

TUESDAY 16 MARCH 2010

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Present

Best, L  
Currie of Marylebone, L  
Eatwell, L  
Forsyth of Drumlean, L  
Griffiths of Fforestfach, L  
Kingsmill, B  
Lipsey, L  
Tugendhat, L  
Vallance of Tummel, L (Chairman)

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

**Q1 Chairman:** Welcome back to the Economic Affairs Committee. Things have moved on, Lord Turner, since you last gave evidence; I think that was about a year ago. Indeed our report on banking supervision and regulation came out last June after that hearing. The purpose of today's session is simply to follow up on developments since then. Would you like to make an opening statement or shall we move straight into questions?

**Lord Turner of Ecchinswell:** I think we will just move straight into questions.

**Q2 Chairman:** Just before we do that, may I declare an interest in financial services in the form of being a member of the International Advisory Board of Allianz SE. I will start with the first question. In December last year the Basel Committee on Banking Supervision issued two reports, one of which was looking broadly at strengthening the resilience of the banking sector and the other was specifically about liquidity. Do you think those two reports are moving in the right direction? Do they go far enough?

**Lord Turner of Ecchinswell:** I certainly think they are a move in the right direction. I am on effectively the governing board of the Basel Committee which is the Governors and Heads of

Supervision meeting that meets twice a year to review that. The FSA is deeply involved in the work of the Basel Committee which is also reviewed carefully by the Financial Stability Board on which I sit. We are very deeply involved in the work of the Basel Committee and we are very happy with the broad direction in which the Basel Committee has been going. It has committed to more capital across the banking system, the introduction of an element of counter-cyclical capital, more capital in particular going into trading books and significantly tighter liquidity requirements. It is all in the right direction. As to whether it will go far enough, I think the crucial thing is that this is the year where we have to turn an international agreement in principle into actual figure work. If you look at the statements which were made by the Committee last December and the supporting statements made by the Financial Stability Board and the Governors and Heads of Supervision meeting they are all so far at the level of more capital, significantly increased capital, greater liquidity requirements. We are now at the stage, really over the next ten months, heading up the G20 summit in Seoul in November to which the Financial Stability Board will be reporting and the Basel Committee before that will be reporting to the Financial Stability Board. When we had a meeting in Basel last week of the Financial Stability Board the Chairman of the Basel Committee, Nout Wellink, set out the very stretching and demanding programme that we have to go through during the next six or seven months to actually get to agreement of what the figures are. The answer is that I am confident we are heading in the right direction but we really are at the difficult stage because actually getting international agreement, not just in principle but to the specific figures and the specific calibration, is immensely important and there are various complexities on the way.

**Q3 Chairman:** The track record of getting the Basel Committee recommendations into legislation around the world is not very good, is it? If you look at Basel II it took years to get some kind of agreement. Do you think there is a better chance this time round?

*Lord Turner of Ecchinswell:* Yes I do. Basel II of course did not so much take a long time getting into enforcement, it took an awful long time getting agreed what it was. It was an immensely complicated intellectual exercise of agreeing the principles and the operation of it, and indeed one of the challenges that the Basel Committee faces is that we are in some ways designing a Basel III in the course of about a year and a half, having spent the better part of an entire decade on the design of Basel II. There are obviously issues about making sure that all countries in the world, once we have an agreement, sign up to it. Again I am a reasonable optimist on that. I think mechanisms like the Financial Stability Board have created institutions at a greater degree of political visibility than existed in the past and a reporting relationship of the Financial Stability Board to the G20 and the political impetus of the G20. I think there is therefore a mechanism which makes it more likely that once we have global agreements they will be then enforced and put into action. Indeed the Financial Stability Board has a mechanism of peer review and implementation review which should speed that process. I do think that once we actually agree the parameters, the calibration and specific ratios we will manage to get that enforced throughout the world. I think one of the big issues though may be transition paths. There will be major debates about the pace at which we should head towards higher capital and liquidity requirements, and indeed those are legitimate debates because we have to make sure that in transitioning to a sounder system for the future we are also aware of the present conjuncture of the economic situation and the impact of what we do on the overall level of demand in the economy.

**Q4 Chairman:** It is not just transition; it looks to be possibly priorities as well. If you look at what might be on the legislative agenda either in the United States or in Europe it is not particularly to do with capital ratios or liquidity to begin with. We have the Volcker Rule on the one side; we have the interest in private equity and so on on the other.

**Lord Turner of Ecchinswell:** There are many other things going on apart from the core Basel Committee FSB agenda. I would say within the European Union that would be an area where I would be most confident that there will be a clear transition. As we get to a Basel Committee agreement on what the principles should be, there is a pretty clear path by which that turns into capital requirements Directives at European level and indeed it is the case that the European Commission has been continuing over the last year to build new capital requirements Directive packages which will implement, for instance, the things that are already agreed such as the package from the middle of last year about trading book capital and re-securitisations and stressed VaR. So I agree there are many other elements of the agenda going on. We now have a quite significant worldwide debate about taxes which is related to but somewhat separate from the capital and liquidity debate; we have the Volcker Rule; we have a whole set of national initiatives. However, I do not think the fact that those are there as well will necessarily get in the way of the implementation of what we still see as the core agenda which is better capital and liquidity standards.

**Q5 Lord Eatwell:** I declare an interest as adviser to two private equity firms, Warburg Pincus and Palamon and a non-executive member of the board of SAV Credit. One thing I was very struck with in the December 2009 report was the appearance of the word “rules”. Previously most Basel reports have referred to principles and codes; now they seem to want to establish international rules, which is a major juridical step compared with just general principles which are then embodied in national structures according to their own peculiar idiosyncrasies. Yet the whole macro-prudential analysis which you played such a large part in developing really does depend on rules, does it not?

**Lord Turner of Ecchinswell:** I think there is a shift in being clear that we want rules which are actually enforced across the world. It is true to say that even if that is the intent it does ultimately depend on political agreement and national implementation. We do not have an

international law body in international financial regulation equivalent to, for instance, the WTO in the area of international trade. I think the way we will end up will be a mixture of things which are hard rules and elements of discretion and we may need that as much as anything else for a macro-prudential point of view. The language which we sometimes use is this Pillar 1 and Pillar 2 within the capital regime which is simply a fancy way of saying there are absolute hard minima which are defined as  $x$  per cent times the weighted risk asset worked out in a particular way, but there are then necessarily degrees of national discretion and supervisory discretion in relation to individual circumstances to make judgments that go beyond that. Indeed I think some of the most difficult challenges we may face this year will be that we may end up believing that some things do require a Pillar 2 discretion at national level in enforcement, and the issue is: how will we be confident that there is an even implementation of a principle with a degree of discretion? Let me give you a specific example. I think we are now really getting engaged on the issue of whether there should be not only higher capital in general across the banking system but specifically higher capital for systemically important banks, essentially a higher ratio of capital or a higher quality of capital for banks which are either larger or more inter-connected or some other category of systemic importance. That is a debate where there is a very wide range of views around the world as to whether you can or should express such a surcharge in a precise formulaic fashion, and it is at least possible that one of the resolutions of that might be a strong presumption in favour but with degrees of national discretion. That is where it will become immensely important: how do we actually make sure that there is some commonality of enforcement of the principles if that is the way we go?

**Q6 Lord Eatwell:** I was thinking particularly about pro-cyclical provisioning. When Jacques de Larosière appeared before this Committee he likened macro-prudential regulation to fiscal policy and was very sceptical whether you could take such measures away from the

legislature and therefore away from discretion. If we have pro-cyclical provisioning which is essentially discretionary, one has to have considerable doubts as to whether in up-swings when politicians are feeling good and everybody is feeling good this will really happen.

