing act. As they get tougher, their impact will get closer and closer to that of a prohibition on proprietary trading. A ban may not be necessary if firms are given sufficient incentive to separate their trading units from their retail banking activities of their own accord, but a ban should not be ruled out by the FSA as an option at this early stage. (Paragraph 53)
12. We agree with the Governor of the Bank of England that highly complex, interconnected banks should face higher capital charges than simpler banks, because they impose a greater risk on the financial system as a whole. In order to inform such flexing of the capital regulations, we recommend that the FSA initiate work to increase its understanding of the extent and nature of the interconnections between financial firms. (Paragraph 55)
13. We recommend that the FSA's advice to the Chancellor on new areas of innovation and their consequences for systematic risk should be published. (Paragraph 59)
14. The FSA should only permit banking activities that it understands, and that it has confidence that the bank concerned understands. (Paragraph 62)
15. We are instinctively wary of placing too much reliance on product regulation, because it tends to be a blunt instrument. Typically it creates new opportunities for the identification and abuse of loopholes and work-arounds, and restricts some legitimate uses of the product concerned. We believe however, like the FSA, that regulators should keep an open mind and look at each product on its own merits. If, for example, a particular product has some legitimate uses and benefits, but these are significantly outweighed by inappropriate uses, the FSA should look very closely at restricting their use. (Paragraph 64)
16. We endorse the approach of the FSA that the focus of regulation should be based on economic substance rather than legal form. (Paragraph 68)
17. Improving bank resolution mechanisms is a vital component of financial services sector reform. Currently, the fact that there is no means by which large, complex banks can be resolved encourages complacency in these banks, contributing to the moral hazard dangers discussed above. The Special Resolution Regime is an

important mechanism, but its usefulness is reduced somewhat by its inability to cope effectively with the resolution of a large, complex bank. That weakness derives from a lack of information about how major banks are internally structured, an issue which must be addressed. We fully support the proposal of each bank writing a 'will' and subjecting that will to regular evaluation by the Bank of England. Banks may not like it, they may even threaten to domicile elsewhere, but in our opinion this is a reform that is clearly needed. (Paragraph 76)

Macroprudential supervision

18. The Basel capital rules are the result of over a decade of negotiations and planning. Unfortunately they do not work, or at least do not work in a crisis, which is precisely when they are most needed. Arguably they have made things worse by distracting the attention of leading experts, and have had the effect of driving much financial activity off balance sheet altogether. There may be a place for risk-based capital requirements, but there is also undeniably a need for a minimum level of capital based on a bank's size. We welcome the steps being taken in the UK and in the international arena to introduce a leverage ratio as a backstop measure to prevent banks being able to reduce their capital levels to an unacceptable level. (Paragraph 89)
19. There is a strong argument in favour of the introduction of a degree of counter-cyclicality in capital regulation. It is important that banks are forced to build up capital reserves in the good years for the inevitable leaner years that will follow. By slowing down credit growth in a boom, counter-cyclical capital rules should also prove a strong tonic to the financial markets' tendency to amplify the natural economic cycle because of irrational exuberance, which is also very welcome. There is now a burgeoning consensus that counter-cyclical capital requirements are needed; the debate has moved on to what that means in practice. We believe that such requirements should, as much as possible, be based on simple rules. This is first so that banks can know where they stand, benefit from regulatory certainty and plan accordingly. Secondly, a rules-based system would reinforce the regulator's ability to avoid succumbing to industry lobbying for lower capital requirements. Thirdly, a rules-based system could remove the need for any one organisation to call the economic cycle, a task which has proven extremely difficult in the past, and which will doubtless continue to be so. Nevertheless, there is a place for regulatory judgements, so there should be some limited flexibility in the application of the rules. (Paragraph 95)
20. Solutions to the problems of liquidity regulation need to distinguish between idiosyncratic failures of liquidity risk management at specific firms, and widespread liquidity crises caused by the freezing of entire asset markets. In the former case, the regulator's onus should be on ensuring that financial institutions are given the right incentives to manage the risk, in order to avoid moral hazard. In situations where there is systemic market freezing, liquidity should be viewed as being a public good, and be provided for by the central bank. Analysis of the maturity mismatch between assets and liabilities on a bank's balance sheet might be one angle from which to approach liquidity regulation in the future, and we would welcome the FSA's views on this matter. (Paragraph 99)

21. We look forward to examining the FSA's proposals for regulatory reform in the area of loan-to-value ratios. (Paragraph 102)

Reform to the institutional framework of financial stability

22. We cautiously welcome the replacement of the Tripartite Standing Committee by the Council for Financial Stability (CFS) in respect of the publication of clear terms of reference for the new body and the fact that minutes of its meetings will now be published. We look forward to engaging with the CFS over how Parliamentary accountability might be improved. However, we view the change as one which is largely cosmetic. Merely rebranding the Tripartite Standing Committee will achieve little by itself; what is required is an improvement in cooperation amongst its members, and a simplification and clarification of responsibilities for each of its members. (Paragraph 112)
23. Devising an appropriate institutional framework for macroprudential supervision is extremely important and should not be rushed. We agree with the argument made by each of the Chancellor, the Governor and the Chairman of the FSA that it is necessary to reach an agreement on the precise instruments needed in the macroprudential toolbox, before considering which organisation should wield those tools. (Paragraph 113)
24. Whatever the final outcome of any institutional arrangements it is absolutely imperative that responsibilities are clear. The biggest failings of the Tripartite's handling of Northern Rock were that it was not clear who was in charge, and, because the Tripartite took a minimalist view of their respective responsibilities, necessary actions fell between three stools. We are not confident that this issue has yet been adequately resolved. Where before no-one had a formal responsibility for financial stability, now many do—the Bank of England, the FSA, the Treasury, the Council for Financial Stability and the Bank's Financial Stability Committee. Where responsibility lies for strategic decisions and executive action was, and remains, a muddle. The Treasury's design of the institutional framework for financial stability must bear in mind that, when the dust eventually settles on a new system, the question that we, and others, will ask is "Who gets fired?" if and when the next crisis occurs. It is a blunt question, but one which is necessary. Only if we have such clear responsibilities can we expect good decisions to be made and the right actions to be taken. Once those responsibilities have been clarified, the appropriate powers must be properly aligned. (Paragraph 114)
25. We are extremely perturbed by the statement by the Governor of the Bank of England that he was kept in the dark over the contents of the Government's White Paper on *Reforming financial markets* to the extent that he had "no idea" what it would contain, or even when it would be published, only a fortnight before publication. The Chancellor must set out why consultation papers on financial reform are now no longer jointly published, or even shared, with his Tripartite colleagues. Failure to do so will only add further cause for concern to those worried about the state of the crucial relationships between the Tripartite principals. (Paragraph 120)

International dimensions

26. The existence of large, complex, cross-border banks brings both benefits and dangers. Such institutions benefit the consumer by simplifying banking transactions and act as a lubricant to global capital flows. However, the risks they present to the global financial system are considerable. As the Governor has said, whilst banks may be global in life, they are national in death, because if such a bank were to fail, the regulator in the bank's home state would have the responsibility of resolving the firm. Not only would this be an unenviable task for the home state authorities, it would also present problems for host states, as they would have very little control over the fate of the firm's banking operations within their countries. This makes all the more critical the insistence on a 'will' for any bank operating in the UK. Colleges of supervisors are certainly a good idea, as they will provide a forum through which information about large banks can be shared, but we doubt that they are enough on their own. We support the idea that the national banking units of global banks should be obliged to establish as stand-alone subsidiaries of the parent group, regulated and supervised by the host state regulator. The capital of these stand-alone banking units would need to be ring-fenced to prevent the parent group snatching it away upon failure of the global bank. We recommend that the FSA should consider how feasible such a system would be, including whether or not it could be implemented unilaterally without international agreement. Sacrifices to efficiency of global firms in peacetime would be a price worth paying for the reassurance that a possible crisis could be contained within national boundaries if the firm failed. (Paragraph 132)
27. We believe that the Government should take the issue of over-reliance on financial services much more seriously than it currently does, and should commission a review by an independent figure from outside the financial community to consider the City's impact on the wider economy and public finances. This is not to suggest it is sensible for any Government to decide the right size of an industry as a proportion of the economy, but rather to ensure that the risks as well as the benefits of specialisation are articulated, understood, and prepared for. (Paragraph 138)

The way forward

28. This Report aims to contribute to the very important debate over the future of regulation and supervision of financial services. The debate is currently at a point where agreement is being reached, nationally and internationally, on the reforms that will be needed, but agreement is not particularly close to being reached on the practical implementation of issues such as counter-cyclical capital agreements, liquidity supervision and cross-border handling of global firms. We acknowledge that UK authorities are at the forefront of much of the agenda on the international stage, which is vital given the size of the UK financial sector. Now that immediate concerns over bank stability appear to be subsiding the temptation to relax must be avoided. Whilst there may not be an urgent need for new rules given the banks' withdrawal from some of the risky business that got the sector into trouble, there is an urgent need for momentum to be maintained towards the design of a better framework. We expect further announcements by the Tripartite bodies in the

autumn, and look forward to reviewing their progress towards the establishment of safer, calmer, banking supervision. (Paragraph 143)

29. We are pleased that the Treasury acknowledges the useful role that the Treasury Committee can play in scrutiny of the future performance of the Council for Financial Stability and pays tribute to our work over the last two years. Such praise, however, will be no more than empty flattery if it is not supported by actions. If we are to offer effective scrutiny this must be based on our considered analysis of the relevant evidence, not on spur of the moment appraisal. We are also unimpressed that the Treasury initially indicated that the White Paper would be issued shortly after the Budget but offered no explanation for the lengthy delay leading up to its eventual appearance. (Paragraph 149)

Formal minutes

Tuesday 21 June 2009

Members present

John McFall, in the Chair

Nick Ainger	John Mann
Mr Graham Brady	Mr James Plaskitt
Jim Cousins	John Thurso
Mr Michael Fallon	Mr Mark Todd
Ms Sally Keeble	Mr Andrew Tyrie
Mr Andrew Love	Sir Peter Viggers

Banking Crisis: regulation and supervision

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

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

Paragraphs 1 to 149 read and agreed to.

Summary read and agreed to.

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

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

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134 (Select committees (reports)).

Written evidence was ordered to be reported to the House for printing with the Report.

* * * *

[Adjourned till Tuesday 15 September at 9.30 am]

Witnesses

Tuesday 23 June 2009

Page

Professor Alan Morrison, Profesor of Finance, Said Business School, Oxford University, **Dr Andrew Lilico, Director**, Europe Economics, and **Dr Kern Alexander**, Senior Research Fellow at the Centre for Financial Analysis and Policy (CFAP), Cambridge University **Ev 1**

Lord Turner of Ecchinswell, a Member of the House of Lords, Chairman, Financial Services Authority **Ev 10**

Wednesday 24 June 2009

Mr Mervyn King, Governor, **Mr Charlie Bean**, Deputy Governor for Monetary Policy, **Mr Andrew Haldane**, Executive Director, Financial Stability, and **Mr Andrew Bailey**, Executive Director, Banking, and Chief Cashier, Bank of England **Ev 25**

Wednesday 8 July 2009

Lord Myners CBE, A Member of the House of Lords, Financial Services Secretary and **Mr Clive Maxwell**, Director of Financial Stability, HM Treasury **Ev 36**

List of written evidence

- | | | |
|---|-------------------|--------------|
| 1 | Bank of England | Ev 50 |
| 2 | Dr Kern Alexander | Ev 54 |

Reports from the Treasury Committee during the current Parliament

Session 2008–09

First Report	Administration and expenditure of the Chancellor's departments, 2007–08	HC 35
Second Report	Pre-Budget Report 2008	HC 27
Third Report	Work of the Committee, 2007–08	HC 173
Fourth Report	Appointment of Paul Tucker as Deputy Governor of the Bank of England for Financial Stability	HC 34
Fifth Report	Banking Crisis: The impact of the failure of the Icelandic banks	HC 402
Sixth Report	Appointment of Paul Fisher to the Monetary Policy Committee of the Bank of England	HC 419
Seventh Report	Banking Crisis: dealing with the failure of the UK banks	HC 416
Eighth Report	Budget 2009	HC 438
Ninth Report	Banking Crisis: reforming corporate governance and pay in the City	HC 519
Tenth Report	Appointment of Professor David Miles to the Monetary Policy Committee of the Bank of England	HC 765
Eleventh Report	Appointment of Dr Adam Posen to the Monetary Policy Committee of the Bank of England	HC 764
Twelfth Report	Banking Crisis: International Dimensions	HC 615
Thirteenth Report	Evaluating the Efficiency Programme	HC 520

Session 2007–08

First Report	The 2007 Comprehensive Spending Review	HC 55
Second Report	The 2007 Pre-Budget Report	HC 54

Third Report	The Work of the Committee in 2007	HC 230
Fourth Report	Climate change and the Stern Review: the implications for Treasury policy	HC 231
Fifth Report	The run on the Rock	HC 56
Sixth Report	Financial Stability and Transparency	HC 371
Seventh Report	Administration and expenditure of the Chancellor's departments, 2006–07	HC 57
Eighth Report	Re-appointment of Dr Andrew Sentance to the Monetary Policy Committee	HC 454
Ninth Report	The 2008 Budget	HC 430
Tenth Report	Re-appointment of Mervyn King as the Governor of the Bank of England	HC 524
Eleventh Report	Counting the population	HC 183
Twelfth Report	Inherited Estates	HC 496
Thirteenth Report	Budget Measures and Low Income Households	HC 326
Fourteenth Report	Appointment of Lord Turner of Ecchinswell as Chairman of the Financial Services Authority	HC 916
Fifteenth Report	Appointment of Charlie Bean as Deputy Governor of the Bank of England	HC 917
Sixteenth Report	Appointment of Spencer Dale to the Monetary Policy Committee of the Bank of England	HC 1009
Seventeenth Report	Banking Reform	HC 1008

Session 2006–07

First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50

Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor's department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934
Tenth Report	Private equity	HC 567
Eleventh Report	Unclaimed assets within the financial system	HC 533
Twelfth Report	The Monetary Policy Committee of the Bank of England: ten years on	HC 299
Thirteenth Report	Financial inclusion follow-up: saving for all and shorter term saving products	HC 504
Fourteenth Report	Globalisation: prospects and policy responses	HC 90

Session 2005–06

First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111

Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	"Banking the unbanked": banking services, the Post Office Card Account, and financial inclusion	HC 1717

Oral evidence

Taken before the Treasury Committee

on Tuesday 23 June 2009

Members present

John McFall, in the Chair

Nick Ainger
Mr Michael Fallon
Ms Sally Keeble
Mr Andrew Love

John Thurso
Mr Andrew Tyrie
Sir Peter Viggers

Witnesses: **Professor Alan Morrison**, Professor of Finance, Saïd Business School, Oxford University; **Dr Andrew Lilico**, Director, Europe Economics; and **Dr Kern Alexander**, Senior Research Fellow at the Centre for Financial Analysis and Policy (CFAP), Cambridge University, gave evidence.

Q1 Chairman: Good morning and welcome to our inquiry into banking and supervisory regulation. If I can start with yourself, Dr Alexander, could you introduce yourself for the shorthandwriter please and say where you come from.

Dr Alexander: I am Kern Alexander from the Centre for Financial Analysis and Policy at the University of Cambridge.

Professor Morrison: I am Alan Morrison from the Saïd Business School at the University of Oxford.

Dr Lilico: I am Andrew Lilico from Europe Economics and Policy Exchange.

Q2 Chairman: Now, there are quite a number of things we want to get through this morning, capital and liquidity regulation, cross-border supervision, macro-prudential tools and narrow banking, so these are the issues that we would like to focus on before Lord Turner comes in at 10.30. Talking about Lord Turner, how culpable is the FSA in the development of the financial crisis, and what has been its biggest failing? What can it take forward as a lesson?

Professor Morrison: It is hard to say precisely who is responsible for the financial crisis, but there were clearly some failings in some supervisory institutions and one of those was the FSA. I should say that, to the extent that it experienced problems, those problems came from two sources. The first was the fact that it has culpability both for conduct of business and for financial supervision and, to some extent, and the FSA has acknowledged this in recent years, it over-emphasised the conduct of business at the expense of financial supervision. The second problem the FSA had, which it has also acknowledged, is that, possibly by virtue of the way that it is constituted, it was concerned largely with understanding the risks at the level of the individual firm and, whilst the risks at the level of an individual firm could each look perfectly acceptable, combining those things and thinking about them in the aggregate could sometimes generate a picture that was much less attractive, and I think the FSA and other supervisors in this country sometimes failed to focus on the aggregate picture or the macro-picture, what we now call the 'macro-prudential'.

Q3 Chairman: Dr Alexander, what should be the priorities for financial regulation in the future?

Dr Alexander: Well, I think financial regulation needs to focus more on the broader financial system, as we have seen it set forth in the Turner Report, focusing on systemic risk. One of the major failures in regulation over the last ten years certainly in the US and in the UK has been that the regulation was too market-sensitive, it focused on the individual institution and did not take into account the level of risk or leverage building up in the total financial system. The regulator thought that, if individual firms were okay and seemed to be managing the risk appropriately, then everything was fine. We now need to link that, and micro-prudential regulation is fine, but it needs to be linked with a robust macro-prudential framework.

Q4 Chairman: Dr Lilico, the next financial crisis is likely to arise from the same source as this one. Lord Turner, on 18 March, set out his stall for the future, but are the FSA just closing the stable door after the horse has bolted, or is it ahead of the curve here?

Dr Lilico: I think it is always very difficult to anticipate what the next financial crisis is going to look like. My view is that the Turner Review has drawn some of the wrong sorts of lessons in ways which mean that it is unable to see the right kinds of lessons, so, in particular, I think that it is a mistake. We have a set of financial regulations which grew out of certain assumptions which were then interpreted through economic theory so as to produce some recommendations, so he decided that those recommendations did not produce the results he liked, and what the Turner Review then did was to ditch the economics. I would rather have kept the economics and challenged the assumptions. In particular, I think there are two kinds of assumptions worth challenging. One is the idea that it is a net gain to replace individual diversified analysis by shareholders, depositors, purchasers of retail financial products with regulatory badging, and the other is that you reduce systemic risk by co-ordinating internationally.

Q5 Mr Fallon: One of the other aspects of Turner, which now seems incredibly fashionable, is that capital should be held on a counter-cyclical basis. How should that be done? Should that be done in a discretionary way, or should it be more formulaic, as is done in Spain?

Dr Alexander: I think that you have to have a combination of rules and discretion, and the rules need to provide reference points or guidelines for regulators. The reason I say that is that in other jurisdictions in Europe the regulators, by law, are required to have more rules-based regulatory regimes and the regulators are not allowed so much discretion as, say, the FSA has, and this is because of principles of due process and constitutional law, so, when we get into the rules versus discretion debate, I think we have to have a balance between both. I would simply say that Europe needs to be working from the same playbook and you need to have a rules-based framework in place, but yet it needs to be flexible enough to change as market conditions change, but regulators need to learn as markets evolve and take advantage of innovations that occur in the market.

Q6 Mr Fallon: Yes, but the rules did not change in Spain or in Canada; they were simple and fairly straightforward and people kept to them.

Dr Alexander: Well, the regulators did change them, I think, in 2004 because of pressure from the banking industry, but you are right, that generally Spain had counter-cyclical rules which basically led to their banks having more capital than other banks in Europe and, therefore, they were able to withstand the crisis much better, they were not getting bail-outs from the Central Bank. I would suggest that the FSA in the UK and other Member States in the EU ought to have counter-cyclical rules as well, and they need to be formulaic somewhat, but there needs to be discretion built into it to adjust to market conditions as they change.

Professor Morrison: I agree that there is a need for a focus on rules-based systems, and ideally they should be as simple as possible and as hard to bend as possible, but one very good reason for rules-based regulation is the one that has been pointed to by people like Charles Goodhart, that in times of boom it is incredibly difficult to put the brakes on when a rule gives you something to refer to and, to the extent that discretion is built into the system, it is incredibly important that the people have the right to exercise discretion, have the right incentives and are accountable, otherwise, I suspect, counter-cyclical regulation will simply have little effect.

Q7 Mr Fallon: How do we reflect counter-cyclical requirements in the banks' accounts?

Dr Alexander: In the accounting standards for reporting?

Q8 Mr Fallon: Yes.

Dr Alexander: I am not an accounting expert, but I believe that one of the things the banks are going to raise is that, if they have to set extra capital aside, they do not have to report it as profit and pay tax on

it if they are just having to hold it, so, if we could allow them some flexibility to set capital aside, reserve capital, and not to have to report it and pay tax on it, then they may be more willing to do that. If they, however, put this in the profit and loss statement and pay tax, then they are going to want to pay dividends, so I think we need to be flexible on how we allow the banks to set aside reserve capital.

Q9 Mr Fallon: So the accounting treatment for banks is going to have to change? Is that right?

Dr Alexander: Possibly, yes, for banks that are subject to prudential regulation, we need to change it in this situation.

Q10 Mr Fallon: Overall, Dr Lilico, are we going to be, or should we be, seeing banks holding much more capital than in the past?

Dr Lilico: I think the likelihood is that we will see banks holding more capital than in the past, but, as much as anything, I think that that would be a reaction by the market to the circumstances that other people have learnt some lessons, and one should be wary of over-reacting at the regulatory level until you have some idea of how the market itself is going to react to circumstances.

Q11 Sir Peter Viggers: You have, quite interestingly, danced away from the question, saying the market should lead, but I just wonder what you can bring to the table in terms of assessing how much capital banks should have. Can you contribute by suggesting what is the optimal level of capital for a bank?

Dr Lilico: My view is that it is useful to have rules, but what I think it is more useful to have is guidance numbers, so I think that prudential regulation is the proper pair to the lender of last resort function. What is happening in prudential regulation is that the Central Bank is deciding whether the institution that it is supervising is a worthy recipient of lender of last resort at a pinch, so I think that means that in normal times it is useful to have some guidance as to what you think is about right for people to hold, and that is a judgment, but that, once you come to difficult periods, such as that from 2007 onwards, I do not believe that formulaic capital adequacy requirements have any role at all and I think that they should be abandoned, so I do not think you could hope to devise a rule that would apply in good times and bad.

Q12 Sir Peter Viggers: But Basel I and of course the Turner Review are looking at ratios for core tier one and tier one capital and so on, but you would not place a great deal of reliance on those?

Dr Lilico: I think that those are useful indicators. I think that it is a mistake to try to have exactly the same rule apply everywhere in the world. The Basel I framework arose at a time when there was some scepticism about the way that the Japanese were treating their capital and I am not convinced that it turned out that the Basel I framework improved the situation for Japan. I think that there is an issue of

discretion which is around how the Central Bank interacts with its own system of banks that it is overseeing.

Q13 Sir Peter Viggers: Dr Alexander and Professor Morrison, would you agree with that?

Professor Morrison: I agree with much of it. The capital regulation, I think, should be as simple as possible. There is a case for some simple rules on things like tier one and core tier one ratios and, at the same time, one should be prepared to relax those requirements in an extreme crisis. However, in an extreme crisis those ratios never bite; the market demands far higher capital requirements before it is comfortable with a bank in a time of crisis than the regulators do. Actually, this is one of the problems with counter-cyclical regulation, that, when you attempt to relax capital requirements, the regulator relaxes capital requirements and it may have very little effect because the market is requiring such massive levels of core capital. One of the problems we have had, however, with capital regulation has been an excessive reliance on highly technical models that feel like the national science's, but in fact are not, so we rely on parameter estimations and things like correlations and so on and this is according a level of scientific validity to these theories which they do not have. They are very useful tools for managers, but whether they should be hard-wired into regulation is a very moot point, in my opinion.

Q14 Sir Peter Viggers: Just moving on a bit, what types of capital should feature in the calculations?

Dr Alexander: I think core tier one capital should be expanded, and of course the definition of 'core tier one capital' should be the ability of the capital to absorb losses fully, and that is mainly common equity shares. If you get into preferred shares or subordinated debt, those types of capital have a more limited ability to absorb losses. What we want banks to have is not necessarily such high capital charges, but that they have good-quality tier one capital that composes most of the regulatory capital that they are holding. One of the problems in Europe is that you get different definitions of the type of capital that banks hold across Member States in the EU and the Capital Requirements Directive does not adequately address that. The point is that the definition of 'capital' should be linked to its ability to absorb losses.

Q15 Sir Peter Viggers: What I am hearing is a message that an abstract approach to this issue should be treated with extreme caution, but the Turner Review suggests that trading book capital requirements might increase by a factor of three. Would you like to comment on that rather specific and concrete suggestion?

Professor Morrison: There is not doubt that trading book capital requirements, I think, are too low. The rationale for having lower levels of capital for trading book instruments is that a troubled bank can sell those instruments rapidly and, hence, does not retail as much capital, but actually we have discovered recently that, at the time you most need

to sell those assets, they may be extremely illiquid because no other bank is prepared to purchase them, so that is one reason why more capital against those instruments might be held. Another is that the liquidity of these instruments is not a fixed and permanent number, it is something that depends on the expectations and the behaviour of market participants and those expectations and behaviour change in response to things like capital regulation, so it is quite conceivable that more capital will actually up the liquidity. Whether the right number is three, two or four, I do not know, but I believe that capital requirements should be much higher for the trading book.

Q16 Sir Peter Viggers: From your earlier remarks, would you agree that the financial sector has relied too heavily on abstract models developed by mathematical experts at the expense of old-fashioned commonsense?

Dr Lilico: I think that mathematical models can be very valuable and that they can provide important insights to those who are making regulatory judgments and are useful guidance, so I think it is a mistake to think that the crisis tells us that the mathematical theories and the mathematics of economics should all be abandoned and are proven to be invalid, but, on the other hand, I think that it is always useful in regulation to be humble and to understand that there are limits to your understanding as a regulator, so you must not think that you can produce some model which enables you to decide on exactly what the right kind of thing to happen is.

Q17 Sir Peter Viggers: As to the division between the banking book, old-fashioned banking, if you like, and the trading book, which has been called the 'casino' element of banking, when one puts to bankers that there might be some kind of division more clearly drawn between these two aspects, the banks tend to say, "Well, it's actually much more complicated than that. It's all shades of grey rather than black and white". How would you comment on that?

Dr Lilico: I do not think that it is necessary or desirable to divide up the casino banking from the utility banking. I also think that it is a mistake to imagine that the utility banking is likely to remain unchanged by these events. I offer, for example, the point that, even if you go back to before the madness of the bonds market to 2004, 30% of income to the European banking sector from the non-wholesale customers was mortgages, and I do not think that that is going to continue in the future.

Q18 Mr Fallon: If we could return to European regulation, whilst the fiscal responsibility for bail-outs and depositor protection remains national, why should we accept some supra-national power to override national regulators and their responsibilities?

Dr Alexander: I would say because the externality is cross-border. Banks have exposure to each other throughout Europe in the money markets through a

variety of risk exposures, and European policy-making needs to begin to have better surveillance of the systemic risk posed by certain banking groups and financial institutions that operate in Europe. It does not mean that we displace national regulators, it simply means that we involve regulators at the national level having more accountability to a committee of supervisors consisting of the Member State regulators themselves so that there is more co-ordination at the European level.

Q19 Mr Fallon: But that is not the proposal. The proposal is not just for surveillance, the proposal is that, under certain circumstances, the national regulator should be overridden and there should be binding mediation on the Latvian regulator or whoever it is. It is not just surveillance, what is being proposed, it is override.

Dr Alexander: Well, it is override regarding the application of EU law. If there is a dispute regarding how the Capital Requirements Directive is being applied, there certainly needs to be a European policy input regarding how the CRD is being implemented by, say, the UK or Spain or Poland. In the past, it has just been up to the Member State to do whatever they wanted to do for the most part and it has been impractical to call a Member State to account.

Q20 Mr Fallon: But do the other two of you agree that it should be done through Brussels or through the Basel framework?

Professor Morrison: I am not sure that it is feasible to do everything through Brussels, even if it were desirable. I presume when you say “what is being proposed”, you are referring to the de Larosière Report and one of the things that de Larosière suggests is this European systemic risk council which would have the power in disputes to apply binding decisions to the parties involved, and de Larosière himself has acknowledged that that is going to involve sometimes overriding macro-policy at the national level. This seems to me to be a hard thing to accomplish for an institution that has not got tax-raising powers and so on.

Q21 Mr Fallon: It may be hard, but is it right, Dr Lilico?

Dr Lilico: I think that always and everywhere the proper prudential regulator is the Central Bank, so I would have a eurozone both micro- and macro-prudential regulator which was the ECB and the European system of central banks. At the UK level, it would be the Bank of England and, in other Member States with their own currencies, it should be theirs, so that is the way, I think, it should be done and the logic of the current system is connected. The reason why that is not the route being pursued is connected with the idea that the long-term destination of the EU is that there should be a single currency throughout the EU and that, because there remains that commitment by all the EU Member States, it, therefore, seems logical that you should have one European regulator.

Q22 Ms Keeble: I want to ask you a bit more about the macro-prudential tool and the working of it, and perhaps particularly Professor Morrison because I think you advised the House of Lords Economic Affairs Committee on this. What, do you think, would be the most effective tool?

Professor Morrison: It is hard to say and I think we should not rush to judgment because we do not have to get this right in the next fortnight, but I suspect that the two most useful tools are likely to be one or a combination of either capital requirements that flex with the economic cycle or lending ratio limits, so loan to value ratios in the housing market or loan to deposit ratios in the banking sector. If you look at loan to deposit ratios in the banking sector over the last seven or eight years, they expanded very rapidly, particularly in institutions which have subsequently got into trouble, and these are the big macro-indicators that one could predicate rules upon.

Q23 Ms Keeble: The big debate, apart from what the tool is, is who wields it. In the Economic Affairs Committee’s Report, the power would shift to the Central Bank, which is what Dr Lilico also says. Is that your view and can you justify it?

Professor Morrison: The decision to use a macroeconomic tool, a macro-prudential tool, is something that requires a knowledge of the macroeconomy and that is a knowledge that resides in central banks, so it seems like a rational place to put this power. However, this would require the right sort of institutional framework and it is not clear that it could simply be handed over to a Bank committee. The Bank is going to need market intelligence, quite a lot of detailed market intelligence, and that will require representation from the FSA because any macro—

Q24 Ms Keeble: Which is not on the committee currently.

Professor Morrison: Well, at the moment there is no committee with a macro-prudential tool, but the committee, as it is currently envisaged, is a sub-committee of the Court of Bank Directors, which is really an advisory body. My feeling is that, if one is going to actually have a policy tool, it is going to be necessary to give the banks sufficient close information about the markets and that information at the moment resides partly in the Bank, but to a large extent in the FSA because it is doing close, day-to-day prudential supervision, so having some senior representation from the FSA on this committee would be a good thing. The second observation is that any committee like this which has the power to use some sort of macro-prudential tool is going to run up against broader questions of economic policy, and the Treasury has to have a representation too.

Q25 Ms Keeble: If you were to give that power to the Bank of England, particularly given you have identified those two particular issues, would you not actually curtail or limit the way in which the FSA currently works in working with banks around the

23 June 2009 Professor Alan Morrison, Dr Andrew Lilico and Dr Kern Alexander

way in which they operate, and would that not actually impede the sort of proper management, supervision and regulation of banks?

Professor Morrison: I am not sure that it has to. The FSA has institution-specific information and uses that institution-specific information to make decisions about individual institutions: are they running their risk systems correctly, do they have the right governance systems and so on and so forth? Those questions can feed into broader questions of macro-policy, but they are distinct. The macro-policy is about aggregate variables, and what the FSA is doing is institution-specific. To the extent that there is a danger that you would wind up double-dipping, there is a cost associated with that. Having two institutions attempting to do similar things and crawling over banks, there is a cost and one should do everything one can to reduce that cost, but, if that cost is what you have to incur to avoid systemic crises, then it is probably a cost worth spending.

Q26 Ms Keeble: What do you say to the issues that David Blanchflower raised in his speech in Cardiff where he argued that you could end up with the Central Bank having to look sort of one way in what it did with interest rates and the other way in what it did with the macro-prudential tool? As he put it rather finely, “Central bankers might have one foot on the accelerator while applying the handbrake”, do you think that is a risk if both tools rest with the Central Bank?

Professor Morrison: It is a risk. One proposition might be that what the Bank needs to do in the money markets could have an adverse effect on the soundness of some banks, and that is one reason why another tool in addition to interest rates is probably a good idea because, if you are trying to use interest rates for both of those things, inevitably you will be conflicted. One needs to be careful that the Bank does not use one tool to cover up mistakes in another tool. At the same time, there are trade-offs to be made here. If one foot needs to be on the accelerator and one foot needs to be on the brake, somebody needs to internalise these trade-offs and it seems reasonable that there needs to be a body to do that, and the Bank has the expertise probably to accomplish that.

Q27 Ms Keeble: What do you think of the way in which things were handled recently with the quantitative easing and could this not apply again, given, as you have said, that we do not need to decide in the next fortnight, where the Bank has the oversight of financial stability through the Banking Act and the legislation is quite broadly drawn with quite a lot left to secondary legislation and, therefore, it is well possible for the Bank to refine its thinking about its tools more and then come back when it needs the powers, as it did, for example, for quantitative easing where it got the powers very quickly and was able to take the actions that were needed, or do you think that that is just leaving it too late?

Professor Morrison: I think we should not leave it until the next crisis before the Bank asks for the tools that it needs because we can design the tools at greater leisure and get them in place before then, but the idea that these tools should evolve rather than appear in a big-bang way seems to me entirely rational. They are complicated things, we have not been here before and it will require quite a lot of thought and discussion.

Q28 Ms Keeble: It is quite unseemly to see a sort of turf war, in a sense, between the Bank of England and the FSA. How do you see it being resolved?

Professor Morrison: I do not know how it will be resolved. If there is a turf war going on, then of course that is an undesirable thing, but perhaps it is just a debate. Hopefully, the turf war will resolve itself in a rational fashion.

Q29 Ms Keeble: What do the other two of you think about the issue about the macro-prudential tool and who should wield it?

Dr Alexander: Of course the Bank of England has got broad powers over macro-prudential policy, interest rates and managing the currency, but we should not lose sight of the fact that in the recent crisis we saw that systemic risk arises not just from individual financial institutions, that it can arise in the broader capital markets and in the over-the-counter derivatives markets, for instance, in the AIG case, so the structure of the financial markets is very important and that is where the FSA comes in. The FSA has got the data and it is not just supervising individual institutions, though it certainly does that, but it also has oversight of the clearing and settlement system and exchanges and this is where a lot of the systemic problems that we had arose, and that is why, I think, the FSA is well-positioned; they have got the data, they have got the oversight of the capital markets and post-trading systems now and we should use that, and there needs to be a better linkage and a better balance with the Bank of England regarding the macro-prudential policy.

Q30 Ms Keeble: So would you agree with the shared membership of the committee then?

Dr Alexander: Certainly. I think it is surprising that they are not on the Financial Stability Committee now, as set forth in the Banking Act, and I think it is anomalous to think that you can oversee systemic risk in the financial sector and not have your financial supervisor at the table, providing data on the capital markets and on clearing and settlement.

Q31 Ms Keeble: But you seem to be quite comfortable with the FSA wielding the tool, or you think it is a possibility?

Dr Alexander: I am comfortable with the FSA doing that exactly. Well, they have got that responsibility already. I think it depends on the jurisdiction. We have become a bit path-dependent in our institutional structure right now, so we have got the FSA and they are already regulating the capital markets and clearing and settlement, so now the

challenge for policy-makers is to have better co-ordination between the Bank and the FSA and to have the FSA on this Financial Stability Committee.

Dr Lilico: I think that the Bank of England should manage the tool insofar as it is a part of macro-management, but the thing I would add here is that there may be a case for having a fully international component, so, for example, you could imagine having an element of your counter-cyclical caps or requirements or a capital buffer of some sort that was dependent upon a rating which the IMF would give of the international economy, so I would call it a 'Defcon rating for the world', something coarse-grained, like light red, dark amber, light amber, green, and then, dependent on that, you would then have a component of the capital requirement which would link it fully internationally.

Q32 John Thurso: The Committee recently visited the US. There were three specific areas that were raised with us: size; interconnectedness; and the business model that the banks were pursuing. Do you think that the FSA has got each of these areas properly covered?

Dr Alexander: Well, on size, we were discussing capital adequacy earlier and what types of rules we might adopt to apply capital standards, and I think that one of the rules should be linked to the size of the bank. Larger banks pose a larger systemic risk to the financial system and, therefore, they should pay a tax for how big they are, and smaller banks perhaps do not need such high capital charges as they pose less systemic risk. Interconnectedness brings us to the capital markets and how they have certainly become complex, they are interconnected, and we have seen how liquidity risk can now arise in the broader capital markets, not necessarily with individual banks, and I think that is why securities regulation has always focused traditionally on conduct of business rules and only focusing on segregating money for client accounts and that sort of thing, but now we see that securities regulators need to focus more on the systemic aspect of their oversight of capital markets. The third aspect, I am sorry?

Q33 John Thurso: Business models.

Dr Alexander: We have seen a major failure of corporate governance in financial institutions. In part, some of it is regulatory arbitrage responding to regulation, but a lot of it too is an over-focus on shareholder wealth maximisation at the expense of the broader social risks that financial institutions take.

Q34 John Thurso: But do you think the FSA are sufficiently alive to these issues and working on them?

Dr Alexander: I believe that in their recent discussion papers they seem to be aware of the problem and seem to be aware of their past mistakes in having a too market-sensitive framework of regulation, so now we see of course the Turner Review, so I think

they are on the right track in addressing these issues, but now follow-through and political support are going to be necessary.

Q35 John Thurso: Professor Morrison, please add to that if you want to, but specifically on the question of size, in his recent Mansion House speech, the Governor said that any bank that was too big to fail was, I think he said in the words of a famous economist, broadly too big to exist, they are too big. Do you concur with that view and should we be taking action to regulate the overall size of banks?

Professor Morrison: Quite a lot of banks seem to be too big to fail either because they are too big systemically or too politically sensitive to fail, and the expression 'too big to fail' dates back to the mid-1980s when Continental Illinois was identified as too big to fail by the US regulatory authorities, and they said at the time that another ten banks—I cannot remember the exact number—were too big to fail. It is probably just a fact of life that banking is such a systemically important activity that some institutions are going to be too big to fail, so the question is how one should respond to the fact that institutions are too big to fail. The critical effect of being too big to fail is that the people who finance you anticipate bail-out and your cost of capital reduces. So there may be an argument for becoming very big because that makes you very effective, you are able to give better support to customers and you have more information about the economy and you can do things efficiently and all of those good things, but there is also an argument about becoming too big because, when you become too big, your funding becomes cheaper. For that reason, I agree with Kern, that something needs to be done to make it costly to become too big and in that way you are making the right trade-off. When you become so big that you anticipate bail-out, some of your costs of funding are transferred to the taxpayer and the Deposit Insurance Fund and you fail to internalise that and, to that extent, there is a failure of markets, so reimposing those costs on institutions via, I do not know, bigger capital requirements, which is one way of doing it, but it is not the only way of doing it, is not a bad idea. That would probably mean that many banks cease to be as big as they are anyway and, if we get this right, the ones that remain big will be making the right trade-off; they will be generating sufficient efficiencies to make it worthwhile imposing those costs.

Q36 John Thurso: We have really got two separate situations, one where the system is working perfectly adequately generally, the markets are working well, and one where an institution, through a set of poor judgments, finds itself in trouble, so you have got a strong basic system and one bank failing, and probably in that situation quite big banks could be managed through a failure and allowed to fail in a managed fashion. However, what we have gone through is something where the entire system has broadly been in considerable distress and, therefore, institutions failing within that compound the problem into the entire system. Should we, therefore,

be regulating on the basis that it is the systemic failure that is the most important thing to guard against rather than necessarily the individual institution?

Professor Morrison: I think we should and, even at the level of the individual institution, we should worry about things like capital charges becoming so big and that, realistically, if one of the major clearing banks in this country were to fail at any time, it could expect support, so that needs to be dealt with, but you are right to say that the key concern is multiple failure or many banks ceasing to have confidence in one another and being unprepared to lend to one another because the knock-on effect on the real economy is profound, and that is the place where things like macro-prudential regulation come in and this sort of thing could happen with many small banks. Many small banks making the same mistakes adds up to one huge systemic problem and that is why we need an overall perspective of the financial system.

Q37 John Thurso: In that case, Dr Lilico, I think you answered earlier that you were not in favour of separating the utility bank from the casino bank, but is not one of the key problems that we have that each has imported into the other the worst aspects of their cultures and that one of the primary functions of the utility bank, which is to take, hold and safeguard deposits, is at odds with the risk-taking culture of the merchant bank? Should we not explore a return to something closer to Glass-Steagall?

Dr Lilico: First of all, I do not think that any bank should be too big to fail, though unfortunately politicians seem not to agree with me, and the markets can anticipate that, so I do not think that you have as clean a scenario as the one you described before in which you are going to have a kind of ordinary time and the rest of the time because what will happen is that, if people anticipate that, if they get large enough, they will be bailed out, then the market will react to that, so you will get mergers that are driven by the desire to become too big to fail. I actually think that that is something which should be now considered as an issue in merger law, so the possibility that a merger is motivated by the aim to gain the taxpayer. I think another kind of consequence connected with that is that you will tend to use higher levels of leverage because in bail-outs the experience we have seen is that bondholders are spared, so you are better to have a capital structure in which you have a larger proportion of debt and less equity, so you will have increased pressure for leverage in the capital structure and, insofar as prudential requirements try to act against that, you will try to find lots of 'get-arounds' for that. I think another thing is that in terms of the investment banks and the others, it is valuable to consumers if they can participate in the gains from the use of their money so as to maximise returns because then they are going to get higher deposit rates. The one kind of thing that I would think is worth considering is the following: that, in order to make it easier to allow institutions to fail, it would be useful if you really did have somewhere where you

could just store your money because that is not what a bank is. Banking is an intrinsically risky activity, so bank deposits should not be regarded as risk-free because those monies are being used in intrinsically risky activities and, if you insure them, that creates an instability at the very heart of the capitalist system. On the other hand, if you wanted to have the possibility of allowing people to lose their deposits, I think it would be useful if they always had the option of a form of account where they could not use their deposits, so I would recommend that every bank licensed to take retail deposits should be forced to hold, what I call, a 'gilt aggregator account', so this is a fully gilt-backed account which you are not able to employ in fractional reserve banking and with this one the only kind of insurance needed of course is against fraud, and then, if anybody wants to take their money out of that, then the bank has some notional charge for storing the money, so it is basically like a sort of safekeeping kind of banking. If you take your money out of that into high-yielding timed deposits, you should be read the Riot Act by the bank and told, "You're no longer insured" and that kind of thing, so that is the extent, so I think the way to deal with this issue is entirely internal to banks, to have a very limited opportunity for people in any retail institution to have a pure safekeeping kind of account.

Q38 John Thurso: I think there was actually a Private Member's Bill in the Lords that proposed very much that type of account for banks. Can I ask you, Professor Morrison, one last question. If it is not thought desirable to actually just separate the parts as a kind of brutal way of achieving an end, is there any merit in looking at the licensing system, such that each bank brand must have a licence and each brand licence has capital requirements, so that a big bank company that had many brands would actually have all of the components? One of the things that I observed with the RBS failure is that Coutts, which is wholly owned by it, actually was very well capitalised and could have been hived off at any moment separately, so, if you had the component parts of a super-group each licensed, as in fact RBS did, but HBOS did not, you would perhaps be able to have more stability. Is that something that has any particular attraction?

Professor Morrison: It is hard to know, without crunching the numbers, exactly what the effect of that would be. I am sure it would generate a greater degree of stability and it would also generate some costs simply because capital cannot be employed quite as efficiently, you have idle capital sitting in some institutions, and that is the argument, to the extent that there is one, against—

Q39 John Thurso: You talk about capital efficiency, but are not capital efficiency and high risk synonymous?

Professor Morrison: Not necessarily. If you are taking a high risk, then you need to get a high return and, if you are getting a high return in return for your high risk, then, purely economically, you are being efficient. The trouble in banking is that much

of the risk and much of the return is beneath the surface. Some of the risk is being borne by deposit insurance funds and being borne by taxpayers and is not correctly accounted for by the people taking the risks, so, to that extent, people, particularly when they are highly indebted, as Dr Lilico said, when institutions are very geared, they have an incentive to take excessive risks, but having capital that could be employed productively not being employed productively is inefficient and there is an opportunity cost to doing that. The question is: how do you measure that cost because there is a gain as well, which is the reduction of systemic risk, and that is something that is terribly hard to measure?

Q40 Chairman: In terms of liquidity, how do you define 'liquidity', Professor Morrison?

Professor Morrison: It is a very hard thing to define, which is why we do not have formal regulations over it at the moment, so many people define a bank's liquidity in terms of the asset base that it has, so, if it has lots and lots of gilts on its book, then it is a very liquid institution. The problem with liquidity, as I remarked earlier, is that it is not a constant, but it is something that evolves in line with market expectations and the beliefs of market participants. When market participants stop believing in one another, liquidity dries up, so I think perhaps a better way to think about liquidity would be to think about the exposure a bank has to the drying up of liquidity, and that is particularly to be measured in terms of mismatches of maturities, so banks have always engaged in maturity transformation and that is something that we would like banks to do. When the maturity transformation is not between deposits and long-term investment, but between short-term wholesale funding and long-term investment, it seems that the liquidity risk is much higher, so my inclination would be to measure liquidity in terms of maturity mismatches on a bank's portfolio.

Q41 Chairman: Why, in Adair Turner's words, did both economics and policy-makers "take their eye off the ball" regarding liquidity?

Dr Alexander: I think that there was an under-appreciation of the risk that liquidity risk poses to the broader financial system. So much of the policy debate and so many of the academic models looked at market risk and credit risk, and then liquidity risk was under-appreciated. In fact, Alan Greenspan praised the fact that we had a smoothing of risk in the financial system and that securitisation helped facilitate this, so the types of financial instruments that were being used in the economy, credit risk transfer instruments like securitisation, were seen as spreading risk throughout to those who were willing to absorb the risk and, therefore, there was not an appreciation that liquidity risk could arise in such circumstances, so the academic models, the policy, the regulatory frameworks were built upon the fact that credit risk transfer was promoting liquidity, but what we did not count on was the fact that suddenly all the institutional investors could just simply not want to roll over their short-term investments and then the liquidity would dry up. That was something

that was not foreseen and it is a major failing, I think, on the part of both academics, policy-makers and of course the risk managers in the banks who should have seen this.

Q42 Chairman: Dr Lilico, the FSA has suggested a 'core funding ratio' tailored to each bank. Now, that might expose the FSA to the accusation of inconsistent regulation across banks. How can it ensure adequate liquidity at each firm whilst ensuring that each firm is treated fairly?

Dr Lilico: It seems to me that the liquidity problem is a mistake, it is just a symptom of the wider mispricing of risk, so, if you got your risk analysis of how much risk there was and if you got your risk assessments right, then the likely fluctuations of the requirements of liquidity would have been less and the liquidity might have proved adequate, so I think that the liquidity point is to be overstated. I think it is important to distinguish between different kinds of crises, so any kind of institution can have a crisis associated with just not having enough cash, sometimes you can have insolvency associated with past losses and sometimes you can have insolvency associated with a lack of future profitability. I do not think that this was just a liquidity crisis and I think that some of the liquidity discussion is just a carryover from the early phases of the crisis when we thought liquidity was a bigger issue, so, although I think liquidity is worth looking at again, I am not convinced that we need to change things all that much.

Q43 Nick Ainger: Following on from that, the Turner Review sets out the figures in relation to structured investment vehicles which show that in four years from 2003 to 2007 the growth of SIVs and their total assets tripled, and Turner says that this was a major contributor to the highly leveraged situation that certain institutions found themselves in. Dr Alexander, you talked earlier about one of the banks' functions is maturity transformation. How important are SIVs to maturity transformation? Do we still actually need these SIVs?

Dr Alexander: I think securitisation is an important component of our financial system and that we should not throw it out, but it is how it is regulated and we have to understand the risk that securitisation presents. Again, many experts did not foresee the liquidity risk that an over-reliance on securitisation funding could pose to the broader financial system. I think that, if we properly regulate securitisation, SIVs and the various conduit funding that banks have been using, then they are appropriate ways to raise capital. They are a part of financial innovation and we should not curtail financial innovation, but we have to understand that the funding through SIVs is short-term and that it can dry up quickly, just like in the old days there was a bank run with depositors running for the exit, but now we have got institutional investors that can turn off the funding pretty quickly, and we have to think about how to regulate that and what types of costs to impose on that.

Q44 Nick Ainger: Coming on to this point about how to regulate, we have been told by academics and practitioners in the financial services sector that part of the problem is the complexity of these various vehicles, these CDOs and CDOs squared, and we even had the Chairman of the Deutsche Bank who did not even know what a CDO squared was. It is all very well saying, “Yes, we should regulate and regulate them better”, but with the very fact that they are incredibly complex and that the risk element is in their complexity, how do we expect regulators to understand the risk involved and, therefore, point out to the institutions, “You are at risk because of this” if the institutions themselves do not even understand the risks involved?

Dr Alexander: Well, if they do not understand it, they should not do it and the regulators should not permit it. Right now under Basel II, regulators have to approve the risk models that banks submit to them for review, for credit risk, for market risk and now liquidity will be included in Basel II, so regulators should not be approving these models as submitted if the bank cannot explain the model and cannot demonstrate an understanding of the model. This is part of the dialogue, the interaction, that the regulator has to engage in with the banks, but it is not the regulator’s problem to figure it out. The bank has to explain it and the regulator needs to have maybe advisory experts there to test the models that the bank is submitting for approval. If they have a model that is testable and it makes sense, then they can approve it.

Q45 Nick Ainger: So what we need is actually far more informed regulators who are able to make an objective judgment of what they are being told by a particular institution?

Dr Alexander: They need to be able to make an objective judgment, but the burden is on the bank to make that model work, to prove that under certain conditions of stress-testing and various other ways, and the regulator has to be there to be vigilant and it is not the regulator’s job to figure it out, but it is the bank’s job to explain it and then the regulator, I think, will rely on expertise to make sure before deciding whether to approve it.

Q46 Nick Ainger: Do the others agree with that?

Professor Morrison: Well, no one could argue against a well-informed regulator, it is like arguing against commonsense, but I think we need to be aware of our own systemic limitations. Some of the models which were generated were very elegant and very clever and had very little economic content; they were essentially physics rather than economics. We made the mistake of thinking that, as a physical model can tell us what happens when water boils, these models would tell us what happens when a default starts to occur in financial markets, and sometimes the problem here was excessive reliance in the regulatory arena upon models which were really intended as devices to help managers to understand what was going on, so, to the extent that there were regulatory failings, I think perhaps the regulatory failings were in taking some of these models too

seriously. When you do that, the incentives to the people who create the models are bifurcated. To some extent, they are concerned with creating accurate models and, to some extent, they are just concerned with reducing their capital charges, so one problem here was not appreciating the limitations of some of the tools that were being used in regulation and that, by using the regulation, it may have changed their nature, and that is a big problem. Another problem was failing to recognise, and this is a simple problem that can easily be fixed, but failing to recognise that banks that provide backed-up lines of credit to SIVs, even if those lines of credit are not legally binding, actually find it very hard to walk away from them and, hence, had a liquidity exposure that was not recognised.

Q47 Nick Ainger: You used the phrase “physics, not economics”, but what do you actually mean by that?

Professor Morrison: What I mean is that, if you take a simple model of a securitisation, say, I have a securitisation where I take two loans that I have made to a corporation, bundle them and then sell another piece of paper that defaults when both of these loans default together, then, in order to put a price on the securitised asset in the absence of a liquid market, I have to make assumptions about how often each of these loans will default individually and how often they will default at the same time. People do this using elegant methods that come from the mathematics of fluid mechanics originally, so I have a model which shows the price of one of these things moving up and down and another one and, when they both move down far enough, we see a default, so those are models that have this feeling of precision. You can calibrate them by going out and gathering data and you get a figure for simultaneous defaults and you get a figure for individual defaults and you treat those things like physical constants in the same way that you have a number that tells you when water freezes and when it boils, but those things are not physical constants, they are economic numbers that depend upon the behaviour and the expectations of market participants. When market participants suddenly realise that everyone is doing the same thing and they suddenly realise that, because of the immense opaqueness of these markets, they do not know what one another is doing and exactly what the exposure of different people is, those parameters can change rapidly, so assumptions built and hard-wired into models about correlation parameters just turned out to be completely incorrect in 2007. It is not that they had been estimated in the wrong way, the estimation procedures were good, but there was a structural change in the way that people saw the world. I think failure to understand these feedback mechanisms as being integral to the way that financial markets operate has got a lot to do with the misuse of these mathematical models, so, when I say “physics, not economics”, I mean that in physics we have some things which are constants and we can make predictions that are going to be correct over time, and in economics we can make statements about how people react to incentives, but straightforward

correlation parameters are not physical constants, they are summaries of how people respond to incentives and what those incentives are.

Q48 Nick Ainger: Dr Lilico, alongside the SIVs and so on, we also had the mutual funds and so on taking part in maturity transformation as well, so this shadow banking system developed. Turner says that this again added further risk into the whole system and much of it appeared to be almost beyond the regulator. Is that a fair analysis?

Dr Lilico: I do not think that that is really right, no. It seems to me that a key discipline for innovation in any sector is that you put a lot into some new, fancy thing where you do not know what is going to happen about it, you get it wrong and you go bust, but, if you do not have that discipline that you go bust if you get it wrong, then you should not expect innovation to be efficient, so that is one key factor here. Also, I think that people have been a little bit harsh on some of the SIVs in that, if the companies had actually gone so far as going into liquidation, I do not believe that as much would have come back on to the balance sheet as it actually did because, when you have some legal separation, the creditors of various bits would have objected to being lumped together with creditors on other parts, so I think that that thought that it is an entirely artificial separation is a mistake. I also think that there is little evidence that actually hedge funds and the wider sector contributed anything negative to the financial crisis. I think that, in some cases, they were the canary in the mine and, in other cases, they were the messenger, the bringer of bad news and I think that, if you did not want to hear the bad message, then you objected to the hedge fund and its practices, and I think that is just a mistake.

Q49 Nick Ainger: Anyone else on shadow banking?

Dr Alexander: I am less suspicious of the structure of finance as it evolves. It evolves in response to government concerns and the financial system has evolved because of the regulation as well. What we have to do is try to ensure that the regulators try to impose a proper cost on risk-taking, and what we had not understood was the type of social cost that this so-called 'shadow' banking sector posed to the financial system. It is not that that shadow banking sector is bad to have, that we should prohibit it, but it is that we want to put a price on it so that the risk-taking is internalising the costs that it is creating, and that, the regulator had failed to do.

Professor Morrison: The shadow banking sector, like most innovations, there are good things and bad things about it. One needs to be careful in financial markets to distinguish, although it is very hard to do so precisely, between innovation which is there to encourage the efficient use of capital and the efficient deployment of resources, which is what we would like financial markets to accomplish, and innovation that is there to get round regulation, and there is no doubt that a good proportion of the shadow banking was about getting round regulation. This may reflect the fact that regulation became excessively complex and there were massive whole regulations and we are now aware that this is a problem, and I suspect that it is being addressed, but a good part of financial innovation is the response to poorly designed regulation.

Chairman: Can I thank you for your evidence this morning; it was very helpful to us in advance of Lord Turner's appearance before us this morning, so thank you.

Witness: **Lord Turner of Ecchinswell**, a Member of the House of Lords, Chairman, Financial Services Authority, gave evidence.

Q50 Chairman: Lord Turner, welcome to the Committee. We are grateful to you for coming along. In your view, are the biggest challenges now faced by the FSA about drawing up new rules and regulations or about improving the supervision of financial firms, as opposed to regulation?

Lord Turner of Ecchinswell: They clearly have to be both, but I think it is important to realise that if we simply significantly improved our supervision in its intensity, but without very significantly changing the regulations that exist—by which I mean the capital requirements, the liquidity requirements, the accounting requirements, et cetera—the former would be absolutely a necessary but not sufficient condition. When the Northern Rock report on the failures of UK supervision came out, one of the non-executive directors of the board told me when I joined last year that he had felt that, when they put out the report, they ought to have said, "On Northern Rock we made a complete hash of it. If we had done it perfectly within the same structure of regulation, it would have made almost no difference to the development of the financial crisis". I think

that is an important thing to understand: that the ability to fix the problem by more intense supervision, by having the correct meetings, by having the correct procedures, but without a different overall approach to regulation and an overall philosophy of what the regulator is trying to do nationally and internationally, is very limited indeed.

Q51 Chairman: In our response to this crisis, how can we avoid the Sarbanes-Oxley equivalent here?

Lord Turner of Ecchinswell: I think that is an important point. Sarbanes-Oxley is a very detailed set of reporting requirements but, if you tried to identify what are the two or three fundamental things it is trying to achieve, it is actually quite difficult to do that. I think that is why it is highly likely that in our regulatory response we need to be able to identify a relatively small number of high-impact levers which will really make a major difference. I think those will be more capital across the whole of the banking system and higher capital—and there are some new ideas emerging

even since the Turner Review of how we could do that, which need to be thought about; more capital in particular against the trading books of banks, the proprietary trading activities of banks; new approaches to liquidity; and a philosophy of a macro-prudential approach to analysis and the pulling of the levers of capital and liquidity. The latter being something which everybody now agrees with in general but where we need to put the flesh on the bones of what the tools are and how it operates. I think that those will make the real difference. It may be that, within that, higher-quality capital, counter-cyclical capital, is the single most important thing. However much we try to get better at foreseeing future problems, we will never get perfect at it and we therefore need to create within the financial system worldwide, and in particular with the banking system, more shock absorbers. The shock absorbers in the banking system are ultimately the capital requirements.

Q52 Chairman: The FSA Supervisory Enhancement Programme—what impact has that had?

Lord Turner of Ecchinswell: It is having a huge impact. In response to your first question, Chairman, I said that it cannot in itself be sufficient but I think that it is important and, alive with everything else, it can make a large difference. It was something which was well under way before I joined the FSA as Chairman. It had been put in place in response to the problems revealed by the internal audit report of Northern Rock, and it is a very major change. First of all, there are significant extra resources devoted to the supervision of high-impact firms. Having said that, the total resources are still significantly less than some other countries devote to the supervision of firms

Q53 Chairman: In November last year you said to us that only 38% of the vacancies had been filled but you had a date, spring 2009, for all of them to be filled.

Lord Turner of Ecchinswell: I think that we are now 90% or so there. We are fundamentally through the process of hiring—it is about 280 new people—but it is also crucial to realise that they are doing fundamentally different things from what we did before. For instance, we are much more involved in a very detailed analysis of the assets of banks; the accounting approaches of banks. In the past, we have not really challenged the way that accounting is done; the accounting judgments being made on the market in trading books. We are involved in detailed discussions now with auditors in a way that we were not before, and we are also using stress testing in a far more intense fashion than we were previously doing. We are also gathering far more detail on the liquidity and we have a new liquidity regime. I think that it is a very major change in the intensity of supervision, with an increase in the scale of resources but also a change in the nature of the questions that we are asking and a greater willingness to challenge business models. There are some bits that we still have to get in place and which the Board was discussing recently. We said that we would get better

at doing sectoral analysis; at understanding peer reviews across sectors; at identifying where banks and insurance companies were making their money and what that means for the risks. I still think that we have to reinforce and improve that. We also have to add a capability to do this sort of analysis of the overall picture, the macro prudential picture; and I have been talking with the Chief Executive about further steps we have to make in organisational structure and resourcing to add to and intensify what we have already achieved on the Supervisory Enhancement Programme.

Q54 Chairman: If we had the senior executives from, say, HSBC, Lloyds, Barclays or whoever here, and asked them what the impact on them has been of your Supervisory Enhancement Programme, what do you think they would say?

Lord Turner of Ecchinswell: That is an interesting question. I think they would say that the nature of our engagement with them is much more intense than it was in the past. That, for instance if you look at the stress test that we have run on banks, they are documents of a size and level of detail, of going through what their assets are, what their risks are, to a greater extent than before. However, that is a very good challenge. What it suggests to me is that one of the things I should probably do to test it is to go round them and get a point of view of what difference they have seen. I think that, if you are talking to them, it would be a very interesting question. I think they would say that there has been a very major increase in the intensity of our supervisory oversight.

Q55 Chairman: There is this new philosophy of intense supervision that you have mentioned, and most people would agree that that change is now required. However, there are signs even at the moment that it is maybe a bit “business as usual”. How will you ensure that you resist the pressure from the banking sector and others to relax your intensity?

Lord Turner of Ecchinswell: You did not ask me, Chairman, whether I wanted to make an original comment but, if I had been, I would have said the following—which relates specifically to this point. I think it is incredibly important for us to realise the enormous intensity of the financial crisis that we have just been through; the huge harm that it is doing in the developed world and indeed the developing world, as the World Bank report revealed this week; and the burden of fiscal debt which the UK and other countries will have. I think we have to realise that this was not a minor event; it was in some ways the biggest financial crisis in the history of market capitalism. It was based upon fundamental intellectual errors about the way that markets work, and the self-equilibrating, or in fact non self-equilibrating, character of financial markets. I think there is a danger that, because we are now seeing some signs of positive things—and I think that there are truly some green shoots out there—because of those positive signs and because of the exhaustion level of driving through the changes required, there

could be some drawing back from the degree of radicalism that we require, particularly given the fact that some of it requires international agreement and getting international agreement is an immensely tiring process of driving it through a complicated set of fora. I think there is a real danger therefore that we do not seize the opportunity of this crisis—and it seems a bit odd to say that a crisis is an opportunity, but that can be the case—to make sure that we make changes radical enough to ensure that we are not sitting here again in ten or 15 years' time. I do have that concern, and I think that one of the things we need to do on the FSA, having launched the Turner Review and our discussion paper in March, having had a process of a consultation that has resulted in several hundred responses which came in over the last few weeks, is to draw breath and to think about it; and we will be heading towards some new sort of statement in the autumn and another conference to discuss it, where we make sure that we are being radical enough and that we do not become satisfied with what we have done so far. I do have that worry internationally, that we could fail to be radical enough in response to what occurred.

Q56 Chairman: In the domestic sense it is obvious that incentives matter, and that is agreed. The focus yesterday was on the pay-out to Stephen Hester at the Royal Bank of Scotland. We had an independent remuneration consultant, Carol Arrowsmith, before our Committee a number of months ago and we asked her what the typical remuneration package would be at the height of the credit crisis. She told us it would be the basic salary; share options five or six times what the basic salary would be; and a bonus, two or two and a half times. That is almost exactly mirrored by the incentives that Stephen Hester had yesterday. They are incentives based on share price, which some would say is a crude measure. Looking at that incentive package, you would be forgiven if you had the impression that it is really “business as usual”.