*Lord Turner of Ecchinswell:* I think it is possible that the way forward may involve a combination of a hard-wired quantitative counter-cyclical rule and an element of discretion. This is an issue which the Basel Committee and the various other bodies have debated at considerable length. There is a lot of attractiveness to hard-wiring some counter-cyclical into the system and I expressed support for that in the Turner Review that came out last year. The difficulty becomes that if you are then trying to link that to generalised credit conditions in the economy, how do you actually turn that into a formula, to what category of credit? You also end up with very complicated things about the treatment of international banks which are operating in many different economies with somewhat different credit cycles. It has therefore tended to be the case that when we actually get down to possible quantitative hard-wired counter-cyclical measures they tend to relate to things like the level of bank profitability or the rate of growth of the assets of a particular bank or the capital level of a particular bank rather than to generalised credit conditions in the economy. That has then left some people saying, “That’s all very well, that hard-wired rule related to profitability, but we really want to be able to respond to the generalised credit conditions in the economy”. I think we may well have to eventually go forward with something which has an element of hard-wired quantification within it, but which still creates some sort of body – some discretionary capability – to pull discretionary macro-prudential levers as well. I have talked in the past about the possibility that we should have some sort of macro-prudential committee equivalent in status to the Monetary Policy Committee which would have to pull together the insights that you get from a central banking arena and from a regulatory supervisory arena, and that this should have the discretion to tighten, for instance, capital requirements on a counter-

cyclical basis in a discretionary fashion. You are absolutely right, that you have to go in two different directions; you either have to create an institutional degree of independence from government or you have to hard-wire it. To be blunt, what one is trying to do here is create mechanisms in which the authorities or the rule in total would slow down an out-of-control housing boom or commercial real estate boom even if that boom was occurring in the months running up to a general election when a government might not feel that it wanted at that precise time to take away the punchbowl. So you either have to do it by institutional mechanisms – I draw attention to the thoughts on that which were in the Bank of England paper on macro-prudential policy from last November - or you have to do it in a hard-wired quantitative fashion. I suspect the way forward may involve a bit of both.

**Q7 Lord Best:** Do you see a danger that the enhanced capital regulation of the kind you have been describing could raise the cost of doing business for financial firms to the point where this restricts the provision of capital to the business sector and thereby damages the chances of economic recovery?

**Lord Turner of Ecchinswell:** It is certainly something we need to look at very carefully, and indeed a new working group has been created called the Macro-Economic Assessment Group, chaired by Steve Cecchetti, Chief Economist at the Bank for International Settlements, and brings together insights from the BIS, the FSB and the IMF, precisely to bring into our thinking this year the level of capital requirements and the transition pace to capital and liquidity requirements a macro-economic point of view about what that will do to short to medium-term growth. There are two specific challenges that I would highlight here, one of which is that there can be a difference here by between what one might call comparative statics and transition dynamics, by which I mean it would be quite possible to believe that the UK economy in 2025 would be a more stable economy and would have just as much investment and growth if its debt to GDP was 80 per cent rather than 100 per cent. It is

possible to believe that whilst also believing that if you start at a debt to GDP of 100 per cent (actually our figure now is something like 130 per cent) you cannot immediately transition to a lower level without harming the short to medium-term growth of the economy. There is a sort of Augustinian problem here, a desire to become more prudent at some stage but not quite yet. One of the things we have to do in this exercise is think through what we think is the best level of capital and liquidity for the long-term balance of the economy and get that clear as a direction, but also then separately think about what is the feasible pace of transition to that given everything else that is going on. The other real complication is, when one thinks about it, credit performs quite different functions in an economy. Often in these debates we tend to talk about if we increased the cost of credit that will limit new investment in productive assets. Part of what credit does is fund new investment in productive assets, but some figures I will be presenting in a lecture tomorrow suggest that about 70 or 80 per cent of credit fundamentally is used to buy prior existing assets to leverage up the purchase of prior existing assets, be they residential homes or be they commercial real estate investments, or indeed leveraged buyouts. One of the problems we have in this whole debate about capital is that there are these different functions of credit. That is not to say that these other categories of credit have no social value but they are really nothing to do with new investment or growth. Lending to the household sector for mortgages is fundamentally about enabling households to smooth consumption over the lifecycle. In a mature population country like the UK it really has little to do with the gross investment rate of the economy. One of the things that comes out of this is that we may need to think, going back to the macro-prudential debate that I talked about earlier with Lord Eatwell, about whether we need macro-prudential levers which could discriminate between these different categories of lending. I think it is possible that the level of increase in capital requirements and tightness of liquidity requirements, which is required to make sure that we reduce the volatility of house price or commercial real

estate cycles, that that level of capital and liquidity which makes sense for that sector of the economy, might indeed have consequences for the cost in relation to the productive investment side of the economy. I think it is a very complicated issue where you actually have to get down to the different categories of credit and the functions which credit performs. To give you a particular figure, the amount of credit in the UK which is extended to non-commercial real estate corporates - corporates rather than households - involved in things other than commercial real estate development is only about 15 per cent of all credit in the UK.

**Q8 Lord Currie of Marylebone:** I declare an interest as Chairman of the International Centre for Financial Regulation and Semperian Investment Partners. You have touched already on EU-level financial regulation but I wonder whether you see it moving in the right direction and in particular do you, the FSA, have sufficient access to the UK branches of EEA banks, thinking of the Icelandic problems?

**Lord Turner of Ecchinswell:** The answer is that there is no perfect solution to the problems such as we faced in Iceland and, as we set out last year and I said in my review last year, faced with where we were we needed either or both a combination of more Europe or less Europe. The fact is, as you know, we have an agreed Single Market in retail banking in Europe which establishes a clear right for banks to operate across border in a branch form, and when they operate in a branch form it is absolutely clear that the primary responsibility for the prudential regulation and supervision of the soundness, solvency and liquidity of those operations rests with the home country supervisor not the host country supervisor. Therefore it is the case when someone places a deposit with a branch of an EEA bank in the UK they are, whether they realise it or not, essentially looking for reassurance through to the prudential supervisor and in some cases the deposit insurance scheme of the home country. That is a complicated bit because branches can top up into the UK FSCS as well, but it is

fundamentally a home country system. We do have sufficient access in the sense that we can ask for information in relation to all of the UK branches of the EEA banks today; we are happy with the flows of information that we have and we have very good relationships with our fellow home country supervisors throughout the rest of Europe. However, the fact is that at the end of the day if we were worried there are situations where we do not have the power to do things. We have certain powers, within limits, and sometimes what we are doing is achieving action by persuasion rather than by legal power, but there are clear limits to the legal powers. I think we have to accept that there are really only two intellectually pure states of the world and the one thing we know about the way we are going to proceed in Europe is that we are not going to proceed on those. Either we would say that a single market does not apply to retail banking - it just does not work in retail banking - we are going to have separate subsidiaries for every single bank which operates in a country, or the right of the regulator to demand that and to demand stand-alone solvency and liquidity, or we should fundamentally say that these things have to be seen at a federal level, they have to be supervised and regulated at a federal level entirely by the home country supervisor with, at the limit, a European pre-funded deposit insurance scheme and a European fiscal authority which picks up the problems if it goes wrong. Bluntly those are the two intellectually pure states of the world and there is no real political support for heading in either of those two directions. What we are trying to do at the moment is combine elements of both. We are reinforcing the power of the European level, and through this we will have the ability to require home country supervisors across the EEA to enforce high-quality supervisory standards, enforce a rulebook, have peer review, et cetera, and we are simultaneously slightly tightening our ability to ask questions and push away at branch level. If you were to be pessimistic, you would say that we are trying to have a three-quarters effective set of braces and a three-quarters effective belt

and hope that our trousers stay up rather than to go intellectually purely in one direction or the other.