Lord Turner of Ecchinswell: Yes, and I do have some concerns that that may be the case; not in particular in relation to a specific individual, but we have certainly noticed that there is now very aggressive hiring going on in the trading activities of investment banks. The specific issues of that particular contract are a matter for the Government and UKFI, not for the FSA; but I think that the issue of how we, as best possible, use regulation to make sure that remuneration structures are consistent with appropriate approaches to risk is one where we need to intensify our focus. Though let me say one thing, because I know that in a previous report you commented that you had some concerns that the FSA have been “complacent” on the issue of remuneration. I think that reflected the fact that in the Turner Review I said that although it was important it was less important than other things. I continue to believe that, and the way I would express it is this. If you roll back ten or 15 years and imagine two states of the world, one in which we had the tightest possible definition of what were appropriate remuneration policies but we had not changed

capital and liquidity standards overall and in trading books, how much difference would that have made? I do not think all that much. The other is one where we had fixed capital requirements in trading books and something in the accounting but had left remuneration to an entirely free market decision. I think that would have made quite a lot of difference, and I suspect that you would not find a serious economist across the world who would disagree with that. We do need to try to make significant changes to the remuneration approaches of banks and investment banks, therefore, and in particular in investment bank activities of banks, but we have to realise that there is a limit to what you can achieve through that route alone. Let me sum up what I mean by that. You yourself said in your previous report that you did not think that the FSA or any regulator could be involved in regulating the total amount of remuneration. Therefore, our focus is what is the structure of remuneration? What is the balance between immediate payment, deferred payment, payment in cash and payment in shares? If we got that as good as we wanted it, the fact is that people may still take excessive risks. If you look at the remuneration of Dick Fuld, the head of Lehman Brothers, he was to a very significant extent paid not in cash but in shares, and those shares were significantly deferred. Actually he lost a very large amount of money when Lehman's went bankrupt. That did not stop him sitting on top of an organisation which was taking excessive risks. The fact is that, when there is irrational exuberance in markets, people are themselves carried away with irrational exuberance. They believe that those deferred equities that they have will pay out. One therefore needs to realise the limits of what we can achieve on that. The final thing I would say is this. We have to realise that there were parts of the wholesale financial services industry—in particular, bits to do with structured credit, credit derivatives and fixed income trading—which I think simply grew beyond their socially useful size. They were, as one of the economists here was just saying, indulging in innovation which was not socially useful innovation but either regulatory arbitrage innovation or a tax arbitrage innovation or forms of rent extraction. As long as that is occurring on a more-than-useful scale, some people will end up, in some way or other, being paid very large amounts of money for things which are not terribly useful. To address that, we have to get the capital requirements right; we have to get the things that determine the scale of that activity right. To try and regulate that by remuneration policies is like trying to control inflation by prices and incomes policies, even while having nominal demand growth faster than is compatible with stable inflation. It is the same category of mistake.

Q57 Chairman: In your evidence you told us that the FSA was scrutinising the accounting judgments made by bankers. What are auditors for?

Lord Turner of Ecchinswell: What has been interesting to us in exercises we did last autumn was to compare the values attached to particular assets

and derivative exposures and the value, for instance, of mono-line insurance cover, for what appeared to be very similar categories of asset or contract in the books of several of our major banks. You can actually compare what is the percentage approach to a value markdown or the credit taken for an insurance cover, et cetera. What we discovered at that time—and this was not something we had done before—was significant variation in those approaches. I think what that illustrates is that there is a role for somebody to be doing that on a compare and contrast basis, then convening the auditors and saying, “On the basis of what on paper are the same accounting standards, you are ending up agreeing to what are significantly different judgments as to what is the application of that standard, in what appear to be somewhat similar conditions”. I think there is a role, therefore, for the FSA—and we are working out the details of this—to be the occasional convenor of auditors, to discuss these issues with the actual figures in front of us, and to try and create a greater commonality in the judgments that are being made. However, I have to say that it was surprising to me how significantly different some of those judgments which had resulted from the auditor application of the same standards were.

Q58 Mr Tyrie: You have given us some very interesting and full replies to these questions. Thank you for that, Lord Turner. This touches on exactly what you have just been alluding to. How much of this detailed information that you are collecting in the enhancement programme can we get into the public domain through accounts and through annual reports, in order that the risk associated with the information can be correctly priced by the markets?

Lord Turner of Ecchinswell: This is an important issue that we need to work on further. Of course, given that it is accounting information, that also needs to be agreed with the International Accounting Standards boards and we do need a commonality of approach on it, across the world ideally. It is something which is being addressed by the Basel Committee because, within the Basel II approach to capital adequacy, there was always what was described as the three-pillar approach: a new way of working out the figures, Pillar 1; Pillar 2, a set of supervisory judgments as to add-ons required; and Pillar 3 was described as a greater degree of disclosure of some of these judgments and how the approach had been used. There was not great progress on that before Basel II was launched and we need to make more progress. That is very much work in progress, therefore, to try to define that. The challenge on disclosure, to which there is no easy answer, is that the disclosures at the back of bank financial reports are getting bigger and bigger, and there is more and more data there already; and it is not clear that we have market analysts who are effectively analysing even what data is there already. We therefore have to be a little careful of simply believing that further data will magically produce a more effective form of market analysis and market discipline than have existed in the past. In general,

however, I do believe that we should probably go down the track of greater disclosure of some of these accounting judgments—if we can describe them in a fashion that is susceptible to a standardised disclosure. We are generally sympathetic to that, therefore, but this is a real devil-in-the-detail issue, on which international work is now going on.

Q59 Mr Tyrie: But is it not the crucial one? Because if you do not get very far with disclosure, we are entirely dependent on the internal judgments you are making.

Lord Turner of Ecchinswell: That is an important philosophical issue as to how much the greater stability of the financial system in future will depend on greater transparency, disclosure and more effective market discipline, and how much it will depend on a greater willingness of the regulator, the supervisor, to make discretionary judgments, or of the macro-prudential authorities to pull macro-prudential levers. I may differ a bit with you on this. I am a little less certain that the discipline will come through market discipline. The evidence for that, I would suggest, is that, even though there was not perfect information in terms of individual bank accounts back in spring 2007, I think it was a reasonable thing to believe that the level of risk within the financial system was increasing—given the scale of the increase of a credit extension, given what we already knew about sub-prime mortgages in the US, et cetera; and yet aggregate, on average, bank CDS spreads, rather than going up, continued to fall, to reach pretty much an all-time low in about June 2007. Therefore, the thing which is meant to give us a forward indicator of risk failed almost entirely. I do think that we have a problem of the fundamental nature of financial markets. The concept of market discipline in response to transparent information depends crucially on the idea that market prices will reflect all of the available information rather than reflect herd and momentum effects. I think that to a significant extent they reflect herd and momentum effects. They serve as available information.

Q60 Mr Tyrie: They certainly cannot reflect it unless they have the information. If I may say so, when I asked you some questions the last time you came before the Committee, I asked you about the mistakes your predecessors had made. You said yes, they had made some serious misjudgements. Then I asked you whether you would have made the same misjudgements, given the information before them at the time, and you said yes, you would have done. What I am concerned about is creating a vast regulatory regime which ultimately depends on yourself or people like yourself making further mistakes in the future. Notwithstanding the fact that you may be better at it than anybody else available, it still may not be good enough. Therefore, transparency might be a better route.

Lord Turner of Ecchinswell: We fundamentally have three ways to progress and I think that we have to progress through each of them, one of which is transparency—in the hope that that improves the

effectiveness of market discipline. Given the failure of markets to use the data which was already available to them, I have some doubts about whether further information radically improves that effectiveness. The other is a greater willingness of regulator or central bank or macro-prudential authorities to make judgments, either at an individual institution level or at a macro level, which lean against the wind of irrational exuberance. Again, I do not imagine that we can ever do that perfectly, but I think we have to be willing to attempt to do that. In a sense, it means that I do not agree with the Greenspan doctrine that that is completely impossible. The third, though—and it is the point I made earlier—is if you believe that market discipline will always be ineffective and subject to herd and momentum effects, if you believe that regulators are also imperfect human beings—which I undoubtedly agree with—and will get things wrong, then what we have to do is put more buffers into the system. We just have to accept that both of those other corners of the triangle are uncertain and we have to have a system which, in the face of inevitable volatility, simply has more shock absorbers to absorb that inevitable volatility and irrational exuberance, followed by irrational despair.

Q61 Mr Tyrie: I would just like to ask a couple more questions about the enhancement programme. To take a specific case, do you think if this programme had been in place, the information that was clearly already available about HBOS's increasing risk would have been acted upon and, in particular, the head of compliance's concerns? Do you think this structure is better capable of reacting vigorously to that?

Lord Turner of Ecchinswell: Yes, I do. I said earlier that in itself it would not make a difference without other tools as well, but it would undoubtedly have made a difference. Indeed, there are also important things that have to be debated, which will come up in the Walker Review, where Sir David Walker is looking at governance issues. I believe, and I think that Sir David is heading in this direction, that the nature of the relationship between the professional executives involved in risk and the non-executives and the risk committee—but also the regulator—the ability to feel that they have a direct line to the regulator and to non-executive risk committees, and are defended against any pressure from the other executives, is one of the most important issues for us to think about within the governance relationships. I think that changes are required there. I think that combining those possible changes which may come out of Sir David Walker's review with our enhanced supervisory approach could make a difference. Where one has to be a little careful is this. If we had had this greater supervisory approach, would we have said in relation to the Dunfermline Building Society that they should stop doing commercial real estate lending on quite the scale they did? The answer is that you would have to combine the more intense supervisory approach with a greater willingness to accept that it is the role of the regulator and the macro-prudential authorities to

have a point of view on the overall trend in the marketplace. That was not there at the time. You have to remember that the Dunfermline Building Society was able to do that commercial real estate lending because Parliament had decided in 1997 that that was a useful freedom for it to have, and was doing so in an environment where we did not have macro-prudential guardians telling us that, on aggregate, commercial real estate was growing too rapidly. With those two as background, actually there was not anything about the specific commercial real estate lending that Dunfermline was doing which would be a red flag. Again, it is why I say that the Supervisory Enhancement Programme, combined with what may come out of the David Walker review, can make a significant difference to many of these issues—the issues which were relevant, for instance, in HBOS—but they need to be combined with new approaches to capital and liquidity and a greater willingness to make macro-prudential judgments about where we are in the cycle.

Q62 Mr Tyrie: One last question on this. Given that the enhancement programme will be very dependent on the quality of staff running it and given that, when City firms recover, their reputational risk will be considered by them to be so high that they will want the very best people on the other side of the table dealing with the people coming in from the FSA, how confident are you that you will be able to keep your staff?

Lord Turner of Ecchinswell: You are quite right to ask the question how we are going to keep our staff. Clearly the last six months has been a favourable period for us to be recruiting, because there have been some quite good people out there. Having said that, the particular people we might recruit, who are competing with the people who are the risk and compliance officers, even before this latest increase in trading remuneration which is going on, even last autumn, that was the bit of the City recruiting which was fairly dynamic. That is why we need an adequate budget to be able to compete. That has not been an easy thing to say over the last six months, and we have had people criticising us for the fact that we have still paid end-year bonuses; but we need that adequate budget. We feel that we have a remuneration structure approach at the moment which, in the conditions of today, is adequately but not excessively competitive. We will obviously need to make sure that we keep that in future, to have the right quality of people.

Q63 Sir Peter Viggers: The Turner Review made six key proposals on capital regulation. Of course, the world has rather moved on since then. I wonder what your present view is of the extent to which you can prescribe the optimal level of bank capital.

Lord Turner of Ecchinswell: The issue of prescribing the optimal level of bank capital is of course a very interesting theoretical one. It is noteworthy that, in the 12 years of the discussion of the Basel II regime, there was intense discussion of the relative weight of capital that should be put against different activities

in the banking book. Then, when it got to the aggregate level of capital, the committee essentially said, "The aggregate level of capital should be the same as it previously is". Not only was that implicit: it was an explicit decision. The whole thing was calibrated to produce roughly the same result as before. It is slightly odd, in retrospect, to think that there was this huge intellectual effort into a capital regime, with very little questioning about what the optimal level is. It is very difficult to derive a complete theory of the optimal level of capital, but I think there is a reasonable argument that it is higher than we have had in the past. There are some very interesting theoretical issues about it. If we overdo it and have too much capital, are we increasing the cost of credit intermediation? This gets to the intriguing debate about what is called the Modigliani-Miller theory of capital. Whereas, at least if you accept that theory, it really does not matter if we double or triple the capital requirements; it does not make a macro-economic difference. That is an issue about which the world has to think. It has also been pointed out, for instance in Bank of England papers, in previous versions of the Financial Stability Report and in American reports, that 40 or 50 years ago banks used to operate not with just a bit more capital but with a great deal more capital than they have at the moment. It is something that we will try to stimulate as a debate—between ourselves and the Bank of England, with the Basel Committee, with the Bank for International Settlements, with academics—as to what the overall level is. However, at the moment we are proceeding on a global consensus that we do want more capital and higher-quality capital, which means more of a common equity or close-to-common-equity form. I think the new idea that has emerged over the last three or four months, which was not in the Turner Review but which we are also very interested in, is the idea of contingent capital: things which are not necessarily common equity but would definitively become common equity under some circumstances, *i.e.* things which are mandatory convertible, for instance not just at the option of the bank but at the option of the regulator. You could imagine something where there is a required Core Tier 1 ratio of X% and where, if a bank fell below that, subordinated debt instruments would have to convert into Core Tier 1. I think that some of those issues about insurance policies or mandatory convertible are very attractive ideas, which we need to add to it. They get us round this debate a little of "Should our Core Tier 1 ratio be 4% or 6% or 8%?" by giving us something which would become Core Tier 1 when that shock absorber or buffer was required.

Q64 Sir Peter Viggers: Your review argues that only Core Tier 1 and Tier 1 capital should feature in regulatory ratios. There is notably less emphasis on Tier 2 capital. Why is this?

Lord Turner of Ecchinswell: Tier 2 capital is subordinated debt. The difficulty about subordinated debt is that, in a sense, it is loss-absorbing in a condition of a failure—what some people have called a "gone concern" situation—but,

on the basis of a going concern, losses go through to common equity and that can then produce very strong pro-cyclical behaviour. For instance, banks which face a hit to common equity may start constraining the growth of their balance sheet very quickly, to try and get their ratios back. There is therefore a feeling, and I think it is reasonable, that in an ongoing basis we need capital as much as possible to be equity or contingent equity, something that becomes equity, because that is really the only thing which absorbs the losses as they occur rather than absorbs losses in condition of default. The other trouble with subordinated debt is that there developed practices in the market whereby they often had call options in them, and although it was available to a company not to take the call option, and for instance to pay it back after five years, you ended up with a set of market practices where it was perceived as very bad for market confidence if you did not call the subordinated debt at the end of, say, a five-year call period. What that meant was that some things which were nominally very long-term, permanent capital, 20 or 30-year bonds, *de facto* ended up being forms of medium-term funding rather than long-term capital. There are lessons for us in that. One of the lessons is about regulatory creep. What you continually have when you define a set of standards in capital is a set of clever investment bankers saying, "Yes, but couldn't this particular version with this particular feature still just meet your definitions of what is capital?" That happened in relation to quite a lot of what are called the hybrid Tier 1 and innovative Tier 1 and Tier 2 capitals. I think we have to be much more rigorous about that in future. Capital should fundamentally be loss-absorbing; it should either be equity or it should be things which are capable under certain circumstances of becoming equity.

Q65 Sir Peter Viggers: In your review you said, "The future world of banking probably will and should be one of lower average return on equity but significantly lower risk to shareholders as well as to depositors", and you call for a public debate. Do you actually want a public debate or do you want a public education programme?

Lord Turner of Ecchinswell: I think both. I do think that is right. If you look at the expectations of return on equity which existed in the marketplace and in market analysts back in 2004–05, they were things which were only compatible either with a very high level of gross margin, *i.e.* some category of rent extraction going on vis-à-vis the real economy, or a high level of leverage, a minimisation of capital, or risky activity. They were not compatible with a banking system simply performing its core functions at the sort of level of profitability that you would have thought was compatible with that. I think that the general principle—I do strongly assert, and would be surprised if somebody could argue against it, is generally accepted and it has been said by some private bankers. Some private bankers have said to their analysts and shareholders, "In future we will be somewhat lower return on equity but we will be lower risk". I cannot remember whether I spoke of a

public debate in relation to that issue, but it is not one where I am in much doubt. I think that is the direction of change which is required.

Q66 Sir Peter Viggers: You have argued that capital requirements should be counter-cyclical and you said they should be hard-wired and formally driven. All of which is fine, but who is going to call the cycle? In 2007 we all thought that we were in a certain position; we all now recognise that we were not.

Lord Turner of Ecchinswell: This is one of the areas where the concept is broadly agreed but I really do think that we now have to put flesh on the bones of that concept, and it is not straightforward. This is where there is very significant work being done by the Basel Committee, where the FSA is deeply involved. It is something we also need to debate with the Bank of England. They have a major input to this. The two choices as to how to go forward are a hard-wired formula and things which are to a degree discretionary. With the hard-wired formula—and the version of this is the Spanish dynamic provisioning—you have set out a formula in advance, which says that if credit grows at a certain pace you will automatically have some extra capital put aside against it. This is on the grounds that we do not know things perfectly but, in general, the more rapidly credit is growing in the economy the more likely it is that some of that credit is fairly risky. However imperfect, therefore, you simply hardwire that into a formula in advance. The other way is to give to some macro-prudential body the right to look at the situation and to reach a judgment back in 2005–06 that the economy is overheating on the credit side and that we need, in the famous phrase, to “take away the punchbowl before the party gets out of hand”; but to do it not through the sole instrument of the interest rate, *i.e.* not using interest rates to prick asset bubbles, but through the use of counter-cyclical prudential requirements. What we suggested in the Turner Review was that we probably need a bit of both. We probably need some hard-wiring but we certainly do not exclude the possibility that in addition there is some counter-cyclical judgment going on. Of course, the more that it is judgment about the position in the cycle, the more that it does have an overlap with the conduct of monetary policy; because you end up with counter-cyclical capital requirements becoming alternatives to the use of the interest rate, to achieve the same effect. This is an area where we are confident that the content is right; it is broadly agreed throughout the world; but there is a lot of work still to be done to decide the precise range of instruments and the balance between formula-driven and discretionary judgment.

Q67 Mr Fallon: Can we turn to the European issue, Lord Turner? If fiscal responsibility for the bail-outs or for depositor protection remains national, why should we accept any degree of supranational authority from Brussels?

Lord Turner of Ecchinswell: I do not think we have perfect solutions, but let me describe the problem. Last year, we had the Icelandic banks growing in the

UK, accepting retail deposits and advertising for retail deposits. They had a right to do that as passported branches under the European Single Market, as members of the European Economic Area.

Q68 Mr Fallon: I think that we understand the problem. We have been studying it for a couple of years.

Lord Turner of Ecchinswell: I am sure you do.

Q69 Mr Fallon: What is the answer to my question?

Lord Turner of Ecchinswell: For the record, which is sometimes useful to do—because you may understand it but not everybody does—that is a problem which arises from the Single Market rights to operate. Suppose in ten years’ time we have similar concerns about the growth of banks from a relatively small country within the European Union, where we have some doubts about the capability of the fiscal resources or the deposit insurance to bail it out if it went down, and we also have, as we had with Iceland, doubts about the approach that the local supervisory authority is applying to the constraint of that growth and the capital adequacy and the liquidity. We would like some capability for there to be a European supervisor of supervisors, which is placing pressure on the supervisory authorities of that potential future small country to make sure, as best possible, that tight standards are being applied. Unless you go to the other extreme and say, “We don’t want the Single European Act. We are going to undo that. We are going to have a treaty change so that there are no longer branch passporting rights in relation to gathering retail deposits”—that is why you have to go in that direction. That is why in the Turner Review we flagged up this concept of more Europe or less Europe; *i.e.* unless you are willing to go in the direction of less Europe, which is limiting retail branch passporting rights significantly, to assure us that in ten years’ time we are less likely to be sitting there with an Icelandic situation, we need some ability at European level to be assuring the quality of the supervision of all supervisory authorities across Europe. I think that is the logic of it.

Q70 Mr Fallon: I did not ask you about surveillance or quality assurance; I asked you about supranational authority. The issue of course is what happens when there are disagreements. Should there be binding mediation at the European level or not? If there is binding mediation at the European level, then the FSA in effect becomes an agency of Brussels.

Lord Turner of Ecchinswell: No, I think it is oversimplistic to describe it as that, frankly. There are some circumstances in which binding mediation may be something which would be attractive to us. If we are worried about the future equivalent of an Icelandic financial authority, unless we have some teeth, not only to observe through surveillance that there are concerns about that capability but actually in some way to make sure that there is improvement, what is our defence against another Icelandic

situation, for which you would quite rightly criticise us, in ten years' time? What is our defence? It is not clear to me what it is.

Q71 Mr Fallon: It is a very British point of view, is it not, to see this as one-way. What would happen if the Icelandic authorities or the Latvian authorities queried a decision that you had taken here?

Lord Turner of Ecchinswell: Yes, and one would have to make sure that one was adequately involved in the process and that the thing was set up sufficiently professionally that one would be sure that that was only occurring if that challenge was reasonable. Of course the challenge has to be both ways; but we will be extensively involved, in detail, in helping create the professional standards and the technical competence of this regulatory authority. You are absolutely right, but you are not giving an answer to me about what you are going to do about the future Iceland in ten years' time.

Q72 Mr Fallon: Happily you are here to answer our questions.

Lord Turner of Ecchinswell: Yes, but sometimes it is actually quite useful to ask you a question, and you do not have an answer to that.

Q73 Mr Fallon: You are here to answer the questions. Let us be clear about this. You concede that there is a case for binding mediation, supranationally over the FSA, from Brussels.

Lord Turner of Ecchinswell: Under some circumstances it can be acceptable. The crucial thing is that we do not want it to be in relation to the supervision of individual institutions; it is about overall supervisory approaches. We are absolutely confident that the supervisory capabilities of the FSA would be extremely unlikely to be challenged, because we think that we would be setting the standard of what that professionalism is. However, I do think—and this is why in the Turner Review we shifted our policy to accept a greater degree of co-ordination—that, after what happened in Iceland last year, it is irresponsible for us not to give the people of Britain an answer as to how we would stop it happening again.

Q74 Mr Fallon: It is not just co-ordination, is it? It would be binding.

Lord Turner of Ecchinswell: Yes, but how would co-ordination without some teeth have stopped Iceland?

Q75 Ms Keeble: I want to ask you about the macro-prudential regulation and tools, which you have referred to previously quite a bit. You referred to three high-impact levers and in your review there was reference to six factors that needed to be taken into account. The previous witnesses talked about the possible tools being controls on capital requirements and also lending rate limits. Out of all of those, which do you think would be the most effective tool?

Lord Turner of Ecchinswell: I am sorry? Capital requirements or lending?

Q76 Ms Keeble: Capital requirements and further restrictions around those, without being too specific, and also lending rate limits.

Lord Turner of Ecchinswell: Lending rate limits?

Q77 Ms Keeble: That is right.

Lord Turner of Ecchinswell: Were they referring there to loan-to-value ratios?

Q78 Ms Keeble: That type of thing, yes, and they referred specifically to the property market. Within all of those, I wondered which you think would be the most effective tools to respond to macro-prudential warnings.

Lord Turner of Ecchinswell: The answer is that I do not have a definitive answer here. This is where I would agree with the comments made by the Governor of the Bank of England at the Mansion House last week: that these are very complicated issues where we need to try and tease out an appropriate answer. We will certainly be thinking over the summer about what our point of view on this is. The available instruments are clearly in capital requirements—the variation of those. As I said earlier, we are strongly favourable to some element of hard-wired counter-cyclicalities in those, through something like the Spanish dynamic provisioning approach. I think that most people would agree that is a key element of it, even if you have other things. Some countries also use loan-to-value ratios. Some countries use it simply as a prudential limit which is stable over time, and some vary it over time. For instance, I spent last week in China and Japan, and China has been varying its loan-to-value ratio limits on residential mortgages as part of its stimulus package. It has therefore been increasing the allowed level of a loan-to-value ratio as a form of stimulus package. What I flagged in a speech I gave to a mortgage conference a month and a half ago was that I really do think that is one where we need to think very deeply before deciding to go down that route. We will produce a paper in the autumn on that particular issue, as to whether loan-to-value or loan-to-income ratios should be used either as a mechanism of consumer protection against over-high lending or as a macro-prudential tool. I guess I would say that, within the possible tools—capital ratios, loan-to-value ratios—the capital ratios is an almost definite; the other issues are whether you want other ones as well. There are also, by the way, quite crucial issues about loan-to-value ratios, or what are effectively loan-to-value ratios, in the wholesale space and, for instance, in the derivative trading space, where it is an issue of collateral requirements within margin lending. I think that those also are worth thinking about.

Q79 Ms Keeble: If you agreed with the Governor about the refining of tools, do you agree with him as to who should wield them?

Lord Turner of Ecchinswell: I have expressed a point of view on how these tools should be applied. Indeed, I did so in front of the House of Lords' Economic Affairs Committee, and I was pleased to see that they largely reflected what I said in their

recommendations. However, my attitude is the following. There clearly needs to be very close co-ordination between the prudential regulation and supervision of banks in particular and central banking functions. The more that we go down the path of macro-prudential levers, the more that integration has to occur. Paul Tucker has used the phrase, the “underlap” between a Bank focused on the inflation target and us focused on supervision, and that that was a mistake. We therefore need to integrate it. I have expressed myself in the past, and I express myself again, as an agnostic on the overall institutional structures by which we ought to organise the different functions. I can see some arguments for the whole of banking supervision being with the Bank of England. It would solve some problems, but it would create others. I am not someone who says, “I will defend to the limit the existing organisational structures”; I am an agnostic on it. Indeed, my biggest argument against change is that any change would produce six months of people looking for new jobs rather than focusing on the job that they had to do. What I will say is this, however. Suppose you had banking supervision in the Bank of England. How would the Bank of England then organise its macro-prudential decision-making process? It would undoubtedly set up a financial stability committee/board, which would combine people from the macro side of the house and people from the individual supervisory side of the house, in order to bring together the insights that come from top-down macro analysis and the insights that come from bottom-up analysis of the situation in specific institutions and sectors. It would have some sort of financial stability committee/board, which would have the head of the supervisory department on it as well as the Governor or the Deputy Governor. My answer is therefore quite straightforward. If that is how you would logically organise it if supervision were within the Bank of England, if we suppose that supervision stays within the FSA, we should organise it in the equivalent process. We should have a joint financial stability committee, which I think should be chaired by the Governor but should include people from both the Bank of England and the FSA. I would be very worried that, if we do not do that, we will simply create unnecessary competitive behaviour and a lack of co-operation between the two entities.

Q80 Ms Keeble: I want to come back to you on that a little more. The need for greater co-ordination is a fairly clear argument. However, you run a slight risk of reinventing some of the problems that we have seen in the Tripartite, of having everybody involved and the question is who takes the decision; who actually has the lead. You may be agnostic, but you are a key partner in all this and your perceptions and your views are obviously important, for us as for others. Even if you have a co-ordinating structure which, for the sake of argument, might theoretically fall inside the Bank, do you think that the decisions about wielding these instruments, so to speak, should be taken in the interests of financial stability

by the Bank or do you think they should be taken by the regulator qua regulator? Ultimately, where should the decision rest?

Lord Turner of Ecchinswell: My point of view is that they should be taken by a joint committee; that there should be an equivalent of a Monetary Policy Committee for financial stability decisions.

Q81 Ms Keeble: Chaired by —?

Lord Turner of Ecchinswell: It should be chaired by the Governor. It should probably have a majority of people who come from the Bank staff. Maybe if it had nine people, there would be five from the Bank and four from the FSA. I think that it should be debating and looking in the same way that the MPC does at papers developed both by Bank and FSA staff, drawing on the insights which come from both top-down macro analysis and bottom-up analysis; and it should be reaching decisions about where we are in the cycle and whether there are then tools, such as capital or liquidity or margins, which need to be tightened or loosened in a counter-cyclical fashion. Unless you do that there is a real danger that, if you simply have that in the Bank and then those instructions are, as it were, handed to the FSA, first of all you will produce wasteful competitive behaviour; but I think that wasteful competitive behaviour would be quite justified. I suspect that whenever an individual institution goes down, the FSA will be blamed. That is almost inherent. It is to do with the majesty that the Bank has and its slight mystery. It is part of Bagehot’s phrase, “the decorative elements of the constitution as well as the functional”. It has a mystique. The blame will attach to the FSA. The FSA therefore cannot simply sit there and say, “We’ll rely on the judgment of the Bank”. Suppose the Bank gets it wrong. Suppose the Bank does not adequately pull counter-cyclical levers. It ends up with power without responsibility and the FSA ends up with responsibility without power. If you are going to do that, then maybe you should think about moving bank supervision back to the Bank.

Q82 Ms Keeble: What is your reflection on the observations made by David Blanchflower in his speech in Cardiff, where he said that if the central bank is responsible both for interest rates and the macro-prudential instruments, they might “have one foot on the accelerator while simultaneously applying the handbrake”? Do you think there is a problem of conflict of interest in the situation you have described?

Lord Turner of Ecchinswell: I agree that needs to be thought out very carefully, but I think the counter-analogy would be to say that we have realised that simply having the interest rate available as a brake, rather than some other brakes as well, is also highly imperfect. I do not know whether Professor Blanchflower disagrees with this. He may be one of those people, for instance like John Taylor of the Taylor Rule, who has written a book on it, who believes that appropriate use of the interest rate by central banks could itself have achieved a better result and that there were failures of classic monetary

23 June 2009 Lord Turner of Ecchinswell

policy, interest rate policy. I do not know whether Professor Blanchflower believes that, but my own conclusion has been that there are difficulties in simply using the interest rate as a brake and accelerator; that it is very difficult to lean against the wind of asset bubbles or credit cycles using just the interest rate—particularly in a medium-sized country which has a floating exchange rate, where you can get complicated impacts through the exchange rate—and that therefore we need more than one brake available. The argument for is that we need more than one brake available. Obviously he is quite right that, once you have said that there should be more than one brake available, you could be inconsistent in taking the pressure off one while putting it on the other, as it were. I did not know that he had said that but, in order for him to be willing to go with the full consequences of that, he has to be arguing that interest rates alone could have been an adequate tool to guard against the cyclical effects which we saw. Some people do believe that, but I think there is a large body of opinion which no longer believes that.

Q83 Ms Keeble: I want to press you once more on where the decision-making rests, just to be absolutely clear, because it has obviously been a matter of some dispute and there are also all the blanks that have to be filled in on the Banking Act. You would argue with the Governor about having a structure inside the Bank to look at the financial stability issues, to look at how to use the macro-prudential tools, and then joint decision-making as to how they should be used; but then the responsibility for implementing them rests clearly with the FSA. Crudely, that seems to be the situation you are describing.

Lord Turner of Ecchinswell: The analytical input to such a committee would come from both houses. They would be receiving papers, analytical inputs, which would be coming from both the Bank and the FSA.