**Q9 Lord Currie of Marylebone:** How do you see the risk of a breach between the EU and the US over regulation, particularly of hedge funds and private equity in the light of the US Treasury Secretary's concerns?

*Lord Turner of Ecchinswell:* There are debates on that and those fundamentally relate to the recognition of mutual supervisory standards and passports for operation within the European Union. There are important issues which need to be resolved. I think they are somewhat tangential to the core issues of the regulation and supervision of systemically important prudential issues. For instance, on hedge funds the one thing we are all agreed is that although hedge funds were not, to any significant extent, the cause of this crisis, we need the ability to gather information from them in order to spot whether at any time hedge funds are mutating into something which is systemically important, as they did in the case, for instance, of LTCM in 1998, and to have the power if necessary to extend capital and liquidity requirements at that stage. That is agreed and the whole debate about the Alternative Investment Fund Management Directive is really a set of completely separate issues from that about recognition and customer protection, et cetera. So they are important issues but I do not think they will get in the way of the really fundamental issues we were talking about earlier about bank capital, bank liquidity and oversight of systemic risks.

**Q10 Lord Forsyth of Drumlean:** Can I just ask you about the transatlantic dimension as opposed to the European dimension? What do you think are the prospects of the Volcker proposals being adopted in the United States? If they were, what, if any, difference would that make from the point of view of the FSA to regulating banks with a presence in the USA

and the United Kingdom? I should declare an interest in that I am regulated by the FSA in that I am a partner in Evercore Partners.

**Lord Turner of Ecchinswell:** I am not convinced that the Volcker Rule will produce as big a distinction between the US and the European approaches as is normally suggested. I say that having discussed these issues at considerable length with Paul Volcker over the last year. I think in relation to the crucial thing which Paul Volcker has suggested, the issue is how would it be implemented, and when you get down to the details of how it would be implemented it is not very different from what we have been suggesting in the UK. I think you have to divide what has been suggested into two. There is a suggestion that commercial banks (defined as banks which take insured deposits) should not be allowed to own in-house private equity funds or hedge funds. I think you will find that most bankers would say, “We are not convinced you need to do that, but that is not too much of a limitation”; not many of them own in-house hedge funds in any case. Some of them do own in-house private equity funds; you can argue for and against, but it is not a fundamental difference. The really crucial issue comes to the second part of the Volcker Rule - and you have to read the words very carefully - which is that commercial banks should not be involved in proprietary trading unrelated to customer service. The issue is, what do you mean by unrelated to customer service? If you are a bank which provides forward foreign exchange options or straight forwards for your large corporate customer services, you will be behind that in your dealing room taking some positions because it is impossible to make a market without, to a degree, taking a position (because the time you take in that particular side of the deal and before you have laid it off you have a position). The crucial issue then becomes on what scale are you taking those positions and are you doing them in support of customer service or are you doing them as pure medium-term punts? I think the crucial thing in relation to the Volcker Rule is how will they actually implement it? If you talk to Paul Volcker and say, “Do you believe that you can

do this by writing a piece of legislation that says that a bank is not allowed to own a marketable credit security?” he says, “No, banks have to be allowed to own marketable credit securities; that is a reasonable part of how the credit extension system works in a modern financial system where some credit takes the form of credit securities”. If you say, “Does it mean that they cannot have a forward position in forward FX?” he would say, “No, they are allowed to do that”. How do you then do it? The thing I have discussed with Paul Volcker is that we do have some considerable ability to look at the trading and position-taking activities of major investment banks and commercial banks and to understand what their philosophy and approach is. Fundamentally, if you take the daily trading profits of a major trading activity and put them as a frequency distribution, if you get a normal distribution with a very small tail of occasional relatively small losses and very few big ones either, it probably tells you that they are fundamentally doing a flow-based market-making activity with relatively few big punts. If you see a distribution which has some pretty chunky losses every now and then and every now and then some whacking great daily profits, it is a pretty strong giveaway that they are taking large punts. If you actually look at what Paul Volcker said in his Senate Committee report when he was explaining how he thought you would actually implement it, what he said is, “Given strong legislative direction, bank supervisors should be able to appraise the nature of those trading activities and contain excesses. An analysis of volume relative to customer relationships and of the relative volatility of gains and losses would go a long way toward informing such judgments. For instance, patterns of exceptionally large gains and losses over a period of time in the trading book should raise an examiner’s eyebrows. Persisting over time, the result should be not just raised eyebrows but substantially raised capital requirements.” If that is the actual way by which they intend to implement the Volcker Rule then that is precisely what we are intending to do in any case through the fundamental review of trading book capital which is part of the Basel Committee agenda this

year. That is why I say that I think when you get down to the details of how they will do this, there is less to this transatlantic disagreement than it looks like at first.

**Q11 Lord Forsyth of Drumlean:** To put that simply, we will not have eyebrows being raised in London on capital requirements and in the US; it will be the same.

*Lord Turner of Ecchinswell:* Yes, absolutely. I think it will be the same.

**Q12 Lord Griffiths of Fforestfach:** May I take you back to that memorable phrase that you used “socially useless” in terms of certain activities within the financial sector. Many people, as you can imagine, have racked their brains to what they are doing, whether it is in fact socially useless or not. In a market where you have willing buyers and sellers, and a market particularly of professionals, have you developed your thinking further as to how you would identify socially useless activities?

*Lord Turner of Ecchinswell:* It is clearly the case that it is incredibly difficult to discriminate and say that this activity has high social value, this has less. However, I do think that there is a reasonable case that there is something about the financial services industry which at times and in particular areas is capable of activities, even where there appear to be willing buyers and willing sellers, where a reasonable economic analysis would suggest that what is going on is a form of rent extraction rather than a form of real economic value added. For instance, I think there are some areas of the industry where the level of trading activity may be on a scale which increases the level of volatility of markets and that very volatility then creates an environment where end users of those markets feel they have to hedge the volatility, that there is, as it were, an ability of trading rooms and trading activities to create the very volatility and then get paid for hedging against the volatility. I think it is also clearly the case that many of the products which were developed in the final period of extreme excess of the complex securitisation (I am thinking about the CPDOs and the CDOs-squared, et cetera) had very

imperfectly understood embedded options, complicated pay-off structures where the people selling them may not fully have understood them but probably understood them a bit and some of the people buying them did not really understand them at all. These are instruments which have the pay-off characteristic of: I have a wonderful product here; this means that rather than getting a boring five per cent by putting your money in the bank, this will turn your yield into six per cent per annum but, there being no free lunch, somewhere embedded within the engineering of this is that one year out of many it will blow up in your face, and I think there were many products of that character which were sold. I think those are not value-added products are, in a sense, socially useless and they are a form of rent extraction. Do I think that this enables any regulator to say, "Right, I know exactly the level of liquidity of trading which is socially optimal and this product is socially useless and this one is not"? No I do not. However, I do think that once you accept the principle that there might be some activities which have minimal or no social value it does change your attitude. Let me give you an example. A few months ago I was talking with our teams about a particular category of capital requirement which relates to a very fancy level of correlation trading in the credit space. There were worries that this is an area where the risks are quite complicated; it is not quite clear whether everybody manages the risks perfectly well; it is very difficult to work out precisely what is the sensible level of capital against it given that it is difficult to work out what the risks are, but you are left with a level of worry about this area of the market. And so there is a proposal on the table that we should really bump up the capital requirements in a very significant fashion. The counter argument was put that this will reduce the liquidity in this market. Then the question was raised: yes, but can anybody tell us what will be worse for humanity if the liquidity in this rather exotic trading activity disappears? One really could not specify why you could think of any end real investor who would be worse off as a result. I think therefore in those circumstances the concept that not all activity which the private

market supports is necessarily economic value added just shifts you towards a bias to conservatism. I think it simply shifts the bias of how you make those judgements in a direction away from what it was before. It does not provide you with precise discriminating tools to say, “This I know is precisely valuable and this I know is precisely unvaluable”.