Q84 Ms Keeble: But that would rest in the central bank.

Lord Turner of Ecchinswell: No. The committee would receive papers developed both by the Bank of England and by the analytical bits of the FSA. I do not think you could have the FSA not doing any of the analysis.

Q85 Ms Keeble: The committee would be in the Bank; it would be part of the Bank structure.

Lord Turner of Ecchinswell: Once you have a joint committee, it gets a bit notional whether it is in the Bank or not. It is in whatever its composition is. Where it would meet, I do not know.

Q86 Ms Keeble: No, but it would be part of the central bank. It would be chaired by the Governor.

Lord Turner of Ecchinswell: Yes, it would be chaired by the Governor, but it would be receiving inputs and papers from analytical resources both within the

sectoral and prudential analysis bit of the FSA and the financial stability bit of the Bank. It would be debating those issues and it would be arriving at a consensus point of view on what had to happen, obviously voting at the limit if required; but I think it would be better if it was consensus. I do not think that it is equivalent to the MPC, because you do not have a nice, simple lever to pull, ie up a quarter, down a quarter. It is therefore more likely to work on a consensus result basis than a voting basis. I think that the execution does have to be done by the supervisors, because they are the people who are actually looking at, “Are these people hitting the capital ratios which are required?”. However, the crucial thing here is to so construct the close working relationship between the FSA prudential supervision of banks and the Bank of England’s financial stability responsibility that you have, as it were, mirrored across the divide the devices that you would have if they were both within the Bank. There is an inexorable logic that that must be the sensible thing to do.

Q87 John Thurso: The Committee was recently in America and three points were put to us as things of concern relating to banks. They were, first, size; second, the interconnectedness; thirdly, the business model. Are there any of those that the FSA does not have covered?

Lord Turner of Ecchinswell: Does not have covered?

Q88 John Thurso: Are there any of those three that you are particularly concerned about?

Lord Turner of Ecchinswell: Absolutely. All of those three. I think that they get to some of the most tricky issues about which, even since the Turner Review, I have spent time thinking, and will be thinking about over the summer, where the FSA really needs to think through what is required. Let us take the size issue—

Q89 John Thurso: I was going to come on to the size one first. I want to ask you in particular if you accept what the Governor said in his Mansion House speech, which was basically “If a bank is too big to fail, it’s too big”, and the concept of an institution which cannot fail sits ill in a market situation. Do you agree with him on that?

Lord Turner of Ecchinswell: I think that this is a crucial issue and we need to break it down into several bits. First, you have to decide what your tools are. Are you saying that a bank cannot be beyond a certain size or do you impose extra capital requirements if they get beyond a certain size? My own suspicion is that if you said, as a sort of rule, “I’m going to stop banks getting beyond a particular size, and no bank can be more than £x billion in assets”, in order to make that figure small enough that you could be really sure that, when it went down, it was not systemically important, you would probably have to make it very small—much smaller than the present level, not just a little bit smaller.

Q90 John Thurso: To save time, could I ask you, at the same time as you address that, to address the other end of the scale? If you take HSBC, Barclays and RBS, their liabilities are four times the size of our GDP. Are they going to be a bank that is too big to save?

Lord Turner of Ecchinswell: Exactly the point I was going to get to because, in that, I think there is a crucial need to distinguish issues. On the “too big to fail”, I have some doubts as to whether we would really be able to get them small enough that we could then say, “They can just fail, without systemic concerns”—unless they were very small. Actually, if they were very small we could have a different systemic problem. Lots of small banks have lots of interconnectedness and lots of potential domino effects. Remember that the 1929–33 banking collapse in the US was a banking collapse of lots of small banks; so we have to be careful of not iconising the small bank model. I do not think that there is an easy definition of what is the most stable banking structure between small and large banks. There is this absolutely fascinating stuff on network interconnectedness, drawing inferences from disease pathologies, which I think is very valuable but it is also very difficult to tease out what precisely follows from it. What I take out of that is that we probably will have banks in the future sufficiently large that, if they did get into trouble, there will be few alternatives other than rescuing them. Therefore, we need to do two things. First, we need to make the likelihood of failure very small. Second, we need to increase the pain which will be felt by those people who in all circumstances suffer in a bank rescue, and those are the equity providers. The crucial issue about “too big to fail” is essentially an issue about where in the capital structure people suffer loss. Is it only the equity holders? Is it also the subordinated debt holders? Is it, under certain circumstances, senior creditors? Who suffers loss? That is the real issue about “too big to fail”. The more that we go down the road of having higher equity capital buffers, first of all we reduce the likelihood of failure; second, we create a large buffer which gets round the moral hazard problem. Because the thing which is clear in all bank rescue operations is that you can wipe out the equity holders—even if you choose, for systemic purposes, not to impose a haircut on creditors. I am therefore significantly attracted by the ideas which are in the Geithner proposals last week and were not in the Turner Review: that we should think not about absolute limits on size—because I think they will be very difficult to achieve agreement on at a global level, or to enforce—but sliding scales of capital requirements which simply require higher capital requirements from larger banks, or higher capital requirements from banks which are involved to a greater extent in risky trading activities alongside retail banking activities.

Q91 John Thurso: It is effectively a kind of tax on size.

Lord Turner of Ecchinswell: It is a tax on size. The idea of a tax on size, although it was not in the Turner Review, is one that we need to think about

and we need to think about it at a global level. The cross-border point is very important. We really need to break down this cross-border point about “too big to save” into three different categories. First, things like the Icelandic banks, retail banking operations in other countries where the home base was not a large enough country to rescue it, operating in a branch fashion. What you have to realise about Icesave in the UK is that it was not a bank in the UK; it was fundamentally raising deposits which were then used to fund assets anywhere in the rest of Landsbanki’s balance sheet. There was no bank that you could look at, with its own liabilities and assets, in the UK.

Q92 John Thurso: Could I ask a quick question on that? Could we not insist that any bank or brand that operates in the UK must be licensed in the UK?

Lord Turner of Ecchinswell: Not under the Single European Act, no. That is what branch passporting rights are. Category two is the complex, interconnected trading activities of a Lehman’s-like equivalent or the remaining investment banks, which typically operate with multiple legal entities, often for tax and regulatory arbitrage purposes—and I think there is a major issue about whether we have been too lenient about accepting proliferation of legal structures for tax and regulatory arbitrage reasons—which are essentially running interconnected, global trading business. Category three is the sort of HSBC or Banco Santander model. Banco Santander’s banks in Latin America are essentially stand-alone banks, regulated as subsidiaries, with their own liabilities and their own assets. Sometimes when we see these things, “The liabilities of HSBC are X% of UK GDP”, we fail to realise that that includes HSBC Hong Kong, regulated by the HKMA, who are absolutely determined that it will be adequately capitalised, such that, if HSBC went down globally, HSBC Hong Kong would survive. What is a possibility with those categories of banks, therefore, is that we essentially accept that they have to be, in each of their countries of operation, adequately capitalised as stand-alone banks which could survive the failure. In which case, you get round the “too big to fail”, because essentially you accept that no one fiscal authority is responsible; that they are holding companies of separate banks. That is a different situation and I think that we need to introduce that into the debate, to understand it.

Q93 John Thurso: Can I take you on from there to the fact that what you have just signalled is that, if you break the interconnectivity, you can save parts of a big bank when it is going down. Indeed, with the experts who were here earlier I pointed out that Coutts had remained wholly solvent and with lots of capital, notwithstanding the troubles at RBS. Equally, in your speech to the Global Financial Forum, you pointed out that many of the measures you advocate will have the effect of what Glass-Steagall would do, which is to suppress the size of banks to some extent. However, in your review you

pretty categorically reject Glass-Steagall. Why? Why do we not just go for what we all really want, which is to chop the thing up, have it separately capitalised and licensed, so that we take an awful lot of this risk of interconnectivity out? Perhaps you could do that without taking too much time.

Lord Turner of Ecchinswell: The trouble is that it is very complicated, but let me try. What I said in the Turner Review that I did not think was a reasonable way forward—and the words were very precise—was achieving a hard and fast legal divide between that which was narrow banking and that which was investment banking. The reason why I said that is this. If you look at the things which caused trouble in this crisis, they were not things far away from the fundamental activities of a commercial bank. They were not, for instance, equity trading activities. They were things to do with the provision of credit; they were to do with securitised credit. Indeed, I think that the vast majority of the things which got us into trouble—the things that UBS were up to in their big fixed income trading in the US—are things which would have ended up on the commercial bank side of the old Glass-Steagall debate. That never said to a commercial bank that you could not own a corporate bond in your treasury portfolio. It did not say that you could not do tradable syndicated loans. It did not say that you could not do credit derivatives. Indeed, the final step in the dismantling of Glass-Steagall was the Gramm-Leach-Bliley Act 1999. Think about it. Before then, JP Morgan had developed credit derivatives and was doing large amounts of credit derivatives—that were sitting on the commercial bank side of the fence. You could say, “We can draw the divide somewhere else”; but the difficulty is that, if you try to write this out as a law and ask, “What are you going to say that a commercial bank cannot do, in order to prevent the problems that arose?” are you going to say that they can never use a credit derivative? Credit derivatives, correctly used, can be a form of achieving insurance. Are you going to say that they cannot do a bond underwriting? Some of the people who are reported as being in favour of a new Glass-Steagall—for instance, Paul Volcker with whom I discussed this recently—say, “No, bond underwriting would clearly be a function which would sit on the commercial bank side of the fence”. Are you going to say that they cannot do tradable securities which they originate—turn into a security, hold for a period of time and then originate? Most of the activities that got us into trouble, when you look at it, are therefore reasonable activities of a commercial bank—which is why I believe that the problem is the scale on which they did it, not that they did it. Therefore, somewhat with the tax on size, I think that what we need is price-based instruments rather than legal division instruments to limit what they are doing; but that we should limit what they are doing, I absolutely agree with.

Q94 John Thurso: There is one question which I do not think you have answered in that, which is that it is a matter of culture. The merchant investment bank comes from a partnership culture; it is all their own

money and they take all the reward. They take risk and they take reward and they bet with their own money. The retail bank comes from the joint stock tradition, with a completely different set of values. What we have actually done is to import the worst of each culture into the other culture. The separation gets back to a greater purity of the risk-taker in one section operating on a risk-taking basis and the more cautious banker on the other side, operating in a more cautious way. It is the cultural element that is a factor.

Lord Turner of Ecchinswell: I partly agree with you but I do not think that we can write a law that says, “Commercial banks cannot do X, Y, Z”, in a way which would make sense, given what large commercial banks for large corporates in the world need to do and which would be effective. Once you tried to draw up that law, you would either be excluding commercial banks from things which their corporate customers would think were perfectly sensible, things required to provide service to corporate customers, or you would be pointing at a line where you make yourself feel good by keeping the commercial banks out of equity underwriting and trading, but actually equity underwriting and trading did not cause any problems in this. You really have to concentrate on where the problems are and where you draw the line. I think that when you get down to that level of detail you end up being in favour of things which are, as it were, economic instruments, such as the capital you require against it, or maybe constraints on the size. We could end up saying, “We are simply going to limit the size of proprietary trading activities that can be done within the same legal entity as the retail side of it”. I would not exclude that. I guess what I am saying is that I do not think—and I would be willing to predict—that we will end up being able to define a law which achieves what we want and says, “Put this on that side of the fence and that on the other”. I think that we are going to do it by a set of economic instruments. However, the fundamental point—that there were banks taking the benefits of retail deposit insurance, of a “too big to fail” status, involving proprietary trading which made lots of money for individuals, and that that is not okay—I completely agree with that, and we have to stop it.

Q95 Chairman: Lord Turner, I think our Committee felt that your report dismissed the implications of Glass-Steagall too readily and there needs to be quite a debate on this, not least the “safe bank” concept and the need to rebuild trust and confidence with consumers. I think that there is more explanation needed there. That is where we were coming from.

Lord Turner of Ecchinswell: That reaction quite surprised me, because I thought I had carefully set out a set of rules that said, “It seems unlikely that we can have a hard and fast legal distinction which excludes commercial banks from all categories of market-making”. I think that was over-interpreted as being against any action in this area—which has quite surprised me as a reaction.

Chairman: Maybe more clarity in the future.

Q96 Nick Ainger: Lord Turner, in the review you say that “The increasing complexity of securitised credit, increased scale of banking and investment banking activities, and increases in total system leverage were accompanied by changes in the pattern of maturity transformation, which created huge and inadequately appreciated risks”. You argue for international agreement to try to address the issue of this system, which was supposedly there to distribute risk but in fact ended up concentrating it in certain institutions. In relation to Mr Fallon’s questions about a European supervisory system and so on, what are the impediments? What is to stop us trying to sort out what you have already described today in relation to SIVs growing beyond their usefulness?

Lord Turner of Ecchinswell: Do you mean what is to stop us doing it domestically?

Q97 Nick Ainger: You argue for international agreement, because obviously these things are internationally traded. What is stopping us setting this up?

Lord Turner of Ecchinswell: Internationally?

Q98 Nick Ainger: Yes.

Lord Turner of Ecchinswell: The answer is that I think we need to keep clear as to what we can do alone, what we can do at European level, and what we can do internationally. The ideal is to get as much agreement internationally as possible. It is not a straightforward process and it requires a lot of energy and activity to try and get agreement. This is not an area which I have been at all involved in in my life before I became Chairman of the FSA, but one of the things that struck me since becoming involved is the complexity and the lack of definition of the decision-making processes at the global level to arrive at agreement. The thing one has to realise is that, unlike for instance in the area of trade where we have the WTO, we do not have a global treaty-based organisation to govern international financial regulation, with defined processes of getting to agreement which then become part of international law with sanctions on them. We simply do not have such an institution. What we have created over the years is a set of institutions—the Basel Committee on Banking Supervision and now the Financial Stability Board—which have either evolved or been created as instruments of the G20 on, as it were, a naturally evolving or declarative basis to say, “You go away and get as much agreement as possible”. The Financial Stability Board, which meets with its new membership for the first time in Basel this week on Friday and Saturday, has been charged by the G20—and there in the G20 statements is a set of statements that “The Financial Stability Board will do X, Y and Z”—but the Financial Stability Board actually has no legal authority to do X, Y and Z. All it can try to do is corral everybody round some agreements and then try to get everybody to agree that they will enforce it. This is an imperfect process but it is the only process that we have, and we have to drive it forward as much as possible. For instance, at the back of the Turner Review, where we talk about the implementation, there are a whole series of

responsibilities and dates for the Basel Committee, for the FSB, of liquidity standards, trading books, which we now need to get on with. They are imperfect processes, however. They are not straightforward to get to agreement and, in the past, they have operated at timescales which, compared with what we want to do now, are glacial. The development of the Basel II capital adequacy regime took about ten years or so between the mid-1990s and 2005, and we are now talking about trying to get agreements on counter-cyclical capital, the trading book capital, within a year. We basically have to drive that and make it work as best as possible, but we are starting with a machinery which a benevolent dictator of the world would not define as the machinery through which to do it. That is what we are doing, therefore, and I am confident that we will drive as much agreement as possible. It also does say that, in some, one may fail to get international agreement. Then, within Europe, you collapse back either to the UK level or the European level, recognising that, where it takes a legal form it is usually European level; because our capital adequacy directives, our capital requirement directives, our legislation in relation to credit rating agencies, are fundamentally European legislation and not national legislation.

Q99 Nick Ainger: If, as your review said, this was a significant reason why we ended up with the crisis that we did—and the Chairman in his introductory questions was expressing concern as to whether we are moving back to “business as usual”—who is actually taking action to try to limit? What is happening now? Particularly as you indicated earlier that the investment banks are recruiting substantially in their trading field, which presumably would cover this sort of area.

Lord Turner of Ecchinswell: What is happening now is that, ahead of global agreements on what Sir Peter Viggers asked me about—what is the optimal level of capital for the long term?—all of us have imposed in our particular national environment *pro tem* capital regimes which are higher than in the past. We have higher capitalised banks. What is happening in trading books is that, over the next year, we have a major exercise to go on at the Basel Committee to do a complete drains-up on how we approach the definition of risk in trading books. Even ahead of that, however, there are proposals which will result in significant increases in trading book capital but not until the end of next year, because of the normal process. That is happening. There is therefore a set of things happening already.

Q100 Nick Ainger: The point is this. Your review also says that the SIVs, the structured investment vehicles, developed as regulatory arbitrage. There was a way of getting round the regulation. How are you plugging that gap?

Lord Turner of Ecchinswell: We are effectively plugging that gap. Those are being looked at far more effectively than in the past. Many of these grew up in the US, where you had the distinction between the regulation of investment banks and commercial

23 June 2009 Lord Turner of Ecchinswell

banks. The SIVs—first of all, most of them are being wound down. It is important to realise that, although we talk about the investment banks hiring aggressively at the moment, what they are making large amounts of money out of at the moment is probably—and it is a thing we need to keep a very close eye on—significantly riskier than it was two years ago. They use the phrase “flow trade”. Essentially what has happened in the investment banking business is, because capacity has gone out of the market, they are making much more profit than before in some relatively plain-vanilla and not all that risky activities to do with trading government bonds, distributing government bonds, et cetera. It is not the case that they are, as best we can tell, recreating these SIVs and conduits. If they are, we will watch that very carefully and we will make sure that they are integrated into our point of view of the capital adequacy that they require.

Q101 Nick Ainger: Obviously SIVs do perform a function, and I have heard you defend their process—what they achieve. However, as you indicated earlier, they went beyond their usefulness and in effect made a major contribution to the crisis. What is to stop, in a year, 18 months or two years, investment banks and commercial banks starting again down this route, and do you have the staff with the capability properly to regulate these instruments?

Lord Turner of Ecchinswell: First of all, I am not sure that I have ever said that SIVs were necessary or useful things.

Q102 Nick Ainger: Are they?

Lord Turner of Ecchinswell: It is not clear to me that they are. I think that we have been over-tolerant of off-balance-sheet vehicles. There are some circumstances in which they usefully separate away risk, and that can be legitimate; but often they are forms of regulatory arbitrage and tax arbitrage, and I think that we need to be much more aggressive in the future at spotting them. That is point one.

Q103 Nick Ainger: Would you say that, because of the risk they pose, not just to the institution but because they pose a systemic risk, we should actually stop them?

Lord Turner of Ecchinswell: You do not necessarily need to stop them; you just need to say, “You can set them up but I’m still going to treat it as if it was on balance sheet”. It is the principle that I set out in the review: that we have to regulate things according to economic substance, not legal form. If somebody sets up a structure for the purpose of tax arbitrage or regulatory arbitrage, which moves something off balance sheet but when you look at it you realise that the risks are the same as if it was on the balance sheet, you have to say, “That’s going to have the same capital treatment as if it was on balance sheet”. Am I totally confident that we have all of this under control? The point I made earlier was that the system has gone through a terrible shock and we are trying to put in place new regulatory controls, many of which we can do under our existing legal power and

regulations, some of which require regulations. However, I have to say that the questions you are asking me I have been asking over the last month or so. Until a couple of months ago, I had said—and indeed I know that the Governor had said—the good news is that we have a bit of time to get this right. The Governor used the phrase, “Exuberance of either a rational or irrational sort was not in great supply at the moment”, so we could take our time to get it right. I do have some concerns that we may see a more rapid return to risky trading activities than we had anticipated was likely in the face of the shock that has occurred, and I therefore think that we have to take away your challenge—which is one I have been challenging internally already—to say that, even before we get some of these fundamental changes in, for instance, the capital against the trading book, are we watching carefully enough what is happening already in the marketplace? I will take that challenge and take it further still.

Q104 Chairman: Lord Turner, one likely impact of the FSA taking a greater involvement in firms’ decisions on business models is that market participants may become lazy and rely more and more on the FSA. Is it not incredibly dangerous for market stability to rely increasingly on institutions like yourselves for your judgment? If you get it wrong, the consequences will not be mitigated by others, if others have been doing less due diligence.

Lord Turner of Ecchinswell: I recognise that could theoretically be a danger. I do not think that it will be the case. I think this is where what we will do as a regulator and supervisor, and what will come out of the Walker review in terms of the internal governance of firms, have an important overlap. We need to achieve, with the internal governance of firms, a much stronger role for key non-executives to look at the risks that companies are running and to feel responsibility for them and for those business models. In the past, I think that it would have been reasonable to criticise the FSA’s previous approach as asking a set of questions about the existence of internal processes and structures for reviewing risk, but without either challenging the business models if we were worried about them or asking enough questions to understand whether those processes and structures were somewhat formulaistic or were really producing internal challenge. I think that in future we need to be close enough to understand whether non-executives and executives are really challenging whether the business models are too risky. That is therefore an intensification of our previous focus on internal management responsibility, alongside being willing to say, “Even though you have reached this judgment, we think you are growing too fast and going into risky areas”. I think that what there will always be in a future better supervisory regime is a sort of fluid interplay between that. It is probably unlikely, if we get it right, that there is a management which is just doing things and we say, “You’re completely wrong”. Hopefully it takes the form of us challenging the business model and that in itself being something where the non-executives say, “Yes, that’s absolutely right. The

FSA is right to challenge it”—but with the ability still, if they do not do it, for us to say, “If you want to do that, we’re going to charge more capital against it, because we think it is too risky”. I understand the danger, but given in particular that our attitude—and it goes back to an earlier reply—is that we have a responsibility to defend systemic risk and to defend creditors. The people we do not have a responsibility to are equity holders. Essentially, equity holders are there to absorb risk. That is why we want more of it there to absorb risk, and that is why I also talked about this idea of contingent capital—things that can become equity. I think the fact that we could perform our job in a way which keeps things systemically sound but is still pretty bad for shareholders will still concentrate the minds of management and boards that shareholders will get upset if they take risks which lead to dilution. For instance, suppose we have mandatory convertible forms of equity which under certain circumstances become equity if ratios fall below a certain level, that may make us perfectly happy about the systemic situation; shareholders will still be very annoyed

with management and boards if that occurs, because it will be a dilution of existing shareholders. I think that it will still work, therefore.

Q105 Chairman: You expressed a firm conviction in an earlier answer that a European body with binding powers would not find any problems with FSA supervision. Should we be renaming you the “Flawless Supervisory Authority”?

Lord Turner of Ecchinswell: We will never be a flawless supervisor, but it should certainly be our aim that we are a model of good supervision. I think that it would be odd if the supervisor of Europe’s biggest and most important financial centre was not a beacon of high-quality supervisory standards and was more likely to be the institution pushing to make sure that there were excellent supervisory standards in all other countries of the European Union, rather than being one which was criticised. That would certainly be our aim but, no, we will not be flawless.

Chairman: On that profound point, can I thank you very much for your evidence. You have been very open with us. It has been detailed and is very helpful to us with our inquiry.

Wednesday 24 June 2009

Members present

Mr John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Jim Cousins
Mr Michael Fallon
Ms Sally Keeble

Mr Andrew Love
Mr Mark Todd
John Thurso
Mr Andrew Tyrie
Sir Peter Viggers

Witnesses: **Mr Mervyn King**, Governor, **Mr Andrew Haldane**, Executive Director, Financial Stability, **Mr Andrew Bailey**, Executive Director, Banking, and Chief Cashier, and **Mr Charlie Bean**, Deputy Governor for Monetary Policy, Bank of England, gave evidence.

Q106 Chairman: Governor, welcome back to this evidence session on the Banking Crisis: Regulation and Supervision. Your Mansion House speech last week made headlines.

Mr King: Would you like me to introduce my colleagues?

Q107 Chairman: I am sorry; we thought we saw you before.

Mr King: We made some substitutions at half time! To shore up the defence I have brought along Mr Bailey, who is the Executive Director for Banking, and Mr Haldane, who is the Executive Director for Financial Stability, and on my left remains from the previous session Charlie Bean, Deputy Governor for Monetary Policy.

Q108 Chairman: Good. Governor, in your opening statement of the Inflation Report, you said, "If ever there was a time when countries need to work together to sort out the problems of the International Monetary System, this is it." What system would you like to see? Would it be all exchange rates freely floating or a managed exchange rate system?

Mr King: I do not have a simple answer to put to the committee, but I do think the system has to be one where there is recognition that there are obligations on certain major countries that their domestic policy needs to take into account what is happening in the rest of the world, and the reason why I think this is the time to do it is that, now that the surplus countries, who very often have tended just to blame the deficit countries for racking up more debt, realise that they have a great deal at stake in the deficit countries not getting into deep trouble and, indeed, you simply cannot rely on the previous set of deficit countries expanding domestic demand, they will need to reign in domestic demand for a period. So this is something where it is not a zero sum game; we are all better off if we work together. I think that this was an observation that was made at the time of the Bretton Woods discussions in 1944, and the US and the UK both had proposals for dealing with it which, essentially, did put obligations on countries not to run too large surpluses or too large deficits, and I suspect that we will need to think quite deeply about

the need to go back to something like that. Otherwise, I think we will see a repetition of the problems we have had.

Q109 Chairman: Yes, but Bretton Woods, Governor, did not work, did it?

Mr King: No, but that is because there were not any symmetric obligations on the surplus and deficit countries.

Q110 Chairman: If we were to propose the rules.

Mr King: It has to be an agreement that we would subscribe to a set of rules determined within, and enforced by, the IMF. If that is unrealistic and countries are not willing to sign up to that, then, I am afraid, we are doomed to repetitions of the problems that we have seen in which there will be, from time to time, quite significant crises in the world economy, precisely because the positions of the surplus and deficit countries are not co-ordinated, and the problems that result from that in financial markets lead to substantial recessions.

Q111 Chairman: The magnitude of sorting out the International Monetary System is enormous, is it not?

Mr King: It is an enormous task, but the prize is also enormous. The ultimate cause of what we have been through in the last two years was the imbalances of the world economy and the inability to cope with the resulting capital flows, and I do not think it is a question simply of exchange rates, and it certainly is not a question of which currency we denominate trade flows in, it is much deeper-seated than that. It is about ensuring that the policy frameworks of countries fit together, and at present, if you have countries which on the one hand believe in domestic monetary frameworks and floating exchange rates and other countries that believe in development strategies in which a large current account surplus is a key part of that strategy, these things will not fit together well.

Q112 Chairman: Following the Mansion House speech, there were some colourful headlines in the Sunday newspapers like "Darling vs King: Blood on the Tablecloth", and the "Punch and Judy show" of the Mansion House dinner. Is your working

relationship beyond repair, as the Sunday newspapers would indicate, or are they just making a mountain out of a molehill?

Mr King: I certainly do not see any relationship between the headlines in the newspapers and the reality. I have a good working relationship with Alistair Darling. That is almost as true now as it was before. We talk often to each other and there is no problem with that working relationship whatsoever.

Q113 Chairman: In recent testimony to Congress, the Brookings Institute suggested there may be a need for a regulator of systemically important financial institutions. Do you think the UK needs a separate regulator for such firms, and what are the implications for moral hazard from the authorities identifying certain institutions as systematically important?

Mr King: I do not know, and I think we are long way from having a clear definition of what systemically important actually means. What we really need now is a period of reflection and debate about what are the substantive problems in the financial sector. One of the things that I said last week, and the Chancellor said, is, "Let us talk about the substance, not who does what." What is the "what" in who does what? We are a long way, I think, from deciding that. The question of "too big to fail" is a very important issue. It is much too important to sweep under the carpet and say, "Oh, no, it is too difficult, we cannot do it." There are many different approaches to it. I outlined three last week. Paul Volcker gave a speech less than two weeks ago. He is a member of the Obama administration, a former Chairman of the Fed, highly respected. Let me tell you what he said on this, because I think you cannot put it better. He said, "Deposit insurance from central bank liquidity facilities are properly confined to deposit-taking institutions. In my view, it is unwarranted that those same institutions, funded in substantial part by taxpayer protected deposits, be engaged in substantial risk-prone proprietary trading and speculative activities that may also raise questions of virtually unmanageable conflicts of interest." Martin Wolf this morning in the FT also made a similar point. I think that those are two highly respected commentators, and it is not just me; others also say that this issue needs to be faced up to. As to the answer to it, as I said last week, there are three different approaches. You could have one of them or all three in different combinations. One is to have legal barriers to the range of activities that deposit insurance applies to, the other is to impose separate capital requirements, higher capital requirements on banks that take part in these risky activities, and a third, and one on which I put a great deal of weight, and I believe the Chancellor does too given that he mentioned it in his Mansion House speech, is the importance of ensuring arrangements for large and complex banks to be wound down. You cannot have a bank where we simply throw up our hands and say, actually, it is too big to fail; that is the reality; we have to accept it. You cannot accept it. Martin Wolf said, "Either it must be possible to close an institution like that down or it has to be run in a

different way. It is as simple and brutal as that," and we need to face up to that. Those are some of the big challenges we need to look at.

Q114 Chairman: We had the pleasure of meeting Paul Volcker in America a few weeks ago and he made those very points to us. At the time he seemed to be the minority in America, but I think this issue is growing and our committee has identified that and we would like, maybe after the summer, to look at this issue of international institutions and the risk they pose, because it seems that the G20 was focusing on areas like hedge funds where this issue is the big issue, and they have not dodged it, but they have not taken it on the agenda yet.

Mr King: Absolutely. Hedge funds is not the central issue of regulation. Information, yes, maybe in a few exceptional cases we need to impose capital requirements, but the big issue is about the banking sector. We have time to do it. This is not something we need to sort out in the next few days. We can take time, and if you want to come back to us in the autumn I would welcome that.

Q115 Chairman: Okay, fine, but in a way it seems a bit depressing, because it looks like business as usual. When Lord Turner was before the committee yesterday he was talking about aggressive hiring by investment banks and bonuses, and we look at the remuneration package that Stephen Hester got with Royal Bank of Scotland, and when we had one of the remuneration consultants before the committee well over a year ago, Carol Arrowsmith, I think, it was, of Deloitte Touche, we said, "What is the basic remuneration package?", and she said, "Roughly about a million pounds per salary." She had options five to six times their basic salary; bonus two to three times. That is exactly Stephen Hester's, and it seems a bit depressing from this angle: the UKFI in charge of the taxpayers' interests and that type of bonus system being implemented for maybe unambitious targets at the end of the day when the share prices get up to 70 pence. So it seems to me, anyway, that the lessons have been lost pretty quickly and we are back at business as usual. Do you share that dismal view?

Mr King: I certainly share the concerns that you express about that. I am disappointed that it seems to have not yet sunk in that we made a change in the way in which these things are structured, but maybe it will come.

Q116 Chairman: Okay. Hope springs eternal.

Mr King: Hope, in the Bank of England, always springs eternal. Cautious, moderate hope, but hope nevertheless.

Chairman: Okay; thank you, Governor.

Q117 Mr Fallon: Governor, in answer to the question just now about who does what, you said the "what" was more important than the "who", but that was not quite what you said in your speech last week. You painted a rather pitiful picture of a neglected clergyman who was conducting weddings and burials but nobody was turning up for the

sermon, or listening to the sermon. So the “who” does matter to you, does it not? You are saying the voice is not quite enough.

Mr King: No, what I said was—and it is a point which I made to this committee in February, so it was not a new point—what matters is that powers and responsibilities must be aligned. We were given a statutory responsibility for financial stability in the Banking Act, and the question I put to you in February at this committee, to which I have not really received any adequate answer from anywhere, was: what exactly is it that people expect the Bank of England to do? All we can do at present, before a bank is deemed by the FSA to have failed, is to write our Financial Stability Report and give speeches. They are important. We have our next Financial Stability Report coming out on Friday. These are important things, but, in the end, I do not believe that people change their behaviour simply because we publish reports. That is fine by me, I am very happy with that position—if you want us just to publish reports, I am very content with it—but I do want it to be absolutely crystal clear before Parliament that you in Parliament understand that the Bank of England can do no more than publish reports or make speeches. If you are content with that, that is fine by me. What you cannot do is turn round afterwards and say, “But you had the statutory responsibility. Why did you not do something?”, when there is nothing that we can actually do. All I am saying is just align carefully the powers and responsibilities, but, believe me, I have got more than enough work on my plate at present; I am not looking for a whole lot more.

Q118 Mr Fallon: You said last week, “It is not entirely clear how the Bank will be able to discharge even its new statutory responsibility if we can do no more than issue sermons or organise burials.” So, clearly, there is actually an extra power out there that you would like to have.

Mr King: I am not forming any judgment about what powers the Bank of England should have at all. What I said last week is that what we need now is a debate about what powers somebody should have. Let us sort that out first and then, once we have sorted that out, we can allocate it; but when we have allocated powers and responsibilities, it is absolutely crucial (and I think Lord Turner made this point yesterday) that, however they are allocated, powers and responsibilities have to be aligned. At present I do not see a clear alignment for the Bank.

Q119 Mr Fallon: It is a mess, is it not? We have had the confusion of the tripartite when Rock started. We are two years on now. We read every day the Bank is at loggerheads with the Treasury, the FSA is feuding with the Bank, and whatever. Is not the real answer here to cut through all this and give you proper responsibility for the big systemic institutions?

Mr King: I do not want to say what the Bank of England should be doing, I want to make up my mind about that once we have worked out what it is

that needs to be done to improve the regulatory system. Let us work out what we have to do first and then work out who should do it.

Q120 Mr Fallon: Would you object if that power was given to you?

Mr King: That is a hypothetical question. I think we should wait. What I have said is that what I do not want to end up in is a position where the powers and responsibilities are not aligned. There are many configurations where powers and responsibilities could be aligned, with more or less responsibilities for the Bank; what matters most is that they have to be aligned. I do not want to argue for anything, I have never engaged in a turf battle and I have no intention of doing so. You in Parliament have to decide who does what, and I am very content to accept whatever you end up deciding.

Q121 Mr Fallon: You agree that that the powers and responsibilities are not aligned at the moment.

Mr King: Correct.

Q122 Mr Fallon: That is the point you are making.

Mr King: Yes.

Q123 Mr Fallon: It is a mess, it needs thinking about but it needs sorting out.

Mr King: Yes.

Q124 Mr Brady: Briefly, Governor, what you have said this afternoon is very much the same as the exchange we had in February, as you said, but, clearly, the powers and responsibilities were not aligned then; they are not now. You at that point were saying, “It is not for me to say where they should be.” You are now repeating that. Are you not concerned that, unless you are prepared to set out how you see this being properly configured, there is a danger that in another few months you will still think they are not aligned properly?

Mr King: They are not aligned now and I would like Parliament to reflect on that fact, but you have to decide how these things should be aligned and I have no intention whatsoever of engaging in a bidding war. As I have said, I am very content to accept whatever allocation of responsibilities Parliament gives the Bank, provided that those powers and responsibilities are aligned.

Q125 Mr Brady: Governor, I am not saying you are engaging in a bidding war or a turf war, and, yes, it is for Parliament to decide, not for the Bank of England, but is it not reasonable for us to ask your views about how that alignment could best be effected before we arrive at that decision?

Mr King: It is, and my answer is that we have to work out what regulation we want to have, and I do not think we are in that position now. We have not solved the “too big to fail” problem or worked out how to handle it, we have not sorted out what the macro-prudential policy instrument or instruments, in the plural, would be and I think it is impossible to give a sensible answer to the question of who does what. I think we have got to solve that problem first.

I do not think there is any immediate rush to do that. There is a lot of things that need to be thought through before we can decide what are the set of regulatory instruments that need to be available to the authorities, and only then, I think, is it sensible to ask how that should be allocated among the various players.

Q126 Mr Brady: So once we have decided what the regulatory instrument should be, you will give us your view.

Mr King: Absolutely, and we are thinking very hard ourselves about what those regulatory instruments should be, and we are very happy that we can start today and we can carry on in the future.

Q127 Ms Keeble: I wanted ask about a similar thing. Obviously, whilst it might be up to us to decide, we need some input from yourself. In terms of the possible instruments, what is your thinking about those? Would you want to comment on the range of issues that were put up yesterday in terms of the instruments; not in terms of who does what, but in terms of the instruments?

Mr King: If we take the macro-prudential instruments as one set (and we will come on to the others in a minute), obviously making capital requirements a function—not just a fixed number like 8%, but a function of the size of an institution, its complexity, should it be a function of the growth of the financial sector or the growth of the individual institution—I think needs to be thought through. I think one of the interesting aspects of the debate that we in the Bank put weight on, that seems to have disappeared from the British debate but actually has been at the centre of the American debate, is that here you would get the impression that macro-prudential is all about having a means of ensuring that the growth rate of credit or the banking centre is not too rapid. It is the time series aspect. In the United States they have been focusing very much more on the inter-connectedness between banks that Mr Haldane has talked about, and the very high degree of interconnectedness between banks itself is a very good way of measuring the riskiness which that bank is contributing to the system as a whole. What I think we are likely to end up with is not just a simple formula that says if things are growing too quickly raise capital requirements. I think it is going to be more sophisticated than that, because it needs to reflect not just the rate of growth of the financial sector or the institution but also the interconnectedness between institutions. Some banks are more interconnected than others and, hence, impose a bigger risk on rest of the system. What we are trying to capture here, in essence, is to get away from the Basel framework view that you can measure the riskiness of a bank by just looking at its own balance sheet to a view that says, no, we have to look at the risks of the system as a whole, and that means looking, not just at that one bank's balance sheet, but at the pace at which the financial sector as a whole is expanding, the rate at which credit is growing, but also the riskiness created to the system as a whole by the degree of

interconnectedness of banks with each other. My guess is that what we will come out with, therefore, is not just one instrument, which is somebody voting on whether capital requirements should go up or down a bit this month or this quarter, but actually a more sophisticated set of regulatory interventions which may make it more difficult to separate out one macro-prudential instrument from some of the supervisory instruments. For example, on the “too big to fail”, we have talked about the need to ensure that banks create very clear frameworks which explain how they can be wound down. That is very much a supervisory intervention. We have talked about whether they can move capital requirements up and down, because banks are big and complex, but then people say, you cannot legislate to separate out the different parts of banks because it is hard to define the different parts of banking. But if it is hard to define that, it is just as hard to define it in terms of which bits attract high capital requirements. So I think these are tricky questions. When it comes to, for example, a global bank, do you relate the growth that you are concerned about to the British part of the balance sheet, or is it the institution as a whole? These are not simple and straightforward questions. So the broad idea of having macro-prudential instruments is a sensible one, but we are a million miles away, in my view, from having translated that into a very clear set of instruments, and we will have to do it in the coming months, there is no question, and we will keep you informed and in touch with how our thinking goes.

Q128 Ms Keeble: Looking also at the structure that Adair Turner set out yesterday, I know you do not want to talk about structures, but it does seem to provide a way in which the different areas of expertise can be brought together to consider the kind of issues that you have discussed. Would you accept that as a starting point for discussion of a model?

Mr King: I do not think it is the right starting point, no. It may be the right ending point, but it certainly is not the right starting point. The right starting point is to say, “What is it we want to do with the regulation of banks?”, work out what the instruments are and then say, “Given that these are the instruments, what is the right decision-making process to think of to implement them?” I have no idea where we will end up on that. All I would say is this. If creating committees were the answer to our problems, we would not have any.

Q129 Ms Keeble: I understand that.

Mr King: It cannot be the right starting point just to say, “Let us create another committee.” It may be a sensible answer, I certainly do not rule it out, but what I want to do is to discuss the substance of regulation, not who does what.

Chairman: Okay; thank you for that.

Q130 Sir Peter Viggers: Whilst we individually may think we are all a bit of a whiz in helping to design financial structures, you are the experts at the Bank of England, with respect, and we need more clues. If

you are suggesting that we need to spell out the powers and responsibilities, we need to know what the tools are that need to be in the tool box, and then we can, perhaps, in our own way, try to contribute to the dialogue about how the tool box can be designed and the tools can be allocated. For instance, I have submitted for a long time that one should divide regulation, which I regard as box-ticking and the job of the FSA, from supervision, which I think is an overall structural approach, which I think the Bank of England should supply. How do you propose to proceed? Will you make further speeches pointing the way ahead?

Mr King: I think, through our report and speeches and, I hope, evidence to this committee, we will put ideas about what the tool kit should look like into the public debate, but I think it is for others to take the lead in the debate on who does what. Again, I do not want to get into that territory, but we do want to play our part and, I am afraid, I do not have a well-designed tool kit today in my pocket to bring out and say, "This is what the tool kit should look like." We have thoughts, we have ideas, but there is a lot of work to be done and we are doing this, obviously, in conjunction with many of our central bank colleagues abroad, through the Financial Stability Board, and so on.

Q131 Sir Peter Viggers: You gave us a helpful and rather complicated note towards a macro-prudential instrument and it points out that a well-designed macro-prudential instrument exercises control over the liabilities and the assets of financial institutions. It is a complicated point. Would you like to expand on that?

Mr King: Let me ask Andy Haldane, who edits and manages our Financial Stability Report, to come in here.

Mr Haldane: I think in the note we sent to you, which I hope you found helpful, we aim to set out the spectrum of instruments that could potentially be used to influence institutions' credit decisions. Looking through history, some of those instruments operated on the liability side of the balance sheet. So a capital ratio would be one example of that, a time-varying cyclical capital ratio would be one means that the Governor mentioned of exercising some degree of control over banks' lending decisions. Equally, you could think of instruments that acted more directly on the asset side of the balance sheet. For example, loan-to-value ratio caps, loan-to-income ratio caps would act more directly on the loan decisions on the asset side. So, I think, in the note we sent you, what we were aiming to do is not at this stage to plumb for one or other, but to set out, as the Governor said, the menu of options that could be available to bear upon aggregate loan decisions.

Q132 Mr Love: Can I ask you, Governor, about some of the specifics that Lord Turner in his review, and indeed in speeches, has been suggesting to see what your response is? For example, in a speech he

made in New York on 27 April he talked about hard-wiring counter-cyclical, and he is also talking about using formulae at least as a backstop. What is your attitude towards some of those ideas?

Mr King: I think very positive, but, as I say, there is an awful lot of work to do to translate the concept into a practical instrument where you could actually explain clearly to the banks, who would be on the receiving end of this, exactly what it would mean and, then, when you could decide who would actually implement it. This is an idea that has been around for some while, and we certainly have pushed very strongly for this in the international debate too.

Q133 Mr Love: Let me be clear on the principle. You think judgment has a role but there needs to be some specific econometric data?

Mr King: No, I think there has to be a role for, as you put it, judgment, not least because, as I said, one of the things that ought to matter here is not just looking at the rate of growth of the financial sector but also at the risks that are created to the system as a whole from the interconnectedness, and that is a question of judgment. There are other policy instruments in the tool kit that could be brought into play. One of the reasons why, in the Bank, we have been pressing strongly, as have the Americans, for pulling greater weight on central clearing of many derivative type transactions is that this would help to reduce the interconnectedness, in effect, among the banking sector and, therefore, reduce some of the risk. So there are elements of the infrastructure that can play an important role in reducing the degree of risk in the financial sector, hence reducing the reliance on variable capital requirements as part of the policy tool kit. I think this is why, deep down, it may not be easy to identify a single policy instrument which you can say is the macro-prudential instrument. I suspect it will be a range of instruments in the tool kit and their use will depend on many of the other reforms that we would like to see.

Q134 Mr Love: Taking that point, Lord Turner seems to be attracted by the Canadian example of a gross leverage ratio as a backstop, not as a safeguard, a safety net. Do you have any thoughts on that?

Mr King: Yes, I am all in favour of a leverage ratio. I think the Swiss, in particular, found, with a large banking sector, that this was a sensible way to go, and I think one of the big lessons from this is how ineffective, in many ways, the risk adjustments to the Basel ratios were. A vast amount of effort, untold expenses and manpower went into designing these regulations, and in normal times the calculations, I am sure, were much more sophisticated than before, but in normal times it did not matter a great deal. When it really mattered, then the models that were used to estimate the risk were pretty worthless. So this was a very good example, I think, where you need to be careful not to be so complicated and sophisticated and actually miss the big picture, and I think leverage ratios clearly have a role to play there.

Q135 Mr Love: Finally, you mentioned about Basel II not recognising the crisis that was going to hit us, but almost everyone says the next crisis will not be the same as this crisis. To what extent can we try to look forward to what may be the next crisis and what we are doing in terms of regulation?

Mr King: It is very difficult, but I think that is why identifying certain clear principles, rather than pretending that some kind of minor massaging will work, is important, and I think that focusing on the “too big to fail” issue, the size and complexity which our banking system has reached, is a very important part of it, and if you want to reduce the likely frequency and severity of future crises, it is almost impossible to avoid dealing with that issue.

Q136 John Thurso: Can I follow on from that question of size and complexity and return to a discussion we have had before about narrow banks and Glass-Steagall, and so on. Would it be right to say, having listened to the answers that you gave the Chairman, that an overriding objective for all of us should be to find ways to suppress the interconnectivity and reduce the risk of that by one of the three means that you put forward?

Mr King: Yes, I think that is certainly one of the things that I would put enormous weight on. It is not the end of the list; there are many other things. In our Financial Stability Report on Friday we will try to draw attention to some of the areas where attention needs to be focused, but I myself do believe that tackling this issue head on and finding a way of dealing with it is absolutely crucial, because the enormous expansion of risk-taking through proprietary trading activities in institutions which were in receipt of taxpayer financed insurance, using retail deposits to fund a good chunk of that activity, is asking for trouble. I am not saying there is an easy way of handling it—there is not—but I do not know anyone who does not actually think this is an issue that needs to be tackled. There may be some differences of view and emphasis on the right approach to it, but I think everyone recognises that this needs to be tackled one way or another.

Q137 John Thurso: Talking to us yesterday, Lord Turner did not reject out of hand but reiterated his view that the kind of straightforward old-fashioned Glass-Steagall was not the way and that he preferred to go down route of what he would describe in shorthand, I think, as a capital tax. It seems to me that there are lots of things that happen in a big bank, but there are two. At each end there is a function. At one end there is the money utility, which basically ought to be low-risk and receives, in return, a high protection, and at the other end there is an equally valuable role, which is in the kind of capital entrepreneur, the slightly old-fashioned merchant banking. Do you think that those two activities can sit culturally in the same organisation without importing the worst of each culture into the other?

Mr King: I do not know. I do not claim to be an expert on the cultures of banking, but what I do know is that if you put into the same institution, on the same balance sheet, very risky activities which

are financed by, basically, retained deposits which have an implicit state guarantee, then you are going to encourage a lot more risk taking, and that is not a question of culture, it is a question of incentives, and I think that is the most important thing that we need to look at. I do not think the differences in approach here are perhaps as big as have been portrayed. After all, the approach which Lord Turner suggested is one that we had talked about and the Americans have talked about. It is not in the Turner Review, but he has come round to advocating it, I think. It is based on the idea of using capital requirements to make it more expensive to combine these activities. That is only a matter of degree different from saying, if you make it expensive enough, you might as well prohibit it. So it depends on the size of the tax. That, in the limit, is the same as prohibiting it, and if there are difficulties in defining the activities on which to base a prohibition, there are also going to be difficulties in defining activities on which to calculate the tax base. So I do not think these things are quite as different, and I do not have strong views about which way we should go at all, but what I do think is that we should not rule any of these things out at this stage; we should discuss it, debate it, learn from people with experience, talk to them and say, “What is the right way forward?”, and let us have a debate and see if we can design a financial system which is somewhat less prone to crises in terms of their severity and frequency. We will never get rid of financial crises—a bank is inherently a dangerous institution that will generate crises from time to time—but what we ought to be really concerned about is that the impact of these crises and their frequency is not diminishing over time. We get used to the idea that aeroplane crashes are less frequent and that we make passenger transport more safe over time. In the financial sector it seems to be the other way round, and that is why we cannot, I think, just put the issue to one side and say practical people who understand the world know there is nothing you can do about it. That is a counsel of despair, and we cannot afford a counsel of despair given the damage that has been wreaked on the rest of the economy by the problems in the financial sector.

Q138 John Thurso: One last question on this. Do you think there might be a role for looking at the licensing system such that each brand has to have its own licence rather than having one licence for a group of brands, noting that some elements of RBS which were separately licensed actually were perfectly strong and could have been hived off at any time, but extending that across from not only retail to the other side, so that a large bank was an agglomeration of separate licenses for separate activities, so that bits of it could die and be plucked off and pruned without bringing the whole thing down?

Mr King: I am not sure about the licenses. That may be right, but I certainly think that the complexity of banks has reached a point where institutions that

24 June 2009 Mr Mervyn King, Mr Andrew Haldane, Mr Andrew Bailey and Mr Charlie Bean

seem to people, in life, to be one business entity when problems occur, in death, turn out to be a very large number of separate entities.

Q139 John Thurso: It is about legally defining that in advance and making it transparent?

Mr King: I think allowing banks to have become so complex with so many different entities of the same umbrella organisation, many of which are off-shore, is a recipe for creating an institution that nobody can wind down remotely easily and, given how important they are, it is very important that we can wind them down. That is the answer to it, I think, in large part. So I do put some weight here on the resolution issues, and I know the Chancellor is very keen to push this forward at the G20 and to see whether we cannot work with our international colleagues to do more here, but I do not think we can say that if they do not do anything we should abandon it. It is too important to simply say without international agreement we can do nothing. We cannot afford to do that. We have got to take action ourselves irrespective of whether others do or not, and that is clearly the approach of the Americans.

Q140 John Thurso: And possibly take the consequence that some institutions may choose no longer to be domiciled in Britain?

Mr King: Indeed.

Q141 John Thurso: Because, as you rightly put it, what lives internationally dies nationally.

Mr King: Yes

Q142 Mr Tyrie: Do you think that reform of corporate governance has anything to offer to try and sort out financial crises of the types we have seen?

Mr King: I do not know. It may do, and I am sure that there can always be improvement in any form of governance, including corporate governance, so I do not think it is a wasted effort to do it, but I think the idea that somehow non-executive directors are going to suddenly turn themselves from people who have had no impact, and who if only they had done their job this would never have happened, into people who would suddenly prevent executives from running institutions. After all, the job of a non-executive is not to substitute themselves for the executive; it is to pose questions, to pose challenge. In the end I think any well run company is bound to have to accept that it is the executive that runs it and what matters are the incentives facing the executive, and if we create a financial system in which the incentives for the executive and the shareholders are to take lots of risks because that is the profitable thing to do for shareholders, it is very hard to see how you should expect non-executives to prevent that. That is not to say it is not worth making efforts in all these areas to improve things.

Q143 Mr Tyrie: What you said a moment ago was a caricature, where you were implying that these non-executives had no influence.

Mr King: It was a complete caricature, because I think the idea that somehow there is a massive improvement to be had by changing the role of non-executives is, to my view, a bit of an illusion. I think there is a limit to what non-executives can be expected to do. They are, by definition, non-executives.

Q144 Mr Tyrie: I know that you are not keen on hypothetical questions, but were the Bank of England to resume a role in banking supervision, you would also, presumably, restore or want to restore, indeed you are to some degree already restoring, what were very close links with the financial institutions that are based very close to you in the City?

Mr King: I think, irrespective of what powers we do or do not exert in the future, the fact that we are involved in the resolution framework for banks and the fact that we need to produce our Financial Stability Report means that we do need to monitor very carefully what goes on, and that involves having close contact with people in the financial sector. We have done that for a very long time. The markets area of the Bank, one of the first things I did on the first day I became Governor, I asked the Markets Director to set up a market intelligence function, and that has blossomed in the last six years, but we are expanding those contacts. Maybe we made a mistake in saying to FSA before 2007 that we would not tread on their toes. We left them to deal with many of the smaller individual institutions. We may need to expand our range of contacts, because at some point we will, or may, have to act as lender of last resort or may have to act to resolve a bank that is in difficulty. So I think we need to know more, and we will do that irrespective of whether we do or do not obtain any extra powers.

Q145 John Thurso: Can I clarify one point from your remarks, Governor, which was regarding non-executives. I wholly agree with everything you have said, but, if I have understood it correctly, one could say that the greatest failure of corporate governance is the failure of remuneration committees, because it is the one area that the non-executives have the ability to affect the overall behaviour of the executives in the forthcoming time. Is that a correct assumption?

Mr King: I stand corrected. You are absolutely right.

Q146 Mr Todd: Can I unpack the word “big”. There seem to be three components. One is sheer size, the second is the complexity of the business model and the range of products and investments that may be traded and the third is the internationality of the business. How do you weigh those factors, because it has been simplified as “too big to fail”? One can imagine a very big utility bank which presents a very different problem from a bank with a very complex model of activity and one that trades across a wide range of very different territories with very different governance.

Mr King: You are absolutely right. I think for us what brings the different dimensions together is the answer to the question: how easy would it be to resolve this bank; that is to intervene in the bank before the conventional definition of bankruptcy which would create chaos? In the case of an international bank, we saw in Lehman Brothers the complexity that was caused by banks that were, as I said, international in life and national in death, and, therefore, one obvious way to proceed is to ask oneself the question, "What can we do to such institutions to make them easier to resolve?" If we cannot get agreement with other countries about resolution mechanisms, then we may need to say they will have to rely more on separately subsidised operations and less on branches, and, as I said, I think last week, there is great merit in forcing these institutions to submit plans for how they could be wound down so that we know the degree of complexity involved and, if necessary, impose a higher capital requirement relating to the degree of complexity. So that is on the international side. If it is just too big, then I think the question is, if we were to resolve it, how easy would it be to sell the deposit book, for example, to another bank and how easy it would be to sell the asset side? If it is big but simple, then it may actually be relatively easy to resolve.

Q147 Mr Todd: The answers must differ really.

Mr King: The answers will differ according to the impact which the failure will have on the rest of the financial sector.

Q148 Mr Todd: The instruments that you would apply would differ as well, because it would be unreasonable to apply, for example, a very high capital tariff, effectively, to a relatively low-risk utility bank, whatever its size, arguably?

Mr King: Indeed.

Q149 Mr Todd: You said that if we cannot reach international agreement, that is not an excuse for doing nothing. That is clearly true. We have regulatory powers over financial institutions that operate in our country which we can impose for ourselves and, effectively, force changes, at least in the model from which they operate within our shores. Is that not so?

Mr King: Yes.

Q150 Mr Todd: Obviously, international regulation is appropriate, because otherwise many of these institutions would choose to rebalance a business against us if we have acted wholly alone without any comfort from the action of others, but how seriously do you contemplate that kind of arbitrage between different nations if we act alone, as you are perhaps suggesting?

Mr King: We certainly should not be blackmailed into accepting institutions that create the too big to

fail problem because of the threat of going elsewhere, but, equally, I feel this may be less of a problem than one might have thought in the past, because all of our major partner countries feel that the same problem is theirs also.

Q151 Mr Todd: It is no competition to have high-risk banks operating within your shores.

Mr King: Take the Americans, having announced that they are going to have higher capital requirements. They did not worry that no-one else was announcing that; they just did it; so I suspect that is not a major worry. To go back to what I was saying about the G7 meeting in 2008 in Tokyo, it is only 16 months, 17 months ago, but it could have been lifetime ago, but I said around the table to my colleagues, "Why do we not just discuss it. What happens if a named particular large global investment bank one day rang up and said that they were bust? What would we do?" There was laughter round the table because it was unimaginable and we had not got any idea what to do. Now people know that it could happen and we have to have an idea what to do. So I think that through the Financial Stability Board, through the supervisory colleges which people are putting in place, there is a real impetus now behind the idea that we cannot allow large international banks to wander around the world in a situation where no-one can afford to let them fail but no-one has any idea how to resolve them if they do other than put lots of money in. I think the will to tackle that problem is infinitely greater now that it was 15 months ago.

Q152 Mr Todd: One instrument which sounds potentially quite unattractive is attempts to directly regulate the instruments which banks may choose to sell, on the basis, presumably, that innovation will always keep ahead of the individual regulatory decisions a nation might take. Is that reasonable?

Mr King: Yes, and I think the immediate concern is that you just cannot imagine that this is a moment when banks are going to want to rush out and take lots of risk with instruments they do not fully understand.

Q153 Mr Todd: No, but we must try and define this for a generation's pasture which is greener than this.

Mr King: We have to have time to think this through. People have raised questions about product regulation. I do not take any view on that. I am not the expert on that, others are, and I have no objection to that being discussed and considered, but it is not to my mind the main issue in terms of prudential regulation.

Q154 Nick Ainger: Governor, you said earlier, when we were discussing how you should have the powers as well as the responsibilities, that it was important to actually put together what was needed, the instruments and so on, before you decided what the structure was, but last week the European Systemic

24 June 2009 Mr Mervyn King, Mr Andrew Haldane, Mr Andrew Bailey and Mr Charlie Bean

Risk Council was set up. Is that not developing the structure before the actual instruments have been developed? Could you comment on that? Were you actually consulted before this agreement was reached in Europe?

Mr King: This is one of the proposals from the De Larosière report. I think it has already changed its name from the Council to the Board. It will start off, I think, meeting four times a year, and no doubt we shall have very fruitful discussions on it. Any recommendations it makes are not binding on the UK, but it may be a useful forum in which we can talk about these issues and identify it at a European level, and I think for us it is an opportunity to take some of our arguments to the Europeans. I have always been amazed by how obsessed they were by hedge funds. I think we do need to collect information on hedge funds, I think there is now consensus on that, but the idea that this was the regulatory problem facing us was extraordinary in the light of where the problems actually were found and started. So I would like to try and persuade them that actually the banking sector is where you start here.

Q155 Nick Ainger: So you do not actually think that this council will have any serious impact on the UK financial services sector?

Mr King: I do not think it need have any adverse effect, in that none of the recommendations are binding on the UK. I think it is an opportunity for us to open up the debate in Europe and maybe create a more informed discussion about what regulation can and cannot do and what the objectives of it should be. We have a lot of work to do to try and persuade our European partners that we have anything to offer in this respect, given that they associate many of the problems with an Anglo-Saxon financial sector. I hope what we can do is to persuade them that it is not an Anglo-Saxon idea, that banking actually originated elsewhere and that they have just as much an interest in resolving problems in banking as we do.

Q156 Nick Ainger: Senor Bini Smaghi has been critical, saying that because the risk board or council, whatever its title is, will have insufficient power, as you have indicated, over national authorities, it is a wasted opportunity. Do you agree with that? It is a classic argument about Europe again. It is about whether things will be imposed on us or whether it will be good idea to have strict regulation, and so on, imposed on other countries in Europe. Do you think it is a wasted opportunity and that it should have greater powers or are you satisfied with the current set-up?

Mr King: No, I do not think it should have greater powers at this stage, because, again, this is an area where no-one has worked out what powers somebody should have. I think it would be a great mistake to hold back progress domestically in order to wait for some European agreement. I think in

terms of going further than that, in terms of the regulation itself, the Chancellor made the fundamental point last week that there cannot be a pan-European body making decisions that imply the use of taxpayers' funds nationally.

Q157 Nick Ainger: I think it is the Prime Minister rather than the Chancellor.

Mr King: They both made it then. The Chancellor certainly made it—I have heard him make it—and he is right to make it, and I think it is peculiar. Again, there is no alignment of powers and responsibilities. You cannot have a decision made at European level if somebody else is then forced to raise taxes or cut spending in order to finance it. There needs to be an alignment. It is not for me to say where that should be, but there has got to be, somewhere, an alignment. So, I think, no. Whether this body turns out to be a mere talking shop or a useful talking shop, in terms of an exchange of views and ideas being generated, remains to be seen—that is up to the people who sit on it. We will see. I go to vast numbers of international meetings and I cannot claim that most of them live up to the billing that one would hope. Nevertheless, as I said, hope springs eternal—cautious, moderate hope for this committee—and we will do our best to try and raise the level of debate.

Q158 Nick Ainger: Will that debate follow the lines that the US administration has taken, who really appear now to be getting ahead of the game?

Mr King: No, I think it will start from first principles, and it will start from the question of what we think in Europe were the problems that we faced, what went wrong and what do we need to put it right? I welcome that. I think it is right to go back to those first principles, and I am sure that the European Central Bank in the Chair, if that is where they turn out to be, will encourage that debate.

Q159 Jim Cousins: Governor, do you not think that the “too big to wind down” strategy and compelling winding down strategies to be in place for large complex international banks, it is very difficult to see how that would have a lot of credibility without an international agreement?

Mr King: I do not think so, because the problems that we saw following the failure of Lehman Brothers were real problems for the UK with a global bank failing, and I think, one way or another, we do not want to leave ourselves exposed to that again, and if there is no international agreement on it, it does not make sense to leave ourselves exposed to those problems again but to do something domestically. It may not be the first best, I agree. The first best is to try to get an international agreement, and I think the time is propitious to try to do that, and we should certainly put that as our first preference, but I do not think we should adopt the attitude that, if we cannot get that, then there is nothing we can do. That is all I am saying.

Q160 Jim Cousins: Do you think that the way that this particular debate has developed in this country right now, with the appearance of some tensions and disagreements between significant players in all of this, impedes the possibility of recovery and increases the stress on the banking system that we were discussing in the previous session?

Mr King: I do not think it is a good thing. I must say, I think that is why I think all three of us, Alistair Darling, Adair Turner and myself, have all said in the last week that the big question is the what not the “who”, and that is what we are focusing on, but I do not think it has any impact on the stresses facing the banking sector or the chances of recovery, no.

Q161 Jim Cousins: Do you think there is a role for new competition authorities here?

Mr King: Of what kind?

Q162 Jim Cousins: To break up banks: an anti-trust approach.

Mr King: We have those authorities already, and they have already expressed views about competition in banking, and there is no doubt that is one of the issues that it would be sensible to discuss, but I do not think it is obvious we need new authorities; we have already got them.

Q163 Chairman: Governor, you did say earlier that you have no complete tool kit for macro-prudential supervision and you have not finished thinking about it, but could you give us an idea how you will progress that and when maybe you think there could be a settled view and who will be involved in coming to that settled view? Would it involve the Chancellor, the Chairman of the FSA, parliamentary bodies like ourselves?

Mr King: I certainly hope that all of us will be involved in discussing it in one way or another. I think all of us would want to think that, come the autumn, we could take the debate a stage on. I do not think there is any need or any sense in imposing an artificial deadline here because, as I said, we are not facing a situation in which the banking sector is gung-ho and taking lots of new risks. I think it is crucial that we maintain the momentum to consider reform—that is fundamental—and I think that on this committee you have a crucial role to play in that because you can maintain that momentum, but I do not think momentum to debate and discuss reform is the same thing as rushing to judgment on the decisions. We have time to get that, and I would hope that in the autumn we would be able to move to the next stage of this, and certainly we would be happy to come back to you with further thoughts then.

Q164 Chairman: That would be good. How many Bank of England staff are working on macro-prudential supervision at the moment and how many are working on financial stability, Andy?

Mr Haldane: About 140 people.

Q165 Chairman: One hundred and forty.