**Q13 Lord Eatwell:** Last October you set out in a discussion paper some definitions of narrow banking in the whole debate over too big to fail and asked for opinions. You were canvassing opinion on John Kay’s extreme narrow banking, intermediate narrow banking and then Glass-Steagall. We have touched on that a little bit in the Volcker proposals but I wonder what responses you got and how have you assessed them.

**Lord Turner of Ecchinswell:** Most of the inputs we have received in response to our discussion paper – most of which come from the industry – are not supportive of narrow banking proposals, but one might say “they would say wouldn’t they” so I would not count that as a piece of evidence. I think the debate more generally has continued to go on. I have to say that I think the real practical debate is probably about the new Glass-Steagall, the Volcker principle, and how you do it. That may endanger that we do not think radically enough, but it is interesting, as I discussed earlier with Lord Forsyth, the US, having appeared to suggest a very radical “we’re going to keep commercial banks out of casino banking”, when it has actually got down to “How am I going to do it?” are doing it by a variation of capital rules. I think broadly round the world – although there is some interest in the Volcker proposals and Glass-Steagall – there has not really been any government or any regulatory body which has picked up the really fundamental ideas. The danger in that is that maybe they are right. I think there are now, interestingly, two sets of really radical ideas on the table; there is the John Kay idea and there is also the idea put forward by Lawrence Kotlikoff, limited purpose banking, which builds on ideas which go back to Irving Fisher who I think called his book *One Hundred Per Cent Money Banking* back in the 1930s. I think there are

reasons not to do it and I think it would be extremely radical and would still leave us with major problems, but I actually think if you were going to argue for something truly radical you would probably be more in that space than John Kay's space. I think John has gone to the sort of *reductio ad absurdum* of narrow banking where he is not actually suggesting a distinction between commercial banking; he is suggesting a distinction between deposit taking and the whole of banking. He basically says that retail insured deposits have to be invested in gilts and everything else is de-regulated. Actually what he has really done is say that what the retail banks will be is franchised distributors of National Savings and Investments. You can invest in gilts through National Savings and Investments today. It is interesting to think about it in that mode. You have basically said the whole of retail deposits have to take the form of a retail investment in gilts. If you do that, my problem with John Kay's proposal is that to me it avoids all the really tricky issues we have faced which is why was credit extension so volatile, why was this banking system willing to lend money either in a securitised or an unsecuritised form to houses, sub-prime borrowers and commercial real estate developers and then suddenly in a credit crunch be unwilling to do it. I think John's idea would undoubtedly mean you would never have to bail out another set of insured depositors, but actually, by saying you can de-regulate the rest of the market, I think it avoids all the really tricky issues about why credit extension is so volatile. What Larry Kotlikoff's idea picks up is fundamentally the idea that we should abolish fractional reserve banking - Walter Bagehot, you were wrong; we are going right back to the basics - that all loans ought to be extended by loan funds in which the investors in them basically share month by month or however rapidly you can do the revaluations in the performance of those loans and therefore you get round all the problems, the instabilities of fractional reserve banking. I am not convinced that that would solve the problems because I think a system of loan funds could still be a system in which there is very volatile credit extension. Essentially what would

happen is that when there was an awareness of large loan losses and that was being expressed in mark-to-market falls in the value of these loan funds, I think we would see a rush to the door of people wanting their money back from these loan funds in a way which would generate downwards spirals of fire sales of assets or at the very least a complete unwillingness to put new money into these loan funds. I do not know, but I think it is possible that if you think through the Kotlikoff ideas you might end up with as much volatility in the process of credit extension as they are at the moment. I hope it is not just a conservatism, sticking to what we have already got and just assuming that fractional reserve banking, having been around for the last 150 years, ought to continue to exist. I have tended to believe that we should improve the regulation and supervision of the existing system, including through some pretty strong action to limit the activity in trading activity rather than reaching for one of these completely radical responses. The final thing I would say is I think in relation to the John Kay and Larry Kotlikoff ideas there is much more debate about these in Britain than anywhere else in the world. Among fellow regulators around the world, the fascination with pure and narrow banking debates is seen as a bit of a British intellectual fascination and really has not been part of the debate in many other countries at all.

**Q14 Lord Eatwell:** Let me suggest a reason why. If you look over the last decade at the ratio of bank assets to GDP, in most major economies it trended up gently through the last decade but did not rise very much except in four countries - Iceland, Ireland, Switzerland and the United Kingdom - in which there was a dramatic increase in the ratio of bank assets to GDP in all those four countries. The essence of course of the financial systems in those four countries is they are pure banking systems; they are providing banking services to the rest of the world, and that is why the share of bank assets to GDP has increased dramatically when those world markets increased. Perhaps the key separation is the separation between banking for the UK domestic economy and banking for the rest of the world, such that the domestic

economy might be protected to some degree from the vagaries which are experienced from volatility in the offshore banking sector as opposed to the needs of the domestic banking sector.

**Lord Turner of Ecchinswell:** I think that is a very important point. One has to separate here the issues as to whether John Kay's narrow banking or Larry Kotlikoff's limited purpose banking are, within a closed economy or a global economy, a better or worse way of splitting up banking functions and addressing issues to do with either depositor protection or volatility in the credit cycle. There is then a separate set of issues which is essentially a set of too big to rescue or so big I would rather not have to rescue banks (quite clearly too big to rescue in the Icelandic case). I think this is where the issues about capital surcharges for large systemically important banks and the whole living wills and resolution approaches come in. One of the reasons why UK banking assets expressed as the assets of UK headquartered banks as a per cent of GDP are so large is that we have some very large global banks, so some of the liabilities and assets which one is comparing with GDP are, for instance, the assets and liabilities of HSBC Hong Kong. It is quite possible to imagine an agreed global approach to large banks of that nature in which the world has agreed in advance that Hong Kong is not looking to the UK tax authorities under any circumstances to make safe the liabilities of Hong Kong depositors of that Hong Kong bank, and therefore there is a model in which we either say to large cross-border banks: if you want to organise yourself as a complex, interlinked global bank which we have to think of as one entity, then we are going to want very, very high levels of capital to very significantly reduce the probability of failure, but the alternative way to go is for you to organise yourself, to a significant extent, as separable subsidiaries with their own capital and liquidity such that this is not all one group and it would be possible for one bit to fail without others or more likely to enable one bit to be sold off to other people without others failing. I think the issue as to whether one needs to think about a global

banking group as one entity or as essentially a holding company of somewhat separate entities is very important to this debate.