Mr Haldane: Yes, depending on how you define it. If you define macro-prudential in the broad way that the Governor has defined it (i.e. embracing a range of instruments, some of which pertain to financial institutions, some of which pertain to the structure of financial markets), then in a sense all of those people, plus some of the other directorates, are involved in thinking about those questions.

Q166 Chairman: Lastly, Governor, to go back to the beginning, we say, business as usual, and you said you have had time, and we have had this aggressive hiring in the trading divisions of the City banks mentioned by Adair Turner yesterday. Will we lose the prize? Will we lose the momentum in that if we do not do certain things? Will we let it slip us by?

Mr King: I think the most important thing is not to worry so much what one or two banks are doing now, but we have got to maintain this momentum to have a debate about the form and to put in place a new structure for banking and its regulation. That is the most important thing. If we keep our eyes on that, if we can achieve that, then what happens in the short run elsewhere will not matter, but having that approach in the long run is absolutely fundamental.

Q167 Nick Ainger: What is the process? You have told us that there will be discussions, but what is the actual process? Is there an agenda between the tripartite authorities to address this issue? Will it produce something for consultation at the end?

Mr King: I do not think the tripartite will, as such. The tripartite is not a decision-making body. The Chancellor will no doubt put forward some proposals shortly in July where he said he wants to publish a White Paper on some of these questions. I do not suppose that this is the last word on it.

Q168 Nick Ainger: But you will be consulted in that process before the White Paper?

Mr King: I imagine we will be. We will see. Some of these questions are not for the Bank to decide on, some questions are for government, and it is up to the Chancellor what he says and thinks about that. The most important thing is that we have a proper public debate about it, that this committee plays a role in it, and actually none of us, I think, are in a position where now, hand on heart, we can say we know what the right answer is, and in that situation it is actually very important that we go away and work out what the right answer is.

Q169 Nick Ainger: That is why I am asking about the process.

Mr King: We will go away and think hard about it—that is what needs to be done—and we will be talking to the FSA and Treasury, no doubt, but also talking to our colleagues abroad to share our ideas and thoughts, and many of these things are international issues, and come up with some thoughts and ideas on it, and I hope that the committee will be a forum in which this can be discussed.

24 June 2009 Mr Mervyn King, Mr Andrew Haldane, Mr Andrew Bailey and Mr Charlie Bean

Q170 Chairman: If we believe the jungle drums, the White Paper could be out next week, but you have been consulted on that, Governor, have you?

Mr King: It all depends on your definition of consultation. I have not seen a draft of it, no, but no doubt we will have a chance to see it before it appears. It may appear next week, it may not. It may be the week after that; I cannot say that.

Q171 Chairman: Somebody has come somewhere or other through the Bank, “Do you think this is a good idea, a bad idea, or should we put it in the bin?”

Mr King: We will see. I have no idea what questions will be asked by the Treasury.

Q172 Mr Fallon: But you have been consulted.

Mr King: I have not been consulted on what will be in the White Paper and I have not seen a draft of it, but no doubt at some time I will. There is still time to be consulted on it before it appears, and I am sure the Chancellor will show it to me before it appears.

Q173 Mr Fallon: That does not sound like consultation, showing it to you before it appears!

Mr King: It depends on what is meant by consultation. White Papers tend to get written somewhat faster these days than they used to!

Chairman: That is quite a fascinating answer.

Q174 Jim Cousins: In the earlier session you referred to your good working relationship with the Chancellor and the fact that you regularly discuss matters with him. Clearly the things we have been talking about just now will presumably be part of the good working relationship and the things that you would discuss with him?

Mr King: He has told me that there will be a White Paper, he has not told me the date when it will come out, because, as far as I know, he has not decided the date when it will come out, but I will see it when it is ready and before it appears.

Q175 Jim Cousins: Yes, but just as you have discussed the three alternative approaches you have set out quite helpful for us, presumably your discussions with the Chancellor have also involved those three different approaches.

Mr King: I have no idea what range of issues the White Paper will cover. It may cover some of the things that we have discussed; it may cover some of the things that we have not discussed. I have no means of knowing.

Q176 Chairman: If I were to say to you tomorrow will be Thursday and we do not know what the weather is going to be like, Governor, is your exchange with the Chancellor more meaningful than me saying there is going to be a tomorrow? In other words, have you got a fair idea, a working knowledge of what you think is going to be in this White Paper or is it a blank sheet and you are saying, “Oh, this is a White Paper”?

Mr King: I do not know what will be in the White Paper. Whether anybody else does, I do not know, but no doubt we will discover what is in the White paper.

Q177 Sir Peter Viggers: The tripartite is not a decision-making body; it is the three bodies with responsibility for financial regulation. How can it possibly be that a White Paper is anticipated in the near future without one of the more important parts of the tripartite being consulted on it?

Mr King: There has not been a principals meeting of the tripartite to discuss a draft White Paper. That is all I can say.

Q178 Chairman: Okay. I do not think we are getting much further. I think the important point is in working on this issue, the macro-prudential supervision aspect, Governor, there is a lot of work to be done there. We, hopefully, will play a part and continue that discussion with you, but thank you for your attendance today; it has been very helpful to us.

Mr King: Thank you, Chairman.

Wednesday 8 July 2009

Members present

Mr John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Mr Colin Breed
Jim Cousins
Mr Michael Fallon

Ms Sally Keeble
John Thurso
Mr Mark Todd
Mr Andrew Tyrie
Sir Peter Viggers

Witnesses: **Lord Myners CBE**, a Member of the House of Lords, Financial Services Secretary and **Mr Clive Maxwell**, Director of Financial Stability, HM Treasury, gave evidence.

Q179 Chairman: Lord Myners, welcome to this evidence session on the White Paper. Can I ask you both to formally introduce yourselves for the shorthand writer, please?

Lord Myners: I am Paul Myners and I am a junior minister in the Treasury responsible for financial services.

Mr Maxwell: I am Clive Maxwell and I am a director in the Treasury with responsibilities for financial stability.

Q180 Chairman: I notice from the White Paper today new spirit and Perestroika on pages 150 and 139 about the democratic accountability and your co-operation with the Treasury Committee. Why then have we only had two hours to prepare for this session and you are just bringing the Paper along with you? It does not help us with scrutiny, Lord Myners.

Lord Myners: Chairman, I think the timing of the meeting of the Committee was presumably set by the Committee. I understand that the document was—

Q181 Chairman: No, no, no, we had this set for last Wednesday and then we were told it was going to be put back another week by you.

Lord Myners: Not by myself personally. I was not aware of that. I understand the document was made available to Members of the Committee at 12.20 and to Opposition spokesmen at 11.45.

Q182 Chairman: It does not help the scrutiny for a Select Committee of the House trying to scrutinise this when we just get a pack thrown at us.

Lord Myners: On the other hand, Sir, it gives you an opportunity to engage with it very early on and to help shape the debate which we need to have around issues of regulation.

Q183 Chairman: Lord Myners, that is a real bit of ingenuity. Who are you kidding, pull the other leg. Kitty Ussher brought along her consultation paper a year or so ago and we told her we needed extra time for this, so why can you not take the message back.

Lord Myners: I will, Chairman.

Q184 Chairman: Okay. Now when Kitty Ussher came along with her papers she had financial stability deposit protection and it contained the Bank of England, HM Treasury and FSA stamp, but

today it only contains the Treasury stamp. Is this a reflection of the appalling relationship between the Treasury, the Bank of England and the FSA that you have got to carry this alone?

Lord Myners: I think the relationship between the three bodies is very good. I have seen it at first hand since I became a minister last October in these three bodies coming together to take vital and necessary and confident action both in support of the system and to handle individual institutions which have been experiencing difficulties. This document represents the Treasury's proposals for reforming financial markets going forward and it is a document which has been informed by close engagement on a continuous basis with the Bank of England and the Treasury over several months.

Q185 Chairman: On that close engagement, if we refer to the Governor's appearance before the Committee two weeks ago today, Wednesday 24 June, I said to him: "If we believe the jungle drums, Governor, the White Paper could be out next week, but you have been consulted on that, have you not?" To which he said to me, "It all depends on your definition of consultation. I have not seen a draft of it, no, but no doubt we will have a chance to see it before it appears. It may appear next week, it may not. It may be the week after that; I cannot say". Then he goes on when someone else asked him: "I have not been consulted on what will be in the White Paper" and "I have no idea what questions will be asked by the Treasury". This does not seem like a consultation at all, Lord Myners, this seems like arbitrary action by the Treasury.

Lord Myners: I think, Chairman, the Governor actually answers that question himself in the quotation which you read. It depends on what you mean by consultation. There have been extensive discussions over many, many months about the shape of financial regulation and supervision going forward. At the time that the Governor was asked that question the White Paper was still in early stages of preparation and ideas were being brought together. The Governor was shown, as indeed was the Chairman of the FSA, drafts as soon as we felt that we had a document which came together in a logical and consistent way. Again, the Governor was unclear as to the date of publication because at that time the date of publication had not been set.

Q186 Chairman: For the sake of the public record, and I think this is important, I know you are trying your best to answer a possible question. Wednesday 24 June, the Governor says: "I have not seen a draft of it but no doubt we will have a chance to see it before it appears. I have no idea what questions will be asked by the Treasury".

Lord Myners: I would repeat that as at the time of that statement by the Governor a draft of a single document, as far as I am aware, did not exist that would be recognisable in the context of the document you now have in front of you. I was with the Governor at meetings last week at which the Governor was consulted and the Governor's colleagues. I would like the Committee to appreciate there has been a lot of work with the FSA, the Bank of England and the Treasury in the preparation of this document. You will no doubt have an opportunity later on—

Q187 Chairman: The reason I say that, Lord Myners, is that in terms of the banking crisis inquiry, we started our inquiry in September 2007 on Northern Rock and as a Committee we have been involved as well. The evidence we have received from people is that this is a complex issue, that it cannot be done alone by the Treasury and others and we need to consult extensively. It does not auger well if we get remarks like that and it is in that context that I am putting that to you.

Lord Myners: I do understand the point you are making, Chairman. The Chancellor indicated that he wanted to bring forward a paper of this sort in January 2008 and here we are now in July 2009. There has been very, very extensive consultation, engagement, discussion, review of possibilities, working with other agencies in the preparation of this document, so this is not the work of the Treasury alone working in isolation or in a vacuum, this represents considered opinions drawing on international bodies including the FSB, the IMF, et cetera.

Chairman: Again, for the public record, and then we will move on. In his Budget statement on 22 April the Chancellor told the House he would: "... publish shortly a Treasury paper on banking reform" and almost two months later we are just getting it now and there does not seem to be much consultation, so I think there are lessons to be learned there, Lord Myners.

Q188 Mr Fallon: Lord Myners, when did the Governor in fact see this White Paper?

Lord Myners: The Governor saw a fairly well developed version of this paper in the middle part of last week.

Q189 Mr Fallon: You are the junior minister responsible for financial services and I assume the work of the tripartite. Do you not agree that it is damaging when the Governor and the Chancellor are seen to be at odds?

Lord Myners: I do not think the Governor and the Chancellor are at odds, Mr Fallon.

Q190 Mr Fallon: Do you mean they were at odds and they are no longer at odds?

Lord Myners: No, I did not say that, I said I do not think the Governor and the Chancellor are at odds. I did not put any time qualification around that. I think the Governor and the Chancellor and the Chairman—I can say this with some perspective coming from outside—I find have a very construction and professional relationship in which they openly discuss what the Chairman has said here are very complex issues.

Q191 Mr Fallon: We have had a week of headlines saying they are at each other's throats. It is not very good for the reputation of the City and you are supposed to be in charge of all this.

Lord Myners: As you characterise it, that is incorrect because you are suggesting that there was no contact at all until a week ago and that this document was dropped into the hands of the Governor at that time. What I was saying is that this is the product of ongoing debates and discussions which have been in place since January 2008.

Q192 Mr Fallon: The Governor is happy with this document, is he?

Lord Myners: You will no doubt invite the Governor to give evidence to you. It would not be appropriate for me to comment on behalf of the Governor.

Q193 Mr Fallon: You do not know whether the Bank of England is content with this or not?

Lord Myners: I believe the Governor and the Bank of England have been properly and fully consulted. From my perspective their views have been taken into consideration and are reflected in this document.

Q194 Mr Fallon: That is not answering the question. Are they content?

Lord Myners: I am answering the question, Mr Fallon, in as honest and constructive a way as I can. I am saying to you that if you wish to hear the Governor's views probably the right thing to do is to ask the Governor.

Q195 Mr Fallon: It sounds as if we had better. Just explain to me how you tackled the Governor's central concern in his Mansion House speech that he issues sermons and in past years they have not been followed through. When the Chancellor was asked about this earlier today, he said that they would now be followed through. Could you explain to the Committee how that is to be followed through? Is it through the Council for Financial Stability? What is the new mechanism that transmits the Governor's warning?

Lord Myners: The Council for Financial Stability will be a new empowered forum, accountable, transparent, with published minutes in which will be quite clear, to use the metaphor the Governor used, to the extent that he is preaching sermons there will be enforced attendance in the church and a correct

record of not only the sermon but the subsequent discussion and decisions made in the light of the sermon.

Q196 Mr Fallon: Page 138 does list the new Council's statutory duties—you are putting it on to a statutory framework—but lists them constantly as “discussion” and the Council will have the duty to discuss emerging risk, the assessment of systemic risk, to discuss particular risks to financial stability and so on. All you are really doing is giving the Council a power to discuss.

Lord Myners: No. The Bank of England will have an important platform to present its assessment of credit conditions, pricing the market against fair value, and to give its indication of any action that it judges necessary in respect, for instance, of capital, and then for the discussion to inform the decisions which the FSA take for which the FSA will be accountable in terms of individual capital determinations for institutions.

Q197 Mr Fallon: But the Bank itself will not then have any new statutory power over systemic risk. You have said the sermons will be published and there will be minutes as to what actions various people take as a result of them, but there is not any new power here for the Bank in terms of financial stability or systemic risk, is there?

Lord Myners: The Bank has already been given significantly greater powers in the 2009 Banking Act where it is given a statutory responsibility for financial stability. The Council for Financial Stability will provide a forum in which the Bank's views can be presented, discussed and decisions that are taken will be minuted and recorded and then will be accountable to Parliament through an annual report and, for instance, the Treasury Select Committee.

Q198 Mr Fallon: But it is a forum. The Governor said: “I was given responsibility for financial stability but not the power to carry it out”. You are not, in fact, giving him any new power, are you?

Lord Myners: I think the power the Governor has through economic analysis and voice is a very powerful one, Mr Fallon. We have also said that in reviewing macro prudential supervision, which is a subject which few of us discussed or recognised by that term two years ago, we need to work with other international bodies to see if we can achieve global agreement on how these mechanisms will work and new tools may emerge in due course. There are some things here which are better done globally than domestically alone; indeed to do them domestically may well see them undermined by people called regulatory arbitrage.

Q199 Mr Fallon: Let us just turn to one international thing. You wrote to Michael Connarty, the Chairman of the European Scrutiny Committee, on 11 June saying: “The Government does not agree with the Commission's proposals to give a European body powers to change national supervisory decisions or powers over individual firms”. Yet two

weeks later at the European Council you did agree to give the European authorities power of binding mediation over what the FSA might do.

Lord Myners: Binding mediation providing it does not have fiscal consequences. We actually also have said that we think that would be very rarely used. We have been to the fore in identifying and addressing the need for Europe to look at issues which require agreement in terms of host and home country supervision.

Q200 Mr Fallon: When you said you do not agree with the Commission's proposals to give a European body powers to change national supervisory decisions, you have in fact retreated from that, have you not?

Lord Myners: I do not think we have, Mr Fallon.

Q201 Mr Fallon: But you have conceded binding mediation?

Lord Myners: We have been content to have a mediation process providing it does not have fiscal consequences.

Q202 Mr Tyrie: I would just like to clarify, Lord Myners, exactly what you are saying about consultation because I am still unclear. You said a moment ago that there has been full consultation over a long period with the Bank and with others, so was the Governor of the Bank wrong when he said: “I have not been consulted on what will be in the White Paper”?

Lord Myners: I think the Governor was correct when he said it depends what one means by consultation, which is an answer the Governor has given in the past on the question of what you mean by somebody who is charge. The Governor is extremely precise in his answers. What I am saying, Mr Tyrie, is there has been very, very lengthy discussion over a long period of time about the core issues which gave rise to this crisis and what can be done to create a stronger system in the future. This has not suddenly been sprung on the FSA or the Bank of England. The Bank's officers regularly meet with Treasury officials, as indeed they do with their partners in the FSA.

Q203 Mr Tyrie: Let us try asking the question another way. Does this document fully reflect proposals made to you by the Bank of England during this ‘long period’ of consultation?

Lord Myners: The views of the Bank of England have been fully taken into account, but this is a Treasury document.

Q204 Mr Tyrie: Therefore you would not expect there to be much of a further response from the Bank, would you?

Lord Myners: I think that is for the Committee to establish. I do not think it would be polite or proper or correct for me to seek to answer on behalf of the Bank.

8 July 2009 Lord Myners CBE and Mr Clive Maxwell

Q205 Mr Tyrie: If you were the Governor, how would you feel receiving this very large document with only a week to read it?

Lord Myners: If I received it, Mr Tyrie, with no prior engagement, no discussion, no sense of how Government thinking was evolving and developing, I would be less pleased than is the case in reality where those things are occurring.

Q206 Mr Tyrie: I just want to come back to the statutory responsibility given to the Bank for a moment. The Governor's concern is that he is being given a responsibility but no extra powers to ensure that he can fulfil it. Do you think that is a groundless concern because he already has the powers, or for some other reason?

Lord Myners: I think that the creation of the Council for Financial Stability, the statutory basis on which it will operate, the transparency about its discussions and decisions, will address many of the Governor's concerns as I understand them.

Q207 Mr Tyrie: Do you think what you are publishing here alters in a fundamental way the balance of responsibility and power between the three parts of the tripartite?

Lord Myners: I think it elevates the responsibilities of the Financial Services Authority, new responsibility for financial stability, new powers, and it gives the Bank of England a new forum for articulating its concerns, if it has concerns, about financial markets and the financial economy and, importantly, to set out very clearly what actions it believes should be taken and for the discussions that take place in the light of those views to be properly recorded and minuted, so it will be very clear what the Bank of England is saying. I think it will go from being a statement of macroeconomic observation alone into more specificity because there will be an encouragement for the Bank of England not only to say, "We judge credit conditions to be getting overstretched, values to be deviating from fair value and, accordingly, we believe the following should be done", the FSA and the Treasury will respond and be required to respond to that.

Q208 Mr Tyrie: Therefore, when people come forward, as I am sure they will, to say that the tripartite arrangement was responsible partly for the failure of regulation in this country and that it appears that system is broadly still in place, you would fundamentally disagree with that?

Lord Myners: I think the fundamental cause of the financial crisis must start with the people who were managing the institutions that got themselves into difficulty, but I believe the proposals made here represent a significant strengthening of the processes by which the Bank of England, the Financial Services Authority and the Treasury will work together.

Q209 Mr Brady: Lord Myners, in reply to Mr Fallon a few moments ago who asked what new powers the Bank of England were being given, you replied, "The Bank has already been given significantly greater

powers in the Banking Act through statutory responsibility for financial stability". But when the Governor was here two weeks ago what he said to us was: "... what matters is that powers and responsibilities must be aligned. We were given a statutory responsibility for financial stability in the Banking Act, and the question I put to you in February at this Committee, to which I have not really received any adequate answer from anywhere, was: what exactly is it that people expect the Bank of England to do?" He goes on to say: "All we can do is write our financial stability report". Is it not the case today that exactly the same set of circumstances applies as was the case two weeks ago when the Governor made those comments?

Lord Myners: The Bank of England, of course, does now have significantly greater powers through the resolution arrangements that Parliament conferred upon the Bank under the 2009 Act.

Q210 Mr Brady: That was the case two weeks ago. I am saying what has changed between the Governor's comments two weeks ago and today in regard to that key uncertainty that the Governor had about how his responsibilities and his powers were aligned?

Lord Myners: I think the Council for Financial Stability provides the forum in which the Bank of England will be able to express with considerable clarity, and require a response, their assessment about things such as credit extension, leverage in the economy and mispricing. So I think the Bank has a new platform from which to express views which draws upon the Bank's core competence in macroeconomic analysis of market awareness.

Q211 Mr Brady: You are saying that if the Governor of the Bank goes to the new Council for Financial Stability, if he expresses a concern that the degree of leveraging in the economy is a risk to stability and the Chancellor and the FSA disagree with him then he will have discharged his statutory responsibility completely?

Lord Myners: I think he will have recorded his views on this matter.

Q212 Mr Brady: No, I am not asking you that, he can record his views at present in the reports the Bank publishes. What I am saying is the Government has given the Bank this statutory responsibility, will that responsibility have been discharged when the Governor raises a concern in the Council for Financial Stability or not?

Lord Myners: The terms of reference for the Council for Financial Stability will be determined after consultation but clearly that is the first and critical stage of the Bank's role, which is to inform thinking. The decision on individual institutions, Mr Brady, must rest with the Financial Services Authority which is the competent body for regulating individual institutions.

Q213 Mr Brady: What I am driving at is the nature and meaning of the statutory responsibility that has been given to the Bank. As far as I can tell from what

you are saying the only avenue through which you are suggesting that responsibility can be discharged is by the Governor going to the new Council for Financial Stability and expressing concern.

Lord Myners: I think that is a very powerful way for the Bank to play an important role in ensuring that in future we significantly reduce the risk of macroeconomic instability feeding through into the financial system.

Q214 Mr Brady: How does the Governor know whether he has discharged his statutory responsibility or not?

Lord Myners: The Governor will discharge his statutory responsibility by participating fully in the process in accordance with the terms of reference that are ultimately set and reflected in legislation for the Council for Financial Stability.

Q215 Mr Brady: So he will completely discharge his statutory responsibility if he reports to that Council according to its terms of reference?

Lord Myners: That is for Parliament to determine but clearly that is the critical factor, Mr Brady, and you are right to identify that. I agree with the central thrust of your observation although, depending on Parliament's judgment on this, the Bank may have additional responsibilities.

Q216 Nick Ainger: Following on from that, you said earlier that these ideas were not sprung on the FSA or the Bank, there has been a long consultation and so on. The concept of the Council for Financial Stability, when was that discussed or did it appear in the draft White Paper that was presented to the Governor last week?

Lord Myners: I think it developed over recent weeks as a consequence of discussions between Treasury officials, Ministers and people from the Bank and the FSA.

Q217 Nick Ainger: Had those discussions been taking place before the Governor expressed his concern?

Lord Myners: Not in the language and terminology with which it is now presented. At the time we were still considering a variety of different models. We were testing one solution against further solutions but importantly concluded that at the core of an effective system there needed to be judgment. We felt the architecture of the three bodies coming together was a fundamentally sound one and should not be dispensed with, but we were working through a mechanism whereby, for instance, we could increase transparency. This group will now meet on a formal basis and the dates of its meetings will be pre-announced.

Q218 Nick Ainger: I am looking at the document itself so I do appreciate what its purpose is. I am trying to tease out the timing issue. Was this idea of the Council for Financial Stability put in the White Paper as a result of the concerns expressed by the Governor?

Lord Myners: The views expressed by the Governor, Mr Ainger, were taken extremely seriously, as were the views expressed by the Chief Executive and the Chairman of the FSA, and indeed the Deputy Governor who also joined discussions with the Chancellor, myself and senior Treasury officials. There were a fair number of people sitting around the table discussing various options and the Chancellor setting out his thinking and seeking reactions to that orally and then inviting both the FSA and the Bank of England to go away and reflect on that and come back with their considered views and then a further response. This is an iterative process that took place over a long period of time. It is not, therefore, the decision of a single individual but rather the Council for Financial Stability bringing together a group of people with a broad range of knowledge and experience.

Q219 Nick Ainger: The final draft that went to the Governor, that would not have been the first time the concept of the Council for Financial Stability would have been put to him?

Lord Myners: That is correct, Mr Ainger.

Q220 Nick Ainger: Can we move on. Goldman Sachs have announced that they intend to pay bonuses globally of \$20 billion. This week, it was also revealed that Goldman Sachs and Barclays Capital were inventing schemes to reduce the capital costs of risky assets on banks' balance sheets. Given those two things, has the financial industry actually learnt the lessons of the financial crisis, or is it business as usual?

Lord Myners: I cannot speak to the specifics of the reports that you mention on Goldman Sachs or Barclays, but it is very important that we do not forget the lessons, and this Paper, I think, shows that Government is not failing to learn the lessons that we are talking about: enhanced capital; strengthening corporate governance through the work of David Walker and the FRC; ensuring that remuneration is no longer likely to be a source of mischief in the way that it has been in the past; a style of supervision by the FSA which they have described as being "intrusive, close and continuous"; and working with international bodies to learn lessons about how accounting and capital issues can be procyclical. I think that throughout this document we are learning the lessons and reflecting that in policy, going forward. As far as behaviours by individual banks are concerned, I will come back to a theme which I have often adopted both in this Committee and elsewhere, which was that we must have stronger and more effective corporate governance and better stewardship by shareholders because, at the core, institutions will fail not because of regulation, but fail because of the decisions which are being taken by the boards of directors and, in many cases, endorsed by shareholders, so I think learning the lessons, learning the lessons of banks not understanding the risks that they were taking. I met the chairmen of a number of the audit committees of the banks at the beginning of this year and I was not, on the whole, impressed by their

8 July 2009 Lord Myners CBE and Mr Clive Maxwell

understanding of some of the more extreme points of risk, tail risk, correlations, the sorts of questions that Mr McFall asked about a year or so ago, and investment banks, when invited to explain what a CDO-squared was, one would have expected a greater technical knowledge than I saw, so those points, Mr Ainger, I think, need to be addressed. Also, shareholders of the big institutions need to be playing their role there.

Q221 Nick Ainger: Okay, but what can the FSA and the Treasury do because we have had evidence all the way through our inquiries into the banking crisis and one of the themes is that innovation will always be ahead of the regulators? When you read this sort of stuff in the current climate, that Goldman Sachs and Barclays Capital are clearly moving into a new area of innovation, what should the Treasury and the FSA be doing to ensure that we are not going backwards to where we were when unacceptable risks were being taken?

Lord Myners: Firstly, there is a new requirement that the FSA should advise the Chancellor twice a year on new areas of innovation and their consequences for systemic risk and any statutory changes that will be required to take account of that. Secondly, we are addressing the perimeter of regulation where risk may lie, having previously not been appropriately identified, measured and monitored, so, for instance, I can think here of conduits, SIVs and the activities of hedge funds. Thirdly, the proposals from Sir David Walker, I imagine, will increase the technical requirements of directors and non-executive directors and, fourthly, I think we are likely to see enhanced risk disclosure to shareholders, so at multiple points, I think, the risk of reckless innovation is more likely to be identified earlier and checked.

Q222 Sir Peter Viggers: In his statement today, the Chancellor went out of his way to point out that the FSA and the Bank were independent of Government, “who are, and will remain, independent of Government”. Will the Council for Financial Stability be independent of Government?

Lord Myners: The Council for Financial Stability will be under the chairmanship of the Chancellor of the Exchequer and to that extent, you could argue, it was part of Government, but the capacity of the FSA and the Bank of England to speak openly and to reflect their own views and not be leaned on, I think, is undoubted.

Q223 Sir Peter Viggers: Also, the Chancellor of the Exchequer said that the Council will draw on the expertise of the FSA and the Bank, and goes on to say, “by looking at their regular reports and formally responding to recommendations”. That sounds a bit limp. Is it meant to be a dynamic organisation?

Lord Myners: In the end, much of this depends on behaviours and judgments. From my experience both in the private sector and now working in Government, architecture is important, but it is not the defining fact. The defining issue is how people conduct themselves and the judgments that they

make, so I think that this test of how the Council for Financial Stability will respond publicly to the issues raised by the FSA and the Bank about financial stability is going to be terribly important.

Q224 Sir Peter Viggers: But, if this body is chaired by the Chancellor of the Exchequer, how frequently will it meet? Will it have an executive function?

Lord Myners: I think it is envisaged that it will meet approximately four times a year to discuss the bigger outlook questions about the state of the economy and the financial risk. It will obviously meet, as and when required, to deal with specific issues, as has been the case with the Tripartite Committee, but this is a formal coming together of the members of the Council for Financial Stability to discuss the bigger economic outlook which, I think, will be three or four times a year.

Q225 Sir Peter Viggers: My next question was going to be: what role will the Treasury seek in macro-prudential analysis and supervision?

Lord Myners: The Treasury will look to the Bank of England to take the lead on macroeconomic analysis, although the Chairman of the FSA has also said that he wants to strengthen the FSA’s ability to analyse and think strategically, so we will have a coming together here, I think, of some very well-informed people, but drawing on their own particular areas of expertise.

Q226 Sir Peter Viggers: I just wonder how well this whole idea has been thought through. How many people will the Council for Financial Stability employ?

Lord Myners: It will have appropriate secretariat support, but the organisations that participate in the Council for Financial Stability will be employing 5,000 or 6,000, the FSA, the Bank of England and the Treasury.

Q227 Sir Peter Viggers: Yes, but that is double-counting. Basically, the Tripartite—I am looking at comments by Lord Turner—“did not work and there was a crucial failure which was the key cause of the crisis”. This sounds like a sort of umbrella to try to make sure that the Tripartite talk to each other.

Lord Myners: I think it will elevate a level of discussion between the three entities and, importantly, for it to be transparent, so it will be very clear what the members of this group are saying, the recommendations that they are making and the actions that are being taken, but the Council for Financial Stability will not itself have executive powers.

Q228 Chairman: Will it have the grip and the overlap that we were looking for originally with the appointment of the Deputy Governor of the Bank of England, in other words, there will be no hiding place and it will be all out?

Mr Maxwell: It is a similar sort of issue; it is a forum which, because of its formality, will allow these sorts of issues to be raised properly and to make sure that there is a response for which people will be accountable.

Q229 Ms Keeble: One of the issues that both the Governor and Lord Turner focused on was what tools there should be. Now, if this organisation is only meeting four times a year and it does not have executive powers, then who is going to actually exercise the tools once they are developed?

Lord Myners: Well, of course some of these things, Ms Keeble, are already happening. For instance, the FSA is clearly now taking into consideration, in setting capital requirements, issues around organisational complexity and scale and their assessment of external risk as identified through stress-testing in a way which was not being done in the past, so we are already evolving into a form of macro-prudential awareness and regulation.

Q230 Ms Keeble: Sorry, but that does not deal with the issue about the toolkit which obviously the Governor wanted and which there has been a great deal of discussion about. Who is going to actually have the executive powers to take the actions that are decided on by the Financial Stability Council?

Lord Myners: Well, if they are decisions, Ms Keeble, around capital, then that responsibility to ensure that the views of the Council on risk are then articulated in terms of capital and capital adjustment will rest with the FSA.

Q231 Ms Keeble: There did seem to be a bit of an emerging consensus in some ways about the structures in that it seemed to be that the Governor thought it would be his structure and the FSA would have a seat on it and be involved in it. This particular structure, has it been discussed with the Governor?

Lord Myners: Yes, it has.

Q232 Ms Keeble: What was his response?

Lord Myners: The Governor understands why the Chancellor has proposed this structure, and I am sure that the FSA, the Bank and the Treasury will work together in the course of the consultation and the response to that to ensure that we come up with a structure which works very well.

Q233 Ms Keeble: Today, in the House of Commons, the Chancellor said that the tools were still being developed. Now, we did not, I did not have a copy of the report then, but actually, looking through it, I have found about five references, I think, to the tools. Page 9 has got the existing tools which you were describing, page 44 has capital and liquidity, page 69 has got reference to a regulatory toolkit, including capital requirements, and page 85 has got risk-based tools, including leverage and countercyclical tools, and again it was discussed that these are things that people want, although they do not have an idea as to what they should be. For something which, I thought, was going to be quite a

major focus of this White Paper, those are pretty sketchy ideas of regulatory tools or a toolkit. Can you expand on this any more?

Lord Myners: Well, I think the nature of the challenge we face is complex and of a very broad front and, therefore, there is a broad range of regulatory and supervisory responses. To talk about a toolkit, each toolkit needs to be fit for the particular purpose for which it is going to be used. The new toolkit, if you like, is in the area of a recognition globally, not just us in the UK, that central banks, regulators and academics failed, on the whole, to see the build-up of systemic risk across the financial system, so we need to develop mechanisms to handle that. Some of those will rest with the Financial Stability Board, some with the European Systemic Risk Committee and some of them with the Council for Financial Stability, as recommended in this Paper. There are other areas where the toolkit now comes in the form of enhanced capital requirement, enhanced supervisory engagement by the FSA, greater awareness to risk and incentivisation in compensation, so there are multiple toolkits at work here, Ms Keeble, to address different areas of need.

Q234 Ms Keeble: But do you not think that that creates a bit of a muddle? It might not be possible to get a simple lever like interest rates and inflation, that, I think, is quite clear, but what you are describing is the Council and then you have got the Bank with its Financial Stability Committee and you have got two toolkits, one used by the Bank and one by the FSA, but it is not quite clear what is going to trigger those and exactly what is expected to work as a result of somebody doing something.

Lord Myners: Well, I think that one of the issues which is still evolving in terms of global thinking is what response mechanisms will work and how they can best be managed to deal with a build-up of financial risk, but clearly capital adjustment is a very important one, as would be controls on loan to value, for instance.

Q235 Ms Keeble: Looking at your consultation questions at the back at page 138 onwards, you have got lots of questions about different things, but not about any of the regulatory tools or what kind of measures people might need. Why is that, that the toolkit is still work in progress?

Lord Myners: Well, I think that these will be invited from a broad range of bodies and individuals.

Q236 Ms Keeble: No, there are no questions about that in the back of your document and I wondered why not, given there are questions about lots of other things.

Mr Maxwell: I understand that most of the questions focus on the legislative changes that would be required. For those sorts of changes to international regulation, and I will check, but it is my understanding, that many of the different sorts of tools that we have been talking about about the countercyclical arrangements, for example, will

8 July 2009 Lord Myners CBE and Mr Clive Maxwell

come up in international fora which the Treasury, the FSA and the Bank will attend, as appropriate, and will no doubt consult on as part of those processes.

Q237 Ms Keeble: I would not accept that those are just questions about legislative changes; I think they are general questions about advice and what people think about things like, “What are your views on this proposal to expand the role of the FSCS?”, which is a fairly general question, and I am quite surprised there is nothing in there about, “What tools or instruments, do you think, would be the most effective?”

Lord Myners: Well, I think the most effective tools, quite clearly identified throughout the Paper, are capital adjustment, leverage caps and regulations relating to riskiness around individual lines of business, for instance, loan to value where the Prime Minister has asked the FSA to bring forward some recommendations later this year.

Q238 Ms Keeble: I just have one question on transparency. There is a lot of mention throughout this about the need for increased transparency. Would you accept it would help if perhaps the Treasury would accede to this Committee’s request that we get quarterly reports on the lending levels by the banks and set an example?

Lord Myners: Quarterly evidence on?

Q239 Ms Keeble: The lending levels.

Lord Myners: I think there are now monthly reports, are there not, from the Bank of England?

Q240 Ms Keeble: To you or to us?

Lord Myners: I think they are published, are they not, the monthly lending reports from the Bank of England, one of which was published about ten days ago, but I can see some merit in ensuring that this Committee receives additional information on our assessment of lending markets, and I will certainly go away and discuss that with officials and with the Chancellor.

Q241 John Thurso: Is it the intention of the White Paper to propose a resolution regime for failing banks which means that no bank will be too big to fail?

Lord Myners: The central thrust of the Paper, Mr Thurso, is to ensure that, as a result of enhanced governance, regulation and supervision, the risk of failure is significantly reduced, that banks have to internalise through capital the likely consequences of failure and that they have to have in place plans for coping with a resolution in the way that can ensure that it is swift, efficient and limits the cost to the taxpayer, this last item having been raised recently by the Governor and building on some proposals which we originally published in January 2008.

Q242 John Thurso: I am not sure if that was a yes or a no.

Lord Myners: It was the best answer I could give you, sir.

Q243 John Thurso: Well, let us try again. Throughout this document and in the Chancellor’s statement, he talks about the importance of reducing the impact of failure. It is on page 13, at paragraph 463, paragraph 489, it is in the Turner table that is there and at 519 it says, “Effective resolution mechanisms are an important element in maintaining failure as a credible option for large and complex firms”. The Paper accepts that these firms will fail, so is it the intention to have a resolution regime which means that banks are not too big to fail?

Lord Myners: It is the intention that a resolution regime will work, regardless of the size of the institution.

Q244 John Thurso: So I will take that as a yes. What in the White Paper hopes to achieve that because, as far as I can see, all of those things I just cited were in the 2009 Banking Act and, apart from the paragraph on the living wills for banks, there does not seem to be anything else that is new, so is there anything actually new that will achieve that objective?

Lord Myners: Well, I think the additional powers which Parliament gave for banking resolution in the 2009 Act are very important in this respect. The FSA is also indicating that larger organisations, all things being equal, are likely to have higher capital than smaller organisations, and what you are describing as the ‘living will’, I think, is a very important step forward. We have certainly found in some of the troubled institutions over the last six months that something akin to a living will would have been hugely helpful and even, quite frankly, for quite small organisations, like the Dunfermline Building Society.

Q245 John Thurso: I quite accept that, but the thrust of my question is that, effectively, there is nothing new in the White Paper, other than the living will, but in fact what the White Paper is saying is that the 2009 legislation, the Banking Act, is sufficient to create that resolution regime, which means that big banks can fail and be dealt with.

Lord Myners: That is correct, but it is important to see that alongside the fact that increased regulation and supervision, more capital and stronger liquidity requirements reduce the risk of failure in themselves.

Q246 John Thurso: If I can move on to another point, a clear effect of the financial crisis has been the concentration of both players and products, the contraction of both in the market, that the market is a smaller place in terms of both products and players, and possibly the single biggest contraction came from the shotgun marriage of HBOS with Lloyds. Given the intention to foster competition, is it not now the time to recognise that that was a deal which should not have happened and to arrange an amicable divorce?

Lord Myners: I think the move to increase concentration in the provision of financial services is another global phenomenon. In almost every market of which I am aware, we have seen a move towards fewer providers and the integrated universal

banking model has become a more compelling one. The merger of Lloyds and HBOS could give rise to reduced competition as a result of industry concentration and that is, quite rightly, receiving the focus and attention both of the European Union in respect of state aid decisions and also our own comments about the need for the FSA and the OFT to be alert to the need to maintain competitive and efficient markets.

Q247 John Thurso: Given that we had to pass secondary legislation suspending the competition rules in order to allow what is now the First Secretary of State to rule that this merger could go ahead, because it almost certainly would not have gone ahead without the suspension of that legislation given the intense worry expressed to this Committee by many consumer organisations, and given that it was conceived at a time when people thought the whole banking system was all right and it was just one bank which had a problem and, therefore, the compelling need for it vanished pretty quickly, would it not be sensible just to accept all these points and not carry on trying to force through something that will probably be unpicked by Europe anyway?

Lord Myners: Well, I would not accept the characterisation of “forcing through”. This was a transaction which enjoyed the full support of the boards and shareholders of the two banks.

Q248 John Thurso: That is why it was a shotgun wedding. If you have a shotgun in your back, you say yes.

Lord Myners: I think that the shareholders of the two banks concluded that this was a good thing to do, and I think you have had Mr Eric Daniels in front of you giving you the same view.

Q249 John Thurso: Yes, and I expressed the same doubt then. Can I ask one last question, which is: why has the Government so comprehensively rejected the ‘narrow bank’ concept, which so many people around the world feel is an answer which should be more thoroughly debated before being rejected?

Lord Myners: Well, I would hope that the Paper actually does address, in a serious and considered way, arguments both around Glass-Steagall, the narrow/broad bank issue and also the issues around scale, and I think it concludes the notion—

Q250 John Thurso: I could not find it, though I only had an hour to read it, so where might I find that?

Lord Myners: Mr Maxwell is familiarising himself with that at the moment because the only editions I have ever seen of this document are ones which have come off a word processor printout and I did not see it any sooner than you did. It is page 74.

Mr Maxwell: Pages 74 and 75 set out a number of the arguments.

Lord Myners: I think the answer, Mr Thurso, lies in the fact that narrow banks got themselves into just about as much difficulty as large banks. Narrow banks, for instance, would clearly cover Northern

Rock, Bradford & Bingley, and in America it would cover Fannie Mae and Freddie Mac. These were very narrow organisations in terms of the scope of their activities, but they still got themselves into considerable difficulties, so dividing the world into narrow banks and broad banks does not in itself mean that you necessarily reduce risk.

Q251 John Thurso: The utility banks have a culture of reasonably low risk and, in return, receive the insurance of taxpayer support and the investment banks are, quite rightly, in the business of being much riskier and of acting in quite a different way. The problem seems to be that they have each imported the worst of each culture into each other’s and it is the cultural problem that caused much of the problem in many of the institutions that failed. If you separate them, you are likely to get a return to more stability of culture and, to reverse the point, the fact that some banks survived did not actually mean there is not a problem with the system.

Lord Myners: Well, I think the elements, Mr Thurso, would take us towards the conclusion that the riskier aspects of banking, those activities that some have described as ‘casino banking’, although I think that is not an appropriate way of defining it, but nevertheless it is a shorthand, must in future carry significantly higher capital requirements than they have done in the past. I saw the culture issue; I was a Director of NatWest in the late 1990s and I did see at first hand the issues of culture to which you refer and I think you are absolutely right in your observations.

Q252 Mr Todd: I have looked again at the objectives of the Bank of England in the Banking Act. I had the pleasure to sit on that Committee, and I need a lot of reminding, but the objective of the Bank “should be to contribute to protecting and enhancing the stability of the financial systems in the United Kingdom”. It is suggested that an objective is established for the FSA, so will it be similarly worded?

Lord Myners: I think it probably would be, but there will be consultation and Parliament will obviously discuss that, but I think we need to be clear that everybody has a responsibility for financial stability and nobody can say, “This is not my area of concern”.

Q253 Mr Todd: Does that help in clarifying accountability if everyone has an objective?

Lord Myners: I can see the weakness, and I could see the supplementary question emerging as I gave you the answer, but I think that everybody has a clear responsibility to contribute towards financial stability in respect of those activities for which they are responsible.

Q254 Mr Todd: But we took the trouble to set up the Financial Stability Committee when I was sitting on the Banking Bill and that of course already has a chunk of cross-membership within it. The Treasury sit on it and, since it is made up of members of the Court of Directors of the Bank, among the Court of

8 July 2009 Lord Myners CBE and Mr Clive Maxwell

Directors are people from the FSA. I am puzzled as to the purpose of this Committee in relation to the Council for Financial Stability which the Chancellor has said he wishes to set up now because, I have to say, this was sold at the time, in the statement supporting it, as the solution to our financial stability problem and we had this Committee of the great and good because we were going to clear out the Court and establish a new membership which would properly resource this new Committee.

Lord Myners: Well, I was a member of the Court until last October and I did occasionally attend the Financial Stability Board meetings and I fully support the changes that Government has made and Parliament has approved in terms of reducing the size of the Court, giving the Bank a statutory responsibility for financial stability and creating a new unit within the Court structure.

Q255 Mr Todd: Could I just stop you there and just pick up the word “responsibility” which you perhaps carelessly used then. In fact, the word used is “objective”. It would be great if responsibility were clearly attributed in this process, but that is not actually what has happened.

Lord Myners: Well, my understanding from recollection, because I was in part responsible for taking this piece of legislation in its latter stages through the other place, is that the Financial Stability Committee of the Bank of England is a sub-committee of the Court and has such powers as the Court might wish to delegate to it, but it will be part of the process of shaping the Bank’s conclusions on the macroeconomic outlook. It is important that we get the views not just of the Chairman and the Governor but of the organisation, and one of the things which the Chancellor has suggested, as far as the Council for Financial Stability is concerned, is that it might be agreed that non-executive members of the Board of the FSA and of the Bank of England’s Financial Stability Committee should be invited to make contributions to discussions and meetings.

Q256 Mr Todd: It is still more difficult to understand the distinctions or, at least, what clear distinctions one might look for between the functions of the two bodies, but let me just tweak out a detail which came up in the Banking Bill. There is not an obligation on the FSA to provide detail to the Bank of their encounters with banks which may pose systemic risk; it is merely hoped that they will. Is that a shortcoming in the communication which may be addressed in this process?

Lord Myners: Well, one of the things which we have said we will consult on is the flow of information to the FSA and that the FSA acts as the gateway for passing information on to the Bank.

Q257 Mr Todd: Part of the sort of intellectual basis of this appears to be to give the Bank more of a voice. Well, they have a number of voices already and I think the Governor has perhaps wanted more than just a voice. To make the voice fully informed, they need the data.

Lord Myners: I completely agree with you, and I think to have a structure in which any of the contributors felt they did not have adequate access to information to formulate their views would be a deficient one, so one of the issues which we will be discussing with the Bank, the FSA and with Parliament is whether any additional information is required and how that information should flow to the FSA and through the FSA to the Bank of England.

Q258 Mr Todd: Let me turn to another subject completely. That one gets quite a lot of attention, but it is quite hard to understand. This one is one where, although there has been quite a lot of discussion, there does not seem to be a great deal said about it in the White Paper, which is the principle of using countercyclical capital requirements. It is in there. Mr Maxwell is looking for it, but I know it is in there. My reading of this, and it is abbreviated because of the time we have been allowed, was that this was recognised as an issue which we needed to discuss internationally partly to avoid arbitrage—yes, he is nodding, good—and that there were no really concrete proposals to address this particular issue. Am I right in that? Lord Turner suggested that these should be “hard-wired”, although wires, hard or otherwise, are not in this.

Lord Myners: I would have to see, Mr Todd, the context in which Lord Turner used those words, but I think they are issues of judgment. I do not think one wants to have a system where automatically things trip.

Q259 Mr Todd: So the Spanish model did not much appeal?

Lord Myners: Well, the Spanish model is an interesting one.

Q260 Mr Todd: Give a concrete, hard-wired example.

Lord Myners: Well, it is suggested by some that it was hard-wired. I think we do need to take account of two things, first, that the Spanish banks have been significantly funded by the ECB and, second, that the Spanish residential housing market has certainly overheated to a far greater extent than was the case in the United Kingdom, so I think we should be careful not to conclude that we just simply have to copy what the Spanish did.

Q261 Mr Todd: Nor did I suggest it.

Lord Myners: No, I know that you did not, but I am making that point.

Q262 Mr Todd: All I am saying is that we do not seem to be a lot further down this track through the White Paper. There is a discussion of, admittedly, difficult issues of how to square this in an international environment, but we do not get much beyond that.

Lord Myners: I think we are being very, very straightforward about this. The concept of leaning against the wind and removing the punchbowl is a very simple one to describe. The practice of

implementation, when it is done, against what background it is appropriate to make the changes and what those changes are going to be are not ones for which there are simple answers. In the end, I think, it is a matter of judgment and it is important that we work with organisations, such as the Financial Stability Board, to try to get some agreement across the world of how this will work.

Q263 Mr Todd: When you say the “Financial Stability Board”, you mean?

Lord Myners: I mean the IMF’s FSB.

Q264 Mr Todd: Presumably, one of the other complexities will be calling what the cycle is, if we can define it as such.

Lord Myners: Yes, I think you are absolutely right because macro-prudential supervision, as simplistically explained, says that, as values become stretched, credit becomes more expensive or more prohibited through leverage caps or through increased capital requirement. That is very simple to say. I think what we are saying, to be quite honest, is that it is going to be significantly more difficult in implementation, but I believe that those decisions, informed by the Bank of England, and let us be clear that the Bank of England’s perspectives here are very, very important, and then implemented by the FSA is a very workable model.

Q265 Chairman: When we commenced our Northern Rock inquiry, we had the Tripartite Authority representatives along and we asked if they had done their job individually and everyone said that they had done it handsomely and, when I asked the Governor of the Bank of England, “Who’s in charge?”, he said, “Can you define that for me, please?” Therefore, the question really arises now with this new body: why is having three people responsible for financial stability better than having no one responsible? Who has got their neck on the line here? Who will get fired if things go wrong? After all, only such an outcome can concentrate the mind.

Lord Myners: I think, Chairman, if you give me 30 seconds, I will come to answer your question. The issues around economic analysis, and we have not really talked at all about global imbalances which are right at the core of where these problems originated and which still need to be addressed through the IMF, the G20 and other bodies, but, if you get back to the core issues, they need judgments on the macroeconomic outlook and on translating that into direct actions both for the system and for individual institutions. Those judgments would be needed to be made, regardless of whether they were in a single organisation or within a triangular body. That is to say, if we said, “Let’s put all the powers with the Bank of England. Isn’t that simpler? Let’s go back to where we were. Let’s forget the fact that that system in itself at the time was found not to have worked too well, but let’s put all the regulatory responsibility back into the Bank of England”, I am suggesting that the Bank of England itself would need to develop something similar to a bringing together of different perspectives within the one

institution, so that tells me that the necessary skills are built into the structure we are proposing here. Who is responsible? The Bank of England is responsible for macroeconomic analysis and judging where we are in the credit and valuation cycle and the FSA is for translating that into individual supervisory determinations, including, in particular, capital. The FSA is quite clearly responsible for conduct of business and the FSA is quite clearly responsible for forming a view on governance, although that responsibility for governance ultimately lies with the shareholders, so I think there is very clear responsibility here for each aspect of the structure.

Q266 Jim Cousins: Lord Myners, unless we get lending going, we are going to be in this state of difficulty for many years to come and competition between financial institutions will be one of the big drivers that will get lending going again. How does this document help us to get that competition?

Lord Myners: Lending will depend upon confidence in the economy and the ability of banks to lend, the ability of banks to lend, in turn, on their capital and their access to deposits. This is creating a structure which, I hope, will encourage greater confidence in the British banking system and in our financial markets and that will create the backdrop for the efficient provision of credit.

Q267 Jim Cousins: If we are going to be heavier on capital requirements and if any institution is going to have to go through this profound ruling-class space created in the Council for Financial Stability and against the background in which securitisation is as good as stopped, wholesale funding is as good as stopped, foreign lending is as good as stopped and new mortgage lending, which was one of the drivers of competition, is as good as stopped, how on earth are we going to get that competition in lending that is going to drive our economy forward?

Lord Myners: Well, I think the British banking system continues to be a very competitive one. What I am suggesting is that at the moment the relatively slow rate of new credit availability is less to do with capital than people’s reaction to the underlying economic situation.

Q268 Jim Cousins: Can I come to some practicalities because in an earlier answer you made it clear that the Government is wedded to the Lloyds/HBOS consolidation, the Government makes it clear in this report that it is committed to maintaining RBS in the form that it is now, the only exception seems to be Northern Rock and the European Commission have made it clear that the Government’s proposals for Northern Rock are to split it into a so-called ‘good’ bank with a mortgage platform and £16 billion-plus of deposits and a so-called ‘bad’ bank of £65 billion-plus worth of mortgage book. Now, how does that help competition, unless the Government is proposing to dispose of the good bank part of Northern Rock at a fairly early date?

8 July 2009 Lord Myners CBE and Mr Clive Maxwell

Lord Myners: Well, we have said that we would like to dispose of our investment in Northern Rock as and when we think it is in the taxpayer's interest, it will contribute to competition and will not undermine financial stability. We have also said very clearly publicly and again in this document that it is our intention to turn the Royal Bank of Scotland and the Lloyds Banking Group to full private ownership as soon as practicable, consistent with those objectives. There are also proposals in this document to enhance competition by promoting access to commercial markets to provide new forms of capital to mutuals. We are very alert to the need for Government to promote good competition in the financial services market in general and banking in particular.

Q269 Jim Cousins: Well, Lord Myners, look at this: if we go to the example of Bradford & Bingley, which was effectively broken up into a good bit and a bad bit, the good bit, £20 billion-plus of deposits, was sold to Santander to be part of another massive consolidation of the market of financial services providers for £400 million, leaving £50 billion worth of mortgage assets in the public sector to be carried on for years, the largest single tranche of buy-to-let mortgages that exists. Now, when we come to the three nationalised banks we have got now and we consider the issue of competition, Lloyds/HBOS stays consolidated, RBS stays not broken up and the smallest component, Northern Rock, is going to be split into a good bit to be sold to whomever to promote competition, leaving £65 billion worth of historic mortgage book still in the public sector for many years to come. How is all of that either good for competition or good for the taxpayer?

Lord Myners: Well, Northern Rock failed to meet its threshold obligations and, therefore, failed as an organisation and, through the resolution mechanism, we are now coping with that.

Q270 Jim Cousins: Lord Myners, that answer is precisely the problem with this document. Could we please stop fighting the last war and start fighting the war we are actually in now?

Lord Myners: Well, we are committed to ensuring that we have an effective and competitive banking system and we have specifically laid out requirements for the FSA and the OFT to ensure that we have healthy competition in retail, small business and commercial banking in the UK.

Q271 Mr Breed: I do not know about the others, but I feel totally underwhelmed, having waited all this time for this White Paper, now to have got what we have got. It is pretty underwhelming really and it just seems to me that it proves we are in real danger of creating more authorities, boards, bodies, councils, committees and meetings than we have actually got banks to supervise, if we are not careful. We are in a sort of situation where we are trying to cut through undergrowth where the forest seems to be growing faster than we can cut it down. Anyway, can I just go back to a point raised by my colleague John Thurso about culture, because I think it is much deeper than

perhaps we recognise, and how far away we have come from what were perhaps our traditional thoughts. A culture some years ago of responsibility, integrity, honesty, good service and professional relationships with customers and clients has been replaced by irresponsibility, greed, obfuscation, denial, poor service and unprofessionalism in their dealings. Now, if we can get back to something similar to what we did have, then your task, our task and everybody else's task is going to be a lot easier, but again what I think Nick Ainger was saying is that there is no evidence whatsoever in the City at the present time that they have any intention of returning to that and, if we do not get something back to that, then light touch, hands-off regulation and everything else is a total and utter waste of time because we are not going to be able to achieve that. What we see in this White Paper so far is very little real action. Can you give us an indication of how sort of embryonic this is, and what is the next stage to actually get to real grips with the institutions that have caused this crisis because I do not think this White Paper excites us that you are going to do that at all?

Lord Myners: I think, Mr Breed, I disagree with your final conclusion, but I agree with many of your earlier observations. I would go back to something which I said earlier, that we must not lose sight of the fact that in the end the problems arose from behaviours and judgments and the solutions lie in improving behaviours, issues around trust, service, to which you refer, and judgments. No amount of good regulation or supervision will in itself guarantee that you will make up for poor governance, poor management and a poor culture. Now, you talk about the City and I think it is very important, and I know that, as you have worked in the banking industry, you are aware of this, but the City is a small part of the financial services and banking industry and it would be very dangerous, and I know you are not in any way suggesting this, but the media characterise me as tempted towards thinking that what happens in the City is representative of what happens in banking. Well, 99% working in banking are extraordinarily hard-working, they are loyal, they are dedicated to their task, they are moderately paid, they are honest, they are not greedy and they are fair, and the problems that we have seen in the world banking system have tended to come from a small number of people at the top of large banks, backed up, I am afraid, by often quite supine shareholders who did not behave as responsible owners. Now, I think it is very, very important to keep that in mind, that the answers here cannot just lie in new bodies and new entities created. I think the Council for Financial Stability will be an important addition. I think over time this Committee will regularly meet with them and I think that their deliberations will receive very close scrutiny, but they in themselves cannot guarantee or legislate for improved behaviours, and your signalling there, I think, is so important.

Q272 Mr Breed: Just to change this completely and to go back to the European side, what actually is the state of discussions and negotiations with Brussels in

respect of some sort of supervision of multinational banks? Where are we in that? Michael Fallon was saying about imposing mediation, but that is just a sideshow to a certain extent. Where are we with the guts of all of this?

Lord Myners: The Financial Stability Forum, which has now become the Financial Stability Board which is part of the IMF superstructure, introduced the concept of colleges of supervisors two years ago, applying to the world's 30 or so largest banks.

Q273 Mr Breed: And that is going to be the answer?

Lord Myners: Well, I think banks which are operating in multiple regimes with multiple regulators do need some form of co-ordination, otherwise we are just on a global scale seeing some of the same problems which we had prior to 1997 in the UK when you had a proliferation of regulatory entities like IMRO, PIA, SIB and others.

Q274 Mr Breed: That is the role of the European body in terms of supervision, is it?

Lord Myners: The European Systemic Risk Committee, which is being established by de Larosière's recommendations, will be monitoring the performance of these colleges, as will the Financial Stability Board, because in regulation the answer has got to lie globally, regionally and nationally.

Q275 Mr Tyrie: I just wanted to ask why it is that it says here that, "Full impact assessments of these proposals are available on the Treasury website", but, as far as I can tell, they are not. I wondered why they had not been published.

Mr Maxwell: I think they should be published and, if not, it is because they are simply just not on the website yet. I can go back to the office and check, but my understanding is that they physically would need to be put on to that site.

Q276 Mr Tyrie: I asked to see them so that I could have them for this meeting and they are not there. I was told that they would hopefully be published tomorrow. Has the Governor of the Bank seen them?

Lord Myners: I am not aware whether the Governor has seen them.

Mr Tyrie: Good Lord! I have no further questions.

Q277 Mr Fallon: One of the specific points the Governor made to us in the major passage of the last Banking Act was that he wanted power in the Bank to seek information about individual institutions, which was refused to him during the progress of the Banking Bill, I think, in your House and on which you appear to be snubbing him again. Why is that? Why should he not have that power?

Lord Myners: Mr Fallon, I would never snub the Governor, I have high respect for him, and the Government would not either. What we have said is that, to make this new structure effective, it is very important that the FSA and the Bank of England have access to the information that they require to make a full and proper contribution, so we are going to consult and discuss on the flows of information,

but it would be foolhardy to create a structure in which the Bank of England, on whom we are placing very considerable reliance and responsibilities, was somehow denied access to information which they regarded as vital to perform their role in respect of systemic financial stability.

Q278 Mr Fallon: So they would not have to go through the FSA? You are in fact reconsidering this and they might be able to go direct to get the information from the institution? Is that right?

Lord Myners: I think, Mr Fallon, the important thing is that they get the information that they require, but at the same time we also need to make sure that we are sensitive to the need to minimise the burden on business and to ensure, therefore, that the gathering of data is consolidated through as few access points as possible, so there is a strong logic for saying that the FSA should be the natural gatherer of information and that there should be a gateway process that allows such information as is necessary for the Bank to fulfil its statutory responsibilities to flow through that gateway. That is something which we have said we will continue to discuss and consult on.

Q279 Mr Fallon: Yes, but that is the present position. The Governor has said he wants the power to be able to go directly. Now, I am not quite clear whether you are now saying that you are prepared to look at that again or whether you are still snubbing his request.

Lord Myners: No, I repeat, I would never snub the Governor or indeed snub anybody else.

Q280 Mr Fallon: But you are not agreeing to his request.

Lord Myners: Well, I think the Governor is saying he needs the information, or he wants to be able to ensure that he has information, necessary to fulfil his statutory duties. I am not sure that the Governor is much concerned about whether that information comes directly or through the FSA, as long as he gets the information, and on that I am in agreement with him.

Q281 Ms Keeble: Just to recap on the structures, you have got the Council, which is non-exec and meets once a quarter, and then the FSA and the Bank both with a financial stability objective, but no clear powers set or no tools to actually do what they are supposed to do over what they have already got. Now, that is not a structure which I would have come up with, though I guess there is an argument which could be made for it, but we have not heard it and I just wondered once again if you could give the rationale for why that structure rather than any other.

Lord Myners: I think there are many structures that have merits, and indeed I was very clear in my earlier answers to the question about the process by which this document has been produced, taking into account the views of the FSA and the Bank of England, and that we tested a number of solutions. We believe that this is a model which firmly draws upon the respective strengths of the participating

8 July 2009 Lord Myners CBE and Mr Clive Maxwell

institutions and then within the FSA and within the Bank they, in turn, have their own structures and focuses of excellence. I think, for instance, the 2009 Banking Act, in creating a new Financial Stability Committee with members of the Court supposed to comprise solely of executives, will significantly raise the contribution that will come from that Committee, so I see this as a group of interlocked entities all contributing towards a system of much greater robustness in the future than was the case in the past.

Q282 Mr Todd: The words “financial stability” have dominated this session. Are we any clearer in understanding what they mean?

Lord Myners: In the course of preparation for the Banking Act going to the House of Lords, I read the committee stage *Hansard* and I know there was considerable discussion—

Q283 Mr Todd: There was.

Lord Myners:—about the meaning of “financial stability”, and I think, from recollection, that the best definition was the one which came from Mr Nigel Jenkinson of the Bank of England, but I think it is an issue which can be debated at some considerable length. In some ways, it is one of those things it is easier to identify when you do not have it than when you do have it.

Q284 Mr Todd: That is true, but, since we are setting objectives or even major responsibilities in this matter, it would not be a bad idea to at least have some broad agreement as to what we mean.

Lord Myners: Well, I think that that may well be something which the Council for Financial Stability will give early priority to. If I may go back to Mr Tyrie, I understand that the impact assessments will be on the website this evening, and I apologise they were not there earlier.

Q285 Mr Tyrie: But the Governor has not had a chance to look at them in advance?

Lord Myners: I think that the Governor has been fully consulted and involved in every aspect of the key recommendations in this Paper.

Q286 Mr Tyrie: You have to agree, do you not, that really much less has changed than many thought would change as a consequence of this White Paper? It does look a bit like rearranging the three key deckchairs on the *Titanic*. In fact, one wonders whether they have even moved place.

Lord Myners: No, I see it rather differently, Mr Tyrie. I see it as a significant reinforcement of existing processes and protocols.

Q287 Chairman: Well, we are concerned about your not being nice to the Governor, Lord Myners! Have you reduced the role of the Bank to that of a chorus in a Greek tragedy where it tells you what is going to happen, but it cannot intervene to change the final normally horrific result?

Lord Myners: I see the role of the Bank as being one of the key actors in—

Q288 Chairman: A Greek tragedy!

Lord Myners:—this particular story.

Q289 Chairman: Okay, we will leave it there. Now, plans to forge a new toolkit, which Sally was on about, I think we should be returning to that in the autumn, and we have not given due justice to the consumer element in the White Paper as well, so, given that this is a long road that we are traversing, if we have you back some time in the autumn, maybe we can take these further and you can elaborate on that then, Lord Myners. I know you will look forward to that!

Lord Myners: Thank you for your courtesy.