**Q15 Lord Forsyth of Drumlean:** I was wondering if you had a chance to follow the debates which we have had in the last few weeks here in relation to the Financial Services Bill where Lord Lawson in particular has been arguing very strongly for some kind of Glass-Steagall separation. I think my position is very close to yours, but listening to Lord Lawson and reading what he is saying, he is actually arguing quite against the prevailing view that by taking action on this unilaterally in London we do not have to go for international agreement; that we would actually enhance the position of the City of London rather than damage it. I am perhaps putting that too simply, but that is the broad thrust, that if we were going to go down this track we do not actually need to get international agreement. A lot of the people who are arguing for some kind of Glass-Steagall separation argue that there should be some international agreement and I wonder what you think about that. The other argument that worries me in holding a position rather similar to yours, which Lord Eatwell has just touched on, is the Governor of the Bank's argument which is to say that it is all very well for the Americans but relative to the size of their economy their banking sector is very much smaller and therefore it is not an issue for them, and therefore you are not going to get international agreement; they are never going to agree to it and therein lies the difficulty for us and that is why we have to act unilaterally. I wonder if you could help me to sort out these arguments in my brain because there is a nagging worry at the back of my mind about what both Lord Lawson and the Governor of the Bank are saying.

**Lord Turner of Ecchinswell:** I think to sort them out it is important to distinguish the issue about the breadth of an institution's activity and its sheer size. If you take the Governor of the Bank of England's argument which simply says, to put it bluntly, that HSBC or Barclays are bigger relative to UK GDP than J P Morgan or Citibank are to US GDP, you could imagine

that still being the case even if you had gone as far down the Glass-Steagall route as you possibly could. You could imagine with a bank like Santander, almost anything you could do along the Glass-Steagall design would make very little difference to a Santander which is fundamentally a retail and pretty pure commercial bank in most parts of the world. Santander is still quite a big bank relative to the GDP of Spain. At the other end you could imagine a medium-sized bank which was both a commercial bank, and an investment bank. I do think the issues of the breadth of activity and whether commercial banking should be combined with investment banking (propriety trading), and the issue of size relative to GDP are somewhat separate issues, and we need to be clear that they are separate issues. The concern which the Governor has which is the sheer size relative to GDP, I agree it is something we need to be aware of; it is something which very clearly focuses the minds of the Swiss authorities with whom we have intensively talked about these issues. I think it does point you in the direction that you either have to make sure that for very large banks which are headquartered in the UK you have one of two or both conditions: either their total level of capital and liquidity and the style of their operation is such that they are very, very sound banks with a low probability of failure; and/or that they are structured in a way that if they did fail there exists the real possibility that the UK authorities would bail out or support in some way the UK entity but would not consider itself responsible for bailing out the Hong Kong entity. It is not clear to me at all that the Mexican authorities consider that in the event of a problem with Santander Mexico that the Spanish taxpayer is on the hook. We have tended to assume that that is the case, but it is not how the world wants to be. This is why there is a very close overlap with the debates about capital surcharges for large systemically important banks and the debate about living wills and where there may be a Pillar 2 trade-off here. The more that large systemically important banks can illustrate to us that they have been organised as constellations of somewhat independent national subsidiaries which could be separated,

sold separately, resolved separately and left to their different national authorities, the more that they can convince us of that the less we may need to hit them with high capital charges. Conversely, the more that they are unwilling to do that or are unable to do that, the more that we have to say: if you want to be a large, complex, interconnected global bank running off a centralised pool of liquidity and with complex interconnectedness between your different operations, then the only way that is acceptable is very, very high levels of capital and very high quality of capital. I think there is a trade off there. The key point about the Governor's point is that if you had a world in which you assumed that the UK was responsible for the UK operations of HSBC and the Spanish were responsible for the Spanish operations of Santander, but that nobody imagined that the Spanish taxpayer was going to make good Mexican depositors or UK taxpayers make good Hong Kong depositors, then you could be relaxed about banks headquartered in your country which happened to be a large multiple of GDP.

**Q16 Chairman:** Just before we leave the question of structural change in the market one way or the other, one thing we do not hear very much about in these debates is regulatory capture, and yet arguably regulatory capture is pretty fundamental to what went on in 2008. Do you think that of the three options of narrow banking, whether it be extreme, intermediate or some form of Glass-Steagall, that any of those would be more or less susceptible to regulatory capture? On the face of it the bigger and more complex an organisation it is, the more susceptible regulatory capture of the regulator is to that organisation.

**Lord Turner of Ecchinswell:** I think that is true for two reasons. First of all, when you have very large, complex organisations they have lobbying power; they have the ability to argue for a particular point of view. Secondly, there is an important challenge in regulation that in order to regulate large, complex banks involved in sophisticated activities a regulator needs to hire people from the industry but people who are hired from the industry may tend to share

the assumption sets of the industry as to what are sensible arrangements. I am not sure, however, that we can get round that by any particular structural way of organising, even if we were to split up banks in some way. As I say, in the John Kay version of narrow banks I think there would be an entire non-deposit taking or non-insured deposit taking business which, in John's version, is entirely unregulated and therefore could be up to as much regulatory capture as anybody else. One of the great values of radical ideas is that the problems with that particular idea are not yet obvious, but if you actually tried to work out how you would regulate and supervise a limited purpose bank which has to be declaring to its investors on some regular basis what is the mark-to-market valuation of all of the loans in their portfolio – loans which do not in themselves take the form of a traded marketable security and therefore every one of which needs to be on some portfolio basis turned into a mark-to-market value - the moment you describe that is the moment you realise there is an enormous supervisory task to do that because you have to make sure that that valuation process is fair, adequate and reasonably effective. I do suspect that none of these narrow banking options get us round this very subtle problem of regulatory capture which is often an issue as much of intellectual capture into the assumption sets of the industry as it is direct lobbying power or the desire to have a nicely paid job when you leave the regulator and move on.

**Chairman:** We do not have much time to pursue it now, but I just leave the thought that immunity to regulatory capture is actually quite an important dimension when looking at the form of regulations.

**Q17 Lord Lipsey:** I want to move onto bank governance, Lord Turner. At the time of the crisis one of the groups to come out very badly were bank boards and within bank boards non-executive directors. We increasingly got the impression they were just turning up for their fee and a free lunch. There have been a number of proposals put forward to change that,

including by this Committee, including that they spend more time on the job and that they are better serviced in doing it. Do you think we are making adequate progress in that respect?

**Lord Turner of Ecchinswell:** I think we are making considerable progress in that respect. I think David Walker's review set out a set of principles which have received a large degree of support. I think there is an increasing awareness of the amount of time which is required to do an effective job on the board of a large and complex bank. I think in particular there is very strong focus on the role of risk committees and the independence of the risk committee and the ability of the risk committee to have direct contact with risk officers. I think it is incredibly important that heads of risk feel they have a direct ability to go to risk committees and to the chairs of risk committees separate from going through a chief executive who might in some circumstances not be overjoyed by the message that he or she has to slow down. A particular FSA insight and input into this issue is that we are now doing a much more significant review of the competence of what we call significant influence functions. Significant influence functions include key non-execs and in particular people who are going to go onto risk committees or who are going to be the chair of risk committees. So for all the major banks and building societies now, if you were becoming a chair of a risk committee, or if you were perceived within the portfolio of the non-execs as playing a major role within a risk committee and you were a new non-exec, you are now interviewed by the FSA, by our own people with a panel of external advisers and senior advisers as well, and we are putting people through quite a rigorous review of what it is in their past that suggests they have professional competence in this area, have they thought about the risks, et cetera. People sometimes ask how much can you actually tell in a one-and-a-half hour interview for which people will have been prepped, but actually if the consequence of this is that it achieves a significant improvement in the induction programmes of non-execs in order to make sure that they pass our interview, that in itself will be a very good thing. I think this is one of the tools

which will increasingly make people aware that these are very, very important jobs for which they need to either have a prior existing set of capabilities or to have very serious and well-designed induction programmes that bring them up to speed and keep them up to speed on the technical capabilities they want. It is early days in this process but I do think we are heading in the right direction. It is certainly something on which we are going to continue to focus and make sure we understand as best as possible what is happening to the quality of these people and to the processes by which they go through it. We are getting, as part of this interview process, a non-trivial withdrawal before interview rate. I cannot remember what the figure is - I believe it is something like ten or 12 per cent - but these are people who, having thought about it and having realised they are going to be subject to this quizzing, decide to withdraw their nomination. Again I think that is a useful indicator of some progress.

**Q18 Lord Tugendhat:** It does sound a very good process and I think the last point you made is actually a particularly interesting one, but do you feel that you are in any danger of running up against the limits of the talent, experience and suitability pool as it were? Secondly, linked to that, do you have any thoughts as to whether the 70 years old cut-off point ought to be altered so that people do not have to be renewed every year?

**Lord Turner of Ecchinswell:** I am in general against 70 year cut-off points; that reflects my job. When I was the chair of the Pensions Commission I think we as a society did throw away a lot of older talent and I think retirement age is going to have to relentlessly increase to be affordable in any case. Broadly speaking I continually believe we need to challenge cut-off points and I think it would be sad if people truly had the capability. The difficulty on cut-off points has always been that cut-off points can be socially useful in an organisation because, bluntly, there are some people who, when they get to 70, are slowing down and beginning to lack the sheer energy level they previously had and the cut-of point in the rules makes it easy to have the discussion, a very nice dinner and good-bye, rather than saying, “I

think honestly you are beginning to lose the energy we need, whereas Mr X over here or Mrs Y over there still has it.” Still, on the whole I am somewhat against cut-off points. Is there a limit to the pool of capabilities? The answer is there should not be. These are very important, demanding jobs but there are not so many of them that there should not be people who are capable of doing them with adequate training and adequate attention to detail. I do not think I am worried that we are, as it were, going to suddenly find there is an absolute limit to the number of people who are capable of doing these types of jobs.

**Q19 Lord Lipsey:** Following on from that in a way, one of the dangers of the approach you are adopting, and I generally welcome it, is that you are asking what it is about your past that equips you to do this. There is another skill that could come to a board which is coming to something afresh and asking questions that nobody else dares ask and not caring if the chief executive gets cross about it. Does the present process adequately incentivise that kind of person to go onto boards?

**Lord Turner of Ecchinswell:** We had a very interesting debate at the board, stimulated by the executive, the other day about to what extent in these interviews we would ever be able to assess cultural issues such as willingness to challenge, willingness to stand up. I think we are very aware that is one of the most important things. One of the things that probably went wrong on some major bank boards was dominant chief executives or leaders who did not particularly welcome criticism and an unwillingness of people to criticise or challenge. I think we are aware this is an issue which, in an ideal world, we would get to, still thinking about to what extent we or anybody else really has an ability to measure that, either in an interview in advance, or by some subsequent process of review or analysis of how the board operates. One of the most important things here is the soft cultural factors of willingness to challenge and it is one of the most difficult things for any regulator or supervisor or investor

to work out from outside whether somebody has those capabilities or not. We are aware of the issue and we do not have a full resolution to it.

**Q20 Baroness Kingsmill:** Lord Turner, I wonder if we might now turn to the vexed question of remuneration. Would you like to amplify a little bit on the steps that the FSA is taking about banker compensation and ensuring that it is related to performance?

**Lord Turner of Ecchinswell:** I think the crucial thing is it should be related to performance and it should also be related to risk. The FSA, I think I can say, was about the first regulator in the world to grab hold of this issue last year and we produced a new set of rules in July for application at the bonus round which has just occurred, ie in relation to the remuneration for the 2009 calendar year. The core focus of those rules was not on the level of remuneration, and that is very important because there is perhaps a legitimate set of social issues about inequality within society but we are not an inequality regulator. Our focus has to be on risk and on whether the structure of the way people were paid was such that encouraged them to take unreasonable risk. The extreme of this is that if you pay somebody a large cash bonus in February on the basis of the accounts as struck at the end of December with all the difficulties of accounting, foreseeing problems that come in the future and mark-to-market accounting, et cetera, there is a very real danger that you encourage people in the previous year to do very risky things and get large bonuses and once they have it, they have it. Those rules focus on how do you design performance criteria which are long term? How do you create claw-back capabilities so that you can see results emerging over subsequent years? How much of a bonus should be deferred; how much should be paid in equity? What are good metrics which understand the risk which is being taken? We put those out last July. They were broadly speaking picked up by the Financial Stability Board and the international principles which have been agreed which were issued by the Financial Stability Board at the time of the Pittsburgh Summit last September are very close to the FSA rules. We had these rules

implemented. These are rules of the FSA; you have to stick to them. We have had intense discussions with all the UK-based banks and investment banks, including the UK-based arms of foreign banks and we have gone through a process from November onwards in relation to this bonus round which has produced, I think, significant changes in the structure of compensation. You can see that in the announcements as to how much was deferred, how much was in equity, et cetera. The FSB meanwhile is conducting its first what is called thematic review of implementation; the first such review is focussed on what is everybody doing round the world to implement the FSB principles on remuneration. We will get that report in April. I think what it will show is that there is a small number of countries, including ourselves, Switzerland, France and a few others, which have a really quite rigorous rules-based approach and there are others which are progressing in a more principles-based approach but are perhaps less aggressive in applying it. I think that has been okay this year. If that divergence exists in the future it gets more and more problematic over time for us to be regulating and supervising large cross-border firms which are active in New York, London and Hong Kong if we do not have commonality of enforcement. We will certainly be pushing to encourage all of our international colleagues to move to the rules-based approach that we have.

**Q21 Baroness Kingsmill:** Do you think there should be any difference in approach for those banks that are owned by the taxpayer?

**Lord Turner of Ecchinswell:** I think that is really not an issue for the FSA actually. Our approach has to be what are good payment mechanisms which, to the best extent possible, shift the incentive structures away from risky activity. I think there is a separate issue about legitimate public concern about public money that has gone into banks and what is therefore appropriate behaviour of top management or people receiving bonuses in those banks in the immediate aftermath of that. However, I think those are fundamentally not regulatory issues

for the FSA; I think those are fundamentally political issues for the government as shareholder in the banks.

**Q22 Baroness Kingsmill:** The enforcement of the remuneration rules is going to be very difficult because many of these bankers can get paid in different jurisdictions, can they not?

**Lord Turner of Ecchinswell:** Yes, and that is why I made the point that in the long term we do need international definition. It is not that hard for a major international bank to declare that somebody is working in x location and not y location. Whether somebody is employed in New York but spends 40 per cent of their time in London or employed in London but spends 40 per cent of their time in New York, these are nuances within the organisation of large banks and therefore we will continue to apply our rules but there will be leakage at the edge of them if we do not get a common application of them across the world.

**Q23 Baroness Kingsmill:** There is a lot of competition for the more productive, shall we say, bankers. It is going to be extremely difficult to regulate the way in which they can be poached if you like.

**Lord Turner of Ecchinswell:** Yes. In a sense you can see that what these regulations are trying to achieve is to get round a collective action problem. I have sat on the remuneration committee of a major bank and I know that the problem in the past has been that you get a statement “We could hire this guy into this trading room; this is the package”. You look at the package and you say: “Why cannot more of it be deferred? Why cannot more of it be subject to claw back? Why cannot more of it be equity with a vesting period of five years? Why can it not be five years and not three years?” You get told, “If we do that they will not join, they will go elsewhere”. So you end up with the frustrating position of knowing what you would like to do but not being able to do it. In a sense what regulation is attempting to get round here is a collective action problem. It is trying to make it easier for remuneration

committees to do what many of the more thoughtful of them always knew was a sensible thing to try to achieve.