Written evidence

Written evidence submitted by the Bank of England

TOWARDS A MACRO-PRUDENTIAL INSTRUMENT

At its hearing on 26 February, the Treasury Committee requested from the Bank of England a paper on counter-cyclical macro-prudential instruments (MPI).

The rationale for an MPI is well illustrated by the events over the past decade. In the UK and internationally, monetary policy was aimed at stabilising the overall level of inflation. It achieved that in part through balancing aggregate demand and aggregate supply in the economy. At the same time, financial regulation focussed on the conduct and resilience of individual institutions. For much of this decade that approach appeared to work well, with demand and inflation stable. There were also very few failures of financial institutions.

But no instrument or institution was charged explicitly with controlling overall financial conditions, except insofar as this affected inflation, aggregate demand or individual institutions. In that environment, bank balance sheets grew unchecked. Between 2000 and 2007, they roughly trebled in size. Latent vulnerabilities built-up within the financial system. The credit crisis of the past 18 months has exposed those vulnerabilities, with highly adverse consequences for both the financial system and the real economy.

With hindsight, there was a gap between the macro-economic and the micro-prudential arms of policy. The growth of the financial sector might have been moderated, and the subsequent crisis made less painful, had there been an instrument filling the gap between the macro-economic and the micro-prudential—a macro-prudential policy instrument. If implemented correctly, this might have resulted in a more stable path for both the real economy and the financial sector.

This is easier said than done. Implementation challenges for an MPI are considerable. This paper provides a preliminary assessment of some of the key operational issues involved in the design of an MPI. These include:

- Key design features of an MPI (objectives, instruments);
- Potential objectives of an MPI;
- Potential instruments for implementing an MPI;
- Practical problems in implementing an MPI.

DESIGNING A MACRO-PRUDENTIAL INSTRUMENT

From the second World War up until the early 1980s, various quantitative restrictions were placed on UK commercial banks in an attempt to stabilise their balance sheets and thereby the real economy. This historical experience provides lessons for the design of an MPI. MPIs are intended to curb cyclical variations in credit provision. But they may also lower average amounts of credit being provided to certain classes of borrower, thereby potentially constraining growth.

The sub-prime experience in the US is salutary. With hindsight, this is seen as a period of laxity in credit provision, with large costs for the US and global economies in general and for US home-owners in particular. But it is important not to forget that, ahead of crisis, the relaxation of credit constraints for large cohorts of previously credit-constrained US households was seen as a success story. In designing an MPI, the key is to find a balance between these factors.

At a high level, the key design features of an MPI are threefold:

- Objectives: *What* is the MPI seeking to achieve?
- Instruments: *How* is the MPI calibrated to achieve these objectives?
- Institutions: *Who* is charged with implementing the MPI?

These decisions follow a natural sequence. For example, without first defining the underlying objectives of an MPI, it is difficult to determine which instruments are most appropriate and how they should be adjusted. And decisions on the objectives and instruments of an MPI should logically precede decisions on who should operate it.

Over the past couple of months, there have been several reports from the official sector internationally and from the academic community on the design of an MPI. Several international committees are also engaged in work programmes. Annex A lists some of those reports and committees. In general, these reports have tended to focus on the “who” more than the “what” and the “how”.

A better starting point is “what” and “how”. But the choice of objectives and instruments raises difficult analytical and practical issues and potential trade-offs. The remainder of this paper focuses on those operational issues.

OBJECTIVES OF MACRO-PRUDENTIAL POLICY

The current debate on MPIs has illustrated that, as yet, consensus on objectives has not been reached. To illustrate, at one end of the spectrum are a set of proposals which are essentially about making banks more resilient against cyclical variations in the economy. They are, first and foremost, about ensuring the safety and soundness of banks and their depositors and creditors. These measures have been the focus of official sector reports to date.

One example of such a policy is “dynamic provisioning”. This is a set of rules which aim to ensure banks set aside sufficient reserves for a cyclical downturn, providing an additional cushion for banks and thereby better enabling them to maintain lending during a recession.¹ This regime has operated in Spain for a number of years. Leverage ratios—a measure of banks’ assets relative to their equity—are a second potential counter-cyclical measure.

At the other end of the spectrum are proposals which are essentially about dampening the growth in credit. Policies which adjust regulatory ratios, or margin requirements, in response to excessive credit growth or asset price inflation would fall into this category. These measures have been discussed in a number of academic reports. They go beyond dynamic provisioning, which did not appear to constrain credit growth in Spain much over recent years.

At present, both sets of policies are being captured under the “macro-prudential” umbrella. But these measures could operate in different ways, potentially requiring different instruments and placing different informational demands on the authorities. They may also have potentially different implications for the behaviour of the financial sector and the real economy.

The current UK conjuncture provides a good illustration of the potentially different objectives an MPI could serve. If the only concern at the present time was protecting banks from the downturn, the authorities would be raising capital requirements to provide an extra buffer. But on broader macroeconomic grounds, there is a case for actually lowering capital ratios, so giving banks extra flexibility to lend. Before hardwiring either approach into the design of an MPI, it will be critical to understand and evaluate these different approaches and their consequences.

INSTRUMENTS OF MACRO-PRUDENTIAL POLICY

There are several aspects to this, including:

(a) *Which instrument?*

In theory, an MPI could be used to exercise control over almost any aspect of banks’ balance sheets—for example, capital or debt on the liabilities side, or lending on the assets side. This control could also be exercised using either prices or quantities. Annex B sets out some options and provides some examples.

Choosing between these instruments involves trade-offs. It involves balancing the desire to exercise leverage over credit supply decisions on the one hand, and the desire to minimise effects on the commercial decision-making of financial institutions on the other. For example, adjusting regulatory capital ratios would be one means of operating an MPI. This would cause less interference in banks’ decision-making. At the same time, its impact on banks’ lending choices would be indirect and thereby uncertain in extent. For example, it is unclear whether lowering capital ratios for banks at present would encourage them to lend.

Instruments that act directly on the assets side of banks’ balance sheets—for example, direct lending controls or prescribed loan-to-value ratios—would strike a different balance. They would, on the face of it, score better in terms of their influence on credit supply decisions. That is why, for example, the UK authorities have during this year used lending agreements to support the economy. But this would come at the expense of greater impact on, and hence potential distortion to, commercial banks’ decision-making.

This is a second area where further analysis of the operational choices, and the tradeoffs they present, would be essential before putting an MPI into practice.

(b) *Single v multiple and rules v discretion?*

Other dimensions to instrument choice include whether there should be one instrument or many, and whether that instrument should operate according to a predefined rule or be discretionary. Earlier UK experience is revealing here. Multiplying the number of restrictions on banks’ balance sheets was rarely beneficial. It added complexity and thus distortion without any correspondingly greater degree of control. As in a monetary policy context, this suggests there should be a strong preference for simple, targeted measures wherever possible and we should aim to avoid a proliferation of instruments.

On rules versus discretion, a case can be made analytically for an MPI having rule-like features. Rules can reinforce the credibility of a regime, by acting as a bulwark against forbearance—for example, offsetting the inevitable incentive to avoid raising required capital ratios when a credit boom was in full swing. Rules also increase clarity and hence policy transparency.

¹ See, for example, Box 6: Countercyclical measures, Bank of England Financial Stability Report, October 2008.

Against that, the inflexibility of fixed rules can be a constraint in some circumstances—for example, if underlying behaviour in the economy is changing. That is one of the key lessons from history. When implementing restrictions on banks' balance sheets, whether for prudential or macroeconomic purposes, Goodhart's Law (that historical relationships are apt to change after a policy is implemented) has been an ever-present problem.

This may point towards an MPI needing to operate within a framework of “constrained discretion”, combining some rule-like features with some discretion. By analogy, this is now widely accepted internationally as the optimal framework for the implementation of monetary policy.

PRACTICAL IMPLEMENTATION

There are a large number of potential practical problems in implementing an MPI. These arise almost irrespective of the precise operational model. Many of these practical issues hinge critically on the choice of end-objective. They include:

- *Institutional scope of regulation:* Historical experience suggests that there will inevitably be strong incentives to avoid regulatory rules: for example, Regulation Q in the US stimulated the euro-dollar market in London; the 1970s “Corset” in the UK encouraged disintermediation, for example through the acceptances market; and, more recently, Basel I stimulated growth in the shadow banking system. At a minimum, this calls for a degree of flexibility when determining the appropriate institutional scope of an MPI. More broadly, however, this underscores the importance of determining the appropriate objective of an MPI. If the aim is to protect depositors, this suggests a focus on deposit-taking institutions. If the focus is on credit supply, this may speak to a potentially different set of institutions.
- *International scope of regulation:* An important additional complication is the treatment of cross-border banks. Without consistent application of the regime internationally, there would be strong avoidance incentives—for example, by booking business in countries where the macro-prudential regime was looser or non-existent. Consider a London branch of a Swiss bank lending to a US firm expanding its operations in Germany. Who should operate the lever, to which entity should it apply and calibrated to whose credit cycle? There is no easy answer to those questions. The answers are once again importantly influenced by the objective of an MPI. If the objective is resilience of the financial system, then conditions in Switzerland and the UK become central; if the objective is stabilisation of the credit cycle, then credit conditions in the US and Germany become a crucial determinant.
- *Consistency with other policy instruments:* A successful MPI will support the other arms of policy—macro-economic policy and micro-prudential policy. This suggests there needs to be consistency between these arms of policy. Objectives are again key. Narrower macro-prudential tools call for consistency with micro-prudential instruments; broader macro-prudential tools for consistency with monetary policy.
- *Bank-specific v system-wide calibration:* Should macro-prudential tools be calibrated to individual firms' own balance sheets positions or to the balance sheet of the system as a whole? A case can be made for either and the case rests, once again, on end-objectives. The greater the orientation of an MPI towards the resilience of the banks, the stronger the case for calibrating to individual institutions' balance sheets. The greater the orientation towards dampening the credit cycle, the more important becomes the need to calibrate interventions according to system-wide financial conditions and behaviour.

NEXT STEPS

There is now a clear consensus in favour of a counter-cyclical MPI. That is considerable progress and it is important that this opportunity to reform the financial system is pursued. At the same time, if an MPI is to be implemented, it is crucial that it is robust and credible. That will require a considerable programme of work to tackle the operational issues raised above. It will also require a broader consideration of other tools to increase systemic resilience.

The experience with monetary regimes suggests that process cannot and should not be rushed. There is time to consider carefully the design of new instruments. Nor should the process be conducted piecemeal, with initiative layered on initiative without a clear sense of direction. The law of unintended consequences applies forcefully when introducing new policy instruments. The aim should be to deliver a macro-prudential regime which both matters and which lasts.

9 April 2009

Annex A

SELECTED REPORTS AND COMMITTEES ON MACRO-PRUDENTIAL INSTRUMENTS

TABLE: SELECTED REPORTS AND COMMITTEES ON MACROPRUDENTIAL INSTRUMENTS

Official sector reports

IMF: “The Perimeter of Financial Regulation” (2009) available at: www.imf.org/external/pubs/ft/spn/2009/spn0907.pdf

IMF: “Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets, and for Liquidity Management” (2009) available at: www.imf.org/external/np/pp/eng/2009/020409.pdf

IMF: “Lessons of the Global Crisis for Macroeconomic Policy” (2009) available at: <http://www.imf.org/external/np/pp/eng/2009/021909.pdf>

G30: “Financial Reform: A Framework for Financial Stability” G30 Report (chaired by Paul Volcker) (2009) available at: www.group30.org/pubs/recommendations.pdf

FSF: “Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System” (2009) available at: <http://www.fsforum.org/>

FSF: “Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience” (2008) available at: http://www.fsforum.org/list/fsf_publications/tid_110/index.htm

Basel Committee, Speech by Chairman Wellink: “Basel Committee initiatives in response to the financial crisis” (2009) available at: www.bis.org/review/r090330a.pdf

EU: “Report by the High-Level Group on Financial Supervision in the EU” (chaired by Jacques de Larosiere) (2009) available at: ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf

FSA: Turner Review and DP 09/ 02: “A Regulatory Response to the Global Banking Crisis” (2009) available at: www.fsa.gov.uk/pubs/discussion/dp09_02.pdf

US: The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (“Paulson plan”, 2008) available at: www.treas.gov/press/releases/reports/Blueprint.pdf

US: Framework For Regulatory Reform (Geithner’s “outline for regulatory reform”, 2009) available at: <http://www.ustreas.gov/press/releases/tg72.htm>

The Tripartite Review Preliminary report (2009) by James Sassoon available at: <https://www.tripartitereview.co.uk/>

Academic reports

“The Fundamental Principles of Financial Regulation” (2009) by Brunnermeier, Crockett, Goodhart, Persaud & Shin available at: <http://www.voxeu.org/index.php?q=node/2796>

“Restoring financial stability: how to repair a failed system” (2008) edited by Viral Acharya and Matthew Richardson. See: <http://whitepapers.stern.nyu.edu/home.html>

“New Ideas for the London Summit” (Chatham House and Atlantic Council) (2009) available at: www.chathamhouse.org.uk/publications/papers/download/-/id/727/file/13733_r0409_g20.pdf

International Committees with work underway

Financial Stability Forum (Working Group on Market and Institutional Resilience)

Basel Committee on Banking Supervision

EU Economic and Financial Committee (Working Group on Procyclicality)

European Banking Committee/Committee of European Banking Supervisors (Joint working group on supplementary measures)

Committee of European Banking Supervisors (Expert Group on Prudential Requirements and Working Group on Cyclicity)

EXAMPLES OF BANK BALANCE SHEET INSTRUMENTS

<i>Side of the balance sheet affected</i>	<i>First variable affected</i>	<i>Policy tool</i>	<i>Comments</i>
Liability side	Quantities	Capital Requirements (floor)	These requirements could take many different forms. For example, a discretionary counter-cyclical buffer, or non distributable cyclical reserves (“dynamic provisioning”).
		Core funding requirement (floor)	Liquidity regulation could impose constraints on the extent to which banks can use less stable sources of funding to grow rapidly. The FSA’s proposed “core funding ratio” is an example of this.
		Margining requirements (floor)	Broad-based collateral arrangements or a margin-setting authority could enforce margining rules.
		Controls on the growth of banks’ IBELs [interest-bearing eligible liabilities] (ceiling)	For example, the “Corset” (used in the UK during the 1970s). This scheme penalised banks whose IBELs grew faster than the prescribed rate.
	Prices	Deposit rate ceiling (ceiling)	A deposit rate ceiling could be used to constrain banks’ ability to expand rapidly, funded by high-paying retail deposits.
Asset side	Quantities	Lending controls (ceiling)	Direct controls on the quantity of bank lending were in place prior to the introduction of Competition and Credit Control in 1971. Between 1965 and 1971, ceilings were used to target a specific rate of lending growth.
		Loan-to-value/Loan to-income ratios (ceiling)	This approach was used in Hong Kong in the 1990s. The HKMA had a recommended maximum LTV ratio in 1991 of 70% for property lending.
		Cash reserve requirements (floor)	Requirements to hold government bonds or cash reserves deposited at the Bank.
	Prices	Loan rate control (floor or ceiling)	If used as a ceiling, loan rate control would choke off lending, because it would hamper banks’ ability to lend to higher risk customers. If used as a floor, control of the loan rate could act directly on the demand for credit.

Supplementary written evidence submitted by Dr Kern Alexander

BANKING CRISIS: REGULATION AND SUPERVISION

The credit and financial crisis has exposed major weaknesses in UK banking supervision and regulation. This written evidence elaborates further on the issues discussed at the Treasury Select Committee’s hearing on 23 June 2009. Specifically, it will address the recommendations set forth in the Turner Report with respect to capital and liquidity regulation and the FSA’s supervisory responsibilities for cross-border banks that operate in the European Union. Further, it will address the regulation of the shadow banking sector, and the meaning of macro-prudential regulation and how it should fit into the UK’s reformed regulatory framework.

1. *The need for macro-prudential regulation*

UK financial regulation will need to expand its focus to include not only individual financial institutions and investor and depositor protection, but also the broader financial system. This means that UK supervisors will have to manage and control systemic risk in the financial system by monitoring the aggregate levels of leverage in the financial system and by adjusting micro-prudential regulation of individual firms to take account of macro-economic factors. One of the major failures in UK regulation over the last ten years was that prudential regulation was too market-sensitive; it focused on the individual institution and did not take into account the level of risk or leverage building up in the whole financial system. The FSA thought that, if individual firms were managing their risk appropriately, then the financial system would be stable. This failed to take into account the fallacy of composition that what appears for individual firms to be rational and prudent actions in managing their risk exposures under certain circumstances can, if followed by all firms, potentially produce imprudent or sub-optimal outcomes for the whole financial system. The challenge now is to link micro-prudential regulation of individual firms within a robust macro-prudential framework.

2. *Counter-cyclical capital adequacy rules*

Capital adequacy regulation will need to become more rules-based. The main aim of Basel II and the Capital Requirements Directive is to make bank regulatory capital more sensitive to the economic risks which individual banks face, while ignoring the larger social risks which bank risk-taking poses to the financial system. Indeed, the FSA has adhered to the Basel II approach by permitting banks to use their own economic capital models to measure credit, market and operational risk and to estimate lower levels of regulatory capital than what regulatory rules would normally require. An important weakness of the CRD/Basel II is that it fails to address liquidity risk, which precipitated the present credit crisis, and allows banks to hold lower levels of regulatory capital for assets which banks securitize through special purpose vehicles in the wholesale debt markets.

Another weakness of Basel II/CRD is that it is procyclical because regulatory capital calculations are based on the riskiness of assets on the bank's balance sheets. Rather, regulatory rules should impose counter-cyclical capital requirements, such as higher capital charges during an asset price boom and lower charges during a market downturn. The experience of using counter-cyclical capital rules—or dynamic provisioning—in Europe has generally been positive. Spain had counter-cyclical capital rules which led to their banks having more capital than other banks in Europe and, therefore, they were able to withstand the crisis much better. Spanish banks did not receive bailouts from the Spanish Central Bank. The FSA and other EU member states should adopt counter-cyclical rules as well, and they need to be somewhat formulaic, but there should be some regulatory discretion to adjust their application to changing market structures and financial innovations.

3. *Rules versus discretion in capital regulation*

It is necessary to have a rules-based capital adequacy regime in order to bind the regulator's actions so that they do not acquiesce to political pressure by failing to apply counter-cyclical capital rules. A rules-based regulatory regime is also necessary in the European Union where many member state regulators are, by law, required to have more rules-based regulatory regimes and the regulators are not allowed so much discretion as, say, the FSA has, and this is because of constitutional law principles of due process and equal protection under the law. Nevertheless, efficient capital adequacy requirements need to provide regulators with a combination of rules and discretion, and the rules need to provide reference points or guidelines for regulators. This means that there needs to be a balance between rules and discretion. Some supervisory discretion, however, is necessary in a rules-based capital adequacy regime, which provides flexibility for the regulator to adopt different rules and practices when market conditions change. This allows regulators to learn and adapt their supervisory practices to evolving markets and to adjust to innovations in the market.

4. *What type of regulatory capital?*

The definition of “core tier one capital” should be made more precise to include any financial instrument that can fully absorb losses on the bank's balance sheet. Core tier one capital should constitute most of a bank's regulatory capital and it should be included as tier one only if it can absorb losses fully. Under this more limited definition, tier one capital will mainly include common equity shares. If you include preferred shares or subordinated debt, those types of capital have a more limited ability to absorb losses, because they are essentially debt claims. Capital regulation should focus not necessarily on having higher capital charges, but instead on ensuring that regulatory capital consists of equity shares and similar instruments that have the ability to absorb losses for the bank, and that this core tier one capital should constitute most of the bank's regulatory capital. Tier 2 capital—subordinated debt and preferred shares and other hybrid instruments—should be relied on less as a regulatory requirement for banks to demonstrate adequate capital. In the European Union, the lack of a harmonised and meaningful definition of tier one capital under the CRD has led to an unbalanced playing field across EU states because there are different definitions of what composes regulatory capital and in particular tier one capital. The main point is that the definition of “regulatory capital” should be linked to its ability to absorb losses.

5. *Bank size and interconnectedness of financial firms*

A bank's or financial institution's regulatory capital level should be linked, in part, to its size and interconnectedness in the financial system. Larger banks pose a larger systemic risk to the financial system and, therefore, they should pay a tax or a higher charge for how big they are, and smaller banks perhaps do not need such high capital charges as they pose less systemic risk. Interconnectedness brings us to the capital markets and how they have certainly become complex. The crisis demonstrates how liquidity risk can arise in the wholesale capital markets, not necessarily with individual banks. Securities regulation has traditionally focused on conduct of business rules and the segregation and protection of client account money, but the crisis shows that securities regulators should focus much more than they have in the past on systemic risk in capital markets.

6. *Regulating liquidity risk*

Before the credit crisis, there was an under-appreciation of liquidity risks in the financial system. Much of the policy debate and so many of the academic models had analysed financial stability issues from the perspective of market risk and credit risk. In fact, Alan Greenspan praised credit-risk transfer and securitisation as spreading and smoothing risk in the financial system and that this had enhanced liquidity in financial markets. Indeed, Dr. Greenspan's view was that securitisation and other types of credit risk transfer financial instruments had spread risk and thus had enhanced financial stability. As a result of this conventional wisdom, there was not an appreciation that liquidity risk could arise in these inter-connected and highly leveraged financial markets. The academic and bank models, and the regulatory frameworks, were built upon the fact that credit risk transfer was promoting liquidity, but what we did not count on was the fact that suddenly liquidity could evaporate in the wholesale funding markets. In the summer of 2007 institutional investors in the wholesale debt markets suddenly refused to roll over their short-term investments, thus causing liquidity to dry up. That was something that was not foreseen and it is a major failing on the part of academics, policy-makers, regulators and, of course, the risk managers in the banks and investment firms who failed to appreciate this. Therefore, regulation should address the maturity mismatches which special purpose entities and structured investment vehicles have in the wholesale funding markets and control and limit these exposures, and require banks to hold some regulatory capital against these exposures, even though they have been swept off their balance sheets.

7. *The European dimension of UK regulation*

UK prudential regulation should take account of the cross-border risks which UK financial institutions pose to other countries—especially in the European Union. The UK financial crisis with the collapse of the Royal Bank of Scotland demonstrated how the risk-taking of UK banks can generate cross-border externalities to other countries and financial systems. Banks have exposure to each other throughout Europe in the money markets through a variety of risk exposures, and European policy-making needs to begin to have better surveillance of the systemic risk posed by certain banking groups and financial institutions that operate in Europe. It does not mean that EU regulation and oversight should displace national regulators; it simply means that member state regulators, at the national level, must have more accountability to committees of supervisors at the EU level in order to carry out more efficiently cross-border supervision of the largest forty or so of Europe's banks that have extensive cross-border operations. The De Larosiere Committee's proposal for a European Systemic Risk Council and for a European Financial Supervision Committee, consisting of the Lamfalussy committees, is an appropriate institutional step to developing a more accountable and efficient EU regulatory structure.

8. *Who should regulate systemic risk*

The Bank of England has broad powers over macro-economic policy, interest rates and managing the currency, but in the recent crisis it was shown that systemic risk can arise not only from individual financial institutions, but also from the broader wholesale capital markets and in the over-the-counter derivatives markets. Indeed, the failure of AIG demonstrated that a non-banking financial firm can have huge counterparty exposures in the credit derivatives market that can put the whole financial system at serious risk. The regulation of the structure of the financial system—in particular clearing and settlement—is another source of systemic concern. The FSA is the primary regulator of wholesale capital markets and the post-trading system in capital markets. The FSA has the data not only for supervising individual institutions, but also for regulating the clearing and settlement system and the exchanges, which is where much of the systemic risk in the recent financial crisis arose, and that is why the FSA is well-positioned to exercise supervision over these systemically-important areas of the financial system. By possessing market intelligence, the FSA is well-positioned to supervise and control systemic risk as it occurs in the broader capital markets and trading systems. Nevertheless, there should be improved operational linkages with the Bank of England regarding the FSA's regulation of systemic risk in the capital markets and its relationship to macro-prudential regulatory policy.

9. *Banks' business models and corporate governance*

Effective supervision and regulation require banks to have robust corporate governance arrangements that incentivise bank management and owners to understand the risks they are taking and to price risk efficiently in order to cover both the private costs that such risk-taking poses to bank shareholders and the social costs for the broader economy if the bank fails.² Corporate governance plays an important role in achieving this in two ways: to align the incentives of bank owners and managers so that managers seek wealth maximisation for owners, while not jeopardising the bank's franchise value through excessive risk-taking; and to incentivise bank management to price financial risk in a way that covers its social costs. The latter objective is what distinguishes bank corporate governance from other areas of corporate governance because of the potential social costs that banking can have on the broader economy.³

Major weaknesses in UK bank corporate governance have resulted not only in substantial shareholder losses, but also have contributed significantly to the significant contraction of the UK economy, which has, among other things, led to massive layoffs in the financial services industry and related economic sectors and dramatically curtailed the availability of credit to individuals and businesses. Most UK bank senior managers and board members did not understand the risky business models that drove UK bank lending and which led to much higher levels of leverage in deposit banks and investment banks. Moreover, they failed to grasp the true risks which their banks' risk managers had approved based on faulty value-at-risk models that were used to determine credit default risk and market risk. Equally important, they allowed irresponsible compensation packages to be awarded to bankers which incentivised them to book short-term profits based on excessively risky behaviour which increased systemic risk in the financial system and weakened the medium and long-term prospects and profitability of the bank. Moreover, weak governance and risky business models contributed to the poor performance of banks and in some cases to their failure and bailout or nationalisation by the government.

The UK regulatory regime should establish new corporate governance standards that cover most areas of bank management, including controls on remuneration that are linked to the long-term profitability of the bank, while foregoing short-term bonuses. The FSA should exercise the power to approve bank director appointments and ensure that bank directors have the knowledge and training to understand the bank's business and risk models and its financial implications not only for the bank's shareholders, but for the broader economy. Bank management should be required to understand the technical aspects of stress-testing, which the regulator should require to be done on a much more frequent basis than what was done prior to the crisis. Essentially bank corporate governance regulation should focus not only on aligning the incentives of bank shareholders and managers, but also on aligning the broader stakeholder interests in society with those of bank managers.

10. *Regulating off-balance sheet structures*

Structured investment vehicles (SIVs) and special purpose vehicles (SPVs) are important elements in financial innovation and these structures largely were responsible for allowing securitisation to thrive and to provide increased liquidity in the financial system. However, these structures were also a type of regulatory arbitrage that allowed banks to reduce their regulatory capital requirements and to lower the costs of managing their balance sheets. Excesses occurred in the use of these off-balance sheet structures that allowed leverage to grow unchecked. Nevertheless, securitisation is an important component of our financial system and we should not prohibit banks from using it and other off-balance sheet operations to generate liquidity and to manage more effectively their balance sheets. Regulators should understand better the systemic risks which securitisation structures pose to the financial system and impose efficient regulatory charges on firms which transfer assets off their balance sheets through such structures and on the risk traders who invest in these risky assets. The real regulatory challenge will be how to require the market participants to internalise the costs of the risks they create in these structures. If we properly regulate securitisation, SIVs, and the various conduit funding mechanisms that banks have been using, then they will provide appropriate and economically beneficial ways to raise capital. They are a part of financial innovation and we should not curtail financial innovation, but we have to understand that the funding through SIVs is short-term and that it can disappear quickly, and we have to think about how to regulate that by devising pricing mechanisms that require issuers and investors to internalise the social costs of these risks.

11. *The UK Tripartite System*

The UK Tripartite System was established by a legally non-binding Memorandum of Understanding in 1998 that was designed to provide flexibility to the FSA, the Bank of England and the Treasury to coordinate their regulatory interventions and systemic oversight in times of crisis. Although the Chancellor chaired the tripartite bodies and exercised ultimate decision-making authority, there was no clear delineation of responsibilities between the three for acting in a financial crisis. The FSA, the Bank and the Treasury had

² H Mehran, *Critical Themes in Corporate Governance*, (April, 2003) FRBNY Economic Policy Review; see also, J Macey, and M O'Hara, *The Corporate Governance of Banks* (2003) FRBNY Economic Policy Review, Federal Reserve Bank of New York, 91–107.

³ Moreover, it should be noted that regulatory intervention is necessary to address the social costs of bank risk-taking because the regulator is uniquely situated to assert the varied interests of other stakeholders in society and to balance those interests according to the public interest.

only committed themselves to consult and there was no clear procedure for determining how the bodies would act in a banking or financial crisis and who would take what decisions. The Tripartite Arrangement failed to work effectively in the summer of 2007 when Northern Rock failed and had continuing difficulties in its operations until the Banking Act 2008 was adopted that established stronger legal grounds and procedural rules for the Tripartite system's operations. Presently, the Banking Act 2009 reinforces many of the reforms that were made to the Tripartite system's operations in 2008. One weakness, however, which should be remedied is the Banking Act's creation of a Financial Stability Committee which is chaired by the Governor of the Bank of England. Membership of the committee is composed of two of the Bank's deputy governors and representatives from the Treasury, but there is no representation from the Financial Services Authority on the Committee. It is necessary to have the FSA as a member of the committee for the oversight of systemic risk because we have learned in the credit crisis that systemic risk can arise not only from individual banks (which the FSA regulates), but also from the broader wholesale capital markets and OTC derivative markets (which the FSA also regulates). Therefore, the FSA should be given statutory authority to supervise both individual institutions and to oversee the broader financial system (ie, wholesale capital and OTC markets) to ensure against systemic risk and other threats to financial stability.

12. *Macro-prudential regulation and principles-based regulation*

Macro-prudential regulation will change in important respects the nature of principles-based regulation. The FSA's principles-based regulation (PBR) approach was focussed on individual firm outcomes and allowed firms to experiment with different risk management practices so long as they achieved satisfactory firm outcomes that was measured by shareholder prices and whether the eleven high level FSA principles were being achieved (ie, treating customers fairly). The FSA's PBR approach did not take into account the aggregate effect of firms' performance on the financial system in terms of leverage generated and overall systemic risks and liquidity risk exposures. To address adequately these macro-prudential risks in the future, principles-based regulation will necessarily become more rules-based at the level of the firm and at the level of the financial system. The Turner Report supports the creation of a macro-prudential regulatory regime that is directly linked to the micro-prudential oversight of individual firms. Macro-prudential regulation will change regulation for individual banks in two main areas: 1) the regulation of individual firms must take into account both firm level practices and broader macro-economic developments in determining how regulatory requirements will be applied to firm risk-taking (ie, the relationship of the growth of asset prices and GDP with contra-cyclical bank reserves and liquidity ratios) and 2) bank innovation in the types of financial products offered will be constrained by controls on the overall levels of risk-taking and leverage at the level of the financial system (ie, limits on loan-to-value and loan-to-income ratios). If adopted, macro-prudential regulation will require that principles-based regulation become more rules-based because tighter *ex ante* constraints will need to be applied to the risk exposures of individual firms (ie, leverage ratios and limits on maturity mismatches in wholesale funding). FSA regulation will gradually become more rules-based in order to achieve macro-prudential regulatory objectives. The FSA's PBR regime that focuses on individual firm outcomes will become much less relevant to achieving macro-prudential objectives. The FSA will need to adopt a new PBR approach based on macro and micro rule-based controls which will dramatically change the nature of FSA supervisory practices and potentially lead to new regulatory risks that will arise because of the responses of market participants who will undoubtedly seek to avoid these regulatory controls by adopting innovative financial instruments and structures. This will be the main challenge for the FSA and its PBR approach in the future.

23 June 2009