**Q24 Chairman:** As someone who has also been on the remuneration committee of a very large bank in the past, I agree with that entirely. It is extremely difficult for remuneration committees to act on their own. Can I come back on that point to what you were saying earlier on that you did not think it was a matter for the regulator to get into the quantum of remuneration because inequality was not an issue for a regulator. You also mentioned earlier on economic rent and in a sense the quantum is partly a function of the ability to exact economic rent and arguably economic rent is an issue for a regulator. I just wonder whether there is not a case on that basis for trying to reduce the amount of punch in the punchbowl and thereby reducing the liability to inebriation downstream. We know, for example, that there is an implicit if not explicit agreement between institutional shareholders and major financial institutions as to what proportion of earnings goes to the shareholder and what proportion of earnings goes to the bonus pot. Is there not a case for some regulation as to what that proportion might be which does not actually get to the quantum but does at least reduce some of the punch in the punchbowl?

**Lord Turner of Ecchinswell:** I think there are at least two separate issues there. The one area where we did get involved in quantum, or at least proportion, last year was that we made it plain that in an environment where future capital requirements of banks are going to go up by amounts which we cannot tell until we have a global agreement fully specified but know it is going up, and in an environment where some banks were making very large trading profits in circumstances made easy for them by the very conditions of the crash. Some banks early last year were making lots of money in part because market shares had gone up because various competitors had disappeared from the market place. They should be devoting the lion's share of that extra money to building their capital requirements. If you actually look at the payout

rates of the major investment banks and major trading commercial banks this year they did come down; the proportion paid out did come down and they are building up their capital. That is a legitimate area for a regulatory input which will have some impact on quantum. However, let us suppose that after a few years of that you have some banks which have capital requirements higher than any that we could reasonably say. Suppose we say, “We really want you to build up to x per cent and they are at x per cent”, I think it then becomes quite difficult for us to say, “Therefore you have to retain earnings rather than pay it out as bonuses or dividends”. We do not have a clear locus in prudential regulation to do that. The separate issue then becomes: is there a process of rent extraction going on here? Is there something about bits of this industry which, as it were, earn supernormal return from some naturally arising structural oligopolies, et cetera? I think there may well be and I think that might be a legitimate issue for society to think about, but at the moment the FSA is not structured as an economic regulator. It is not our responsibility to think about what is the appropriate return on capital for financial services companies in a way analogous to the way the energy regulators have been set up. There is a set of extremely complex, interesting but amazingly difficult issues related to why some parts of the financial services industry are quite so profitable and why does quite so much of at least the private value added stick to the employees rather than the shareholders? Those are the two characteristics of these markets which are quite striking. I think they are interesting and important issues, but I do not think they are immediate ones which we have the legal remit to address.

**Q25 Lord Tugendhat:** I am going to change the subject completely; this is a question on the regulation of the mortgage markets in the United Kingdom. When we conducted our first inquiry I remember the people from the building societies who came before us were rather smug about their situation, since when a number of things have come to light in the building society sector. Quite apart from that, of course, some of the most vulnerable of the banks

were primarily mortgage banks. Do you have any views about the changes in the regulation of mortgage markets in the UK and, as a sub-set of that, any views about extending your consumer protection responsibilities to buy-to-let?

*Lord Turner of Ecchinswell:* In relation to buy-to-let and even more so probably second mortgages of a non-buy-to-let characteristic – it is important to realise we do not regulate either of those; I think some people would understand intuitively why history would have left us without buy-to-let but I think more people are surprised when they realise that we actually have no regulatory remit in relation to a second mortgage taken out even by a residential customer – we have said in the past that we could see an argument for those being brought within our regulatory remit. It seems to have some sense for one regulator to have oversight of the totality of these markets. Buy-to-let has been excluded on the grounds that it is a business and we do not regulate small businesses. That is how it has ended up in that category, but it is a particular form of that business. As to the wider issues of the mortgage market, we did issue a discussion paper last October which did signal our intent to propose what would be significant changes in our regulation of the mortgage markets. We are about to go the next stage in our required process, which is a feedback statement recording what the industry and consumer groups have fed back to us in response to that discussion paper. We will then be proceeding through our processes of consultation paper and then to proposed rules, et cetera. In the run-up to this crisis there was clearly an interesting development in the UK mortgage market. I would describe it as being the development of a tail of very bad lending. If you compare mortgage losses this time round from the early 1990s actually this time round they are considerably less. They are considerably less for a very simple reason, which is interest rates have come down. You have to remember that between 1989 and 1990 the mortgage rate went up from seven to 14 per cent so even people who were still in jobs were, in some cases, very stressed in terms of making their mortgage payments. Most people,

as long as they are maintained in employment this time round, are in a position of actually paying less on their mortgage now than they were a year ago, but we still have a tail of very poor mortgage lending which, despite those favourable circumstances, is producing a significant amount of arrears. We can see where this is coming from. It is coming from practices like self-certified mortgages with no income verification; it is coming particularly from some of the specialist mortgage lenders who were packaging up mortgage securities and then distributing them and who therefore perhaps did not feel the same need to make sure of the creditworthiness of their borrowers because they did not think they were going to be living with that loan for the rest of their life. In relation to that we are therefore coming forward with a set of proposals – the discussion paper raised a set of proposals - first of all which would require income verification; secondly it would place some sort of affordability criteria requirement on lenders, that lenders have to go through a process of making sure that the borrower truly is able to afford to repay the mortgage, and therefore would be basically saying that it is not all right to lend money to a borrower who is borrowing in the expectation of capital gain. This clearly was the huge problem in US sub-prime lending. You had lending to people where it was quite clear that on their income and consumption basis they really had no ability even to pay the interest on these loans and who were simply taking out these loans on the grounds that as long as three years later the house price was higher than it was at the moment they would be able to refinance this loan at another teaser rate and live for many years with a sequence of re-mortgaging. We are intending very significantly to tighten that up. We have looked at the issue of whether there should also be straight loan-to-value ratio limits or loan-to-income ratio limits and we have not concluded in favour of those but we have left that as an open issue and considered whether there might be combinations of loan-to-value ratio or loan-to-income ratio where you might say that combination is so

unlikely ever to make sense that it is simply disallowed. The direction of change is a significant change in the regulation of the mortgage market.

**Q26 Lord Tugendhat:** Let me just ask one supplementary arising from my recollections as Chairman of Abbey National. I remember back in the early 1990s one of the lessons we felt we had learned was that if you could get to people quickly enough you could generally stop a problem becoming too difficult. If you got to them after they were one or two months in arrears you could do something about it; if you did not get to them until they were six months in arrears it was too late. I wonder if there is any connection in the bad tail you were talking about between those who have the capacity to keep a very close eye on individual payments and those who do not.

**Lord Turner of Ecchinswell:** I do not know whether that is the case, but that may well be the case. It is certainly the case that where you have a large amount of lending that has taken a securitised and distribution form, you are less likely to have a lender relationship which is on-going and therefore in a good position either to respond immediately to problems or to renegotiate, make deferral arrangements, make reduction arrangements. The process of mortgage securitisation and origination - although it has some advantages and I think will continue to be a part of the mortgage market in many parts of the world - does complicate, for instance, re-negotiation of loans because you no longer have that on-going relationship between a lender and a borrower.

**Q27 Chairman:** Last year in our report one of our recommendations was that the FSA might reinstate its regular meetings with the external auditors of the banks. Has that happened? What is the relationship now with the external auditors?

**Lord Turner of Ecchinswell:** We have significantly increased our relationship with the auditors of banks and we do have a regular set of meetings. For instance, we now do discuss

with them and we gather data on the relative treatment across different banks of the valuation of apparently similar assets. One of the things we found when we looked at some of the problems in late 2008 was that a similar or, to all intents and purposes, identical asset in terms of what its credit characteristics were and in particular the degree of assurance that it had from monoline insurance showed up in the trading books of banks or the available-for-sale books of banks with really quite dramatically different marks (some of them 30 per cent of the face value, some of them 60 per cent of the face value). That alerted us to the fact that although there is a commonality of accounting standards interpretations can be very significantly different. So we are now involved on things like valuation in discussions on both the gathering of data so that we can understand that variation of practice and in discussions with auditors about why that variation exists and therefore trying to encourage a greater commonality of approach.

**Q28 Lord Best:** Has enough been done to address the problems of credit rating agencies that were so easily perceived before the credit crisis?

**Lord Turner of Ecchinswell:** Yes, I think we have done the appropriate measures on credit rating agencies but they will not solve all the problems that derive from the very essence of credit ratings. What was the problem with credit rating agencies? First of all, it is important to understand that if you actually look at the performance of credit rating agencies in the years up to 2000 they appeared to be doing the job that you expect them to do. The job that you expect them to do can be measured by saying, let me take everything they rated as AAA in 1980 and everything as AA and everything as A; was that a reasonably good forward predictor of the relative probability of default of these different securities over the next 20 to 25 years? It turns out when you do that historic analysis it was not bad, so there appeared to be, despite all the problems that people can in theory suggest about an issuer-pays model, a model which in some way or other worked effectively. What we found was that in the crisis

the ratings - not of the sort of classic things they had always been rating like the single name corporate bonds but of the fancier complex securitised credits - performed very badly and were subject to rapid ratings downgrade et cetera. There were also problems, quite clearly I think, of conflict of interest, which at the very least had tempted credit rating agencies into being willing to put ratings on securities for which there really was not a track record or a degree of information that made any rating reasonable, or indeed conflicts of interest which in some cases were tempting them to give the rating which the issuer wanted. I think there was a reasonable suspicion of that. The regulation of them is very heavily focused on their internal governance, their registration, making sure that they have processes to ensure independence of the professional raters to regulate their conflict of interest. I think also that regulation will be supported by a market reaction. I think the market will simply not pay any attention to ratings on extremely complicated re-securitisations in future. There will be a simple "once bitten twice shy" and therefore there will be some structures which simply will not come back into the market place. I think we will make progress. The challenge which we cannot get round is the inherent procyclicality of the role of ratings in the financial system. The difficulty is that there are lots of people who say, "Why do people over-rely on ratings?" The fact is if you are the board of a medium-sized charity deciding where to put your money, you are not going to have that charity employing a set of independent credit analysts of banks; you are going to say that all of our money must be deposited with banks with a credit rating of at least AA. This is quite pervasive in all sorts of institutions and institutional investors, charities and individuals throughout the economy. It does mean that when something is down-rated there are trigger points. That down-rating produces a whole load of people who are required by their investment mandates, their treasury mandates to take money out of bank x or out of a particular investment in a corporate and put it elsewhere. That undoubtedly does create a procyclicality within the system. I think the difficulty is we cannot get around that by

addressing the ratings systems; we have to recognise that that is one of many features which puts some procyclicality into the total system against which we have to lean by other features of the regulatory requirements. We are making progress but it will not resolve all problems that exist as a result of the existence of ratings.

**Q29 Lord Best:** To what extent should ratings be used in financial regulations?

*Lord Turner of Ecchinswell:* We are trying to reduce the extent to which they are used in financial regulations because I think the one thing we can do is to try to make sure that we are not contributing to those procyclical triggers. Having said that, there is an issue there for us but also for central banks. Central banks typically use ratings as the basis for the definition of the collateral which they will accept for re-discounting discount windows and liquidity support. That of course creates another potential ratings trigger within the system.

**Q30 Lord Forsyth of Drumlean:** After nearly two hours this is obviously the moment to talk about credit default swaps. When you gave evidence to us last year you suggested the FSA might become involved in the approval and design of financial products. Where are you at now?

*Lord Turner of Ecchinswell:* We have not gone down that road, although I think the issue as to whether there might be any conditions under which one can restrict naked credit default swaps, ie credit default swaps where there is not an underlying credit position which one is hedging, I think that still remains an open issue which is worth debating. Our focus over the last year has been very much on removing the systemic risk - or putting in place the actions which will remove the systemic risk - which arise from the complete cat's cradle, the incredibly complicated inter-connectedness of multiple bilateral credit default swaps. One of the problems which emerged, particularly with the problem with AIG, was a whole load of people who had a credit default swap counter-party risk with AIG, there was a complicated

interface between that and the issue we have just been talking about which is the credit rating trigger, and we realised at that point that the existence of this huge mesh of bilateral swaps created a very major risk. The crucial way forward there is actually to try to get as much of this market as possible onto central counter-party systems with disclosure of trades alongside it as well, but in particular with central counter-party systems so that the credit default swap exposure of each individual is with a well capitalised central clearing house and with processes of daily margin call and collateral to make sure that when problems arise you do not have a large open exposure. We are going forward with that and combining it with significant increases in capital requirements which would be required against any credit default swap which is not traded through or not cleared through that central counter-party clearing in a way which will significantly reduce the risk. That is the way that we and the other regulators are going at the moment. I do not exclude the fact that there might at some stage be other issues that we could look at but that has been the immediate thing with which we have been getting on.

**Q31 Lord Eatwell:** Could I ask about the central counter-parties because if you have central counter-parties do you not therefore concentrate risk at the site of the central counter-party? Is it conceivable that the proliferation of central counter-parties which seem to be emerging at the moment is actually going to create greater risk than they mitigate? Would it not be preferable for central counter-parties actually to be public bodies?

**Lord Turner of Ecchinswell:** I think that is a separate issue. It is certainly the case that when you have central counter-parties they do create a potential point of failure in the system and therefore it is vitally important that they are adequately capitalised in their fundamental reserve and emergency crisis funds but also that the processes of daily margin call make sure that the scale of the open positions that they have with any other counter-party are limited to daily movements. There are crucial issues then about how big the reserve funds need to be

relative to the size of each of the counter-parties that they have and you can make it either equal to the positions of the top three counter-parties, et cetera. We are very well aware that in taking the risk out of the bilateral meshes we create a new point of risk and therefore the capital and the margining arrangements which exist at that point are incredibly important. To your second point, you can then achieve that objective by the regulations that you impose on a private central counter-party or a public central counter-party; both are ways of arriving at the same end point.

**Q32 Lord Eatwell:** Just one point on naked CDSs, it has been suggested that insofar as a CDS is an insurance contract, a naked CDS is illegal anyhow since there is no interest in the underlying.

**Lord Turner of Ecchinswell:** That is the argument for banning naked CDS. I do not think they are actually illegal in law but that is certainly the argument that they ought to be illegal in law for that. The counter-argument that people make is: what is a hedge? Suppose I have an open credit exposure to a bank of a country and there does not exist a liquid CDS market in that particular bank but the sovereign of that country is somewhat meshed in with the risk of that bank, then by taking a naked CDS on the sovereign I have some somewhat hedged my risk. These are the arguments that you would have to get into if one was going down the route of banning naked CDS. It is almost: have I taken out an insurance on your house because for some reason of a non-existing market I have been unable to take out an insurance on my house and they are next door and they will burn down together. That is where the argument gets complicated, but it is certainly a very useful challenge as to whether, under certain circumstances, naked CDS can create undesirable incentives.

**Chairman:** That brings our session to a close. Thank you very much, Lord Turner, for spending so much time and for your clear and helpful answers.