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Too important to fail– too important to ignore

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Summary

The banking crisis of the last two years resulted in government support for the sector around the world amounting to almost a quarter of global GDP. One of the factors contributing to the crisis was that banks had been carrying out risky activities, and had mispriced and misallocated that risk. The actions Governments took to prevent financial meltdown may have been necessary, but they also revealed the implicit subsidy to the financial services sector from states which could not afford to let their banks fail. The bail-outs have not ended the mispricing of risk, and have arguably made it worse: ratings agencies now provide a 'support rating' which takes into account the likelihood that a government would not allow a particular bank to fail.

Banking reform is needed. First, both global and national regulation must be made better and more effective. Secondly the comparatively narrow capital base upon which banks operate should be addressed. The Basel Committee is currently working on reforms to capital and liquidity ratios which should go some way towards this. There is indeed scope for better regulation. But while better regulation and higher capital ratios could mean that crises are less severe, they can not stop them. History is littered with examples of financial boom and bust, from the tulip boom in 17th century Netherlands, to the South Sea Bubble, to the dot-com boom. The challenge is to make sure that the financial system itself is not, as it has been recently, a prime cause of such instability, and to ensure that, in so far as possible, financial institutions bear the consequences of their own actions. That will require more radical action.

Reform is particularly pressing for the United Kingdom. In the 1970s the UK banking sector had a balance sheet of 50% of United Kingdom GDP; it is currently 500% of GDP.[1] During the financial crisis, governments have effectively stood behind the banking system. If international banking in the United Kingdom is to remain credible, reform must ensure that the tax payer is better protected from picking up the bill.

This Report looks at the range of reforms currently under consideration, and assesses them against the objectives of an orderly banking system such as protecting the consumer, protecting the taxpayer, setting an appropriate cost of doing business and providing lending to the economy. There are trade-offs between these objectives: the more consumers are protected, the more risks tax payers may have to bear; the more banks have to pay for their capital, the higher the rates they will charge their customers. Policymakers will have to decide where the trade-offs should properly be made and how this should be explained to the public who understandably want to see rapid and sustainable change.

Successful reform would transfer risk away from Government and back into the banking sector. We are clear that radical reform is necessary but it cannot be achieved immediately: if it were done too quickly the cost to banks and to their customers would increase too quickly to be absorbed. But it has to be done. The collapse of Lehman Brothers showed that the failure of an interconnected systemically important international firm has widespread

1 Q 110

and cataclysmic implications. An indication of improvement will be a system which enables a large international institution to go bankrupt smoothly—and where prices in financial markets do not implicitly or explicitly assume a government guarantee.

1 Introduction

Too important to fail—too important to ignore

1. The emergency actions taken by governments across the world during the banking crisis appear to have identified a type of financial firm, or group of financial firms, so integral to the financial system ('systemic') that the respective governments were forced to bail them out in some form, rather than let them fail as an ordinary firm would. Box 1 describes how the Financial Services Authority suggests such systemic firms could be identified. These firms are collectively known as 'Too important to fail'. This Report examines the structure of the financial system that has led to the existence of such firms, the benefits and costs from allowing such firms to exist, and what objectives should be considered should we modify how the financial system is run to minimise the problem.

Box 1: Identifying systemic financial institutions

The FSA'*s Turner Review Conference Discussion Paper* highlighted three potential reasons why a financial institution (or set of institutions) may be systemic, and therefore under the current regime are difficult to unwind:

i) **systemic by size**. This can be a function of the firm's absolute size or in relation to a specific financial market or product in which a firm is particularly dominant. The channels through which systemic risks would crystallise as a result of the failure of such a firm include: losses to uninsured creditors and depositors through high bankruptcy costs and reduced recoveries; disruption to financial services (such as to payments, clearing and settlement, extension of credit); and losses to insured depositors because the DGS [Deposit Guarantee Scheme] could not pay out sufficiently quickly or because the aggregate payout imposes unsustainable costs on those who fund the DGS. In addition and crucially, systemic risks can take a macroeconomic form, with the loss of credit extension capacity leading to, or exacerbating, a downturn in economic activity which then has consequences for the rest of the financial system.

ii) **systemic by inter-connectedness.** Links and inter-connections can include, inter alia, inter-bank lending, cross holdings of bank capital instruments, membership of payment systems, and being a significant counterparty in a crucial market. The channels through which such problems manifest themselves include:

• *interbank exposures*. The domino effect where the collapse of one firm leads to major losses at others, and then in turn leads to their collapse. This can then trigger a chain reaction;

• *the confidence channel*. The collapse of a systemically important firm leads to a crisis of confidence in financial markets. The confidence channel is particularly important to the 'systemic as a herd' category (see below), given the perceptions by the market that a number of firms are exposed to the same set of risks;

• *the asset margin spiral channel*. Firms increasingly finance themselves through repo and reverse repo arrangements. The haircuts charged on the collateral underlying these contracts dictate the extent to which firms can leverage themselves. In a crisis, both funding conditions and credit concerns will lead counterparties to increase haircuts, triggering a deleveraging process. This will in turn be disruptive, through a self-reinforcing spiral between lower market liquidity and funding liquidity.

iii) **systemic as a herd.** The market can perceive a group of firms as part of a common group (for example, because they have a similar business model, such as building societies in the UK and the savings and loans banks in the US), or common exposures to the same sector or type of instrument. A single firm in this group may not be systemic in its own right, but the group as a whole may be.[2]

2. One of the characteristics of firms that are classified as 'too important to fail' can be that they operate across borders. Such international financial institutions bring benefits both to the firm and countries in which they operate. But they can also be more difficult to resolve (i.e. close down or make bankrupt) should the firm run into difficulties. The most recent Financial Integration Report prepared for the European Commission considers the integration of the countries of Central and Eastern Europe into the European financial system, and describes the following benefits:

> EU financial integration, through cross-border establishment, has risen sharply over the past decade and has brought with it a range of benefits to both home and host countries. Benefits range from increased income generation, improvements in technology and risk management, increased access to funds, risk diversification and deepening of financial markets.[3]

3. However, it also recognises that such integration is not without difficulties:

> The current crisis has demonstrated that there is a risk in building up major concentrated exposures. If several CESE use a 'common funding channel', such as Austria or Sweden, this significantly increases their risk and vulnerability to fluctuations in home countries. The same conversely applies for home countries in the event of excessive concentration of the cross-border lending business of their banking sector on a few countries. [...].
>
> Swedish bank establishments in the Baltic region provide an illustration of the difficulties that may occur for both home and host countries [...].
>
> For the home country, Sweden, the establishment of banks in the Baltic countries has had significant benefits for the Swedish banking sector, in particular in terms of market expansion and creation of new revenue streams. However, when the global crisis emerged, the credit expansion came to an end and credit losses started to increase in the Baltic region. Many commentators then explained the fall in the

2 Financial Services Authority, Turner Review Conference Discussion Paper, A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact, October 2009, Para 3.18

3 European Commission, European Financial Integration Report 2009, January 2010 , P 37

> Swedish Krona and falls in market confidence as directly stemming from Sweden's high exposure to the Baltic region. Swedish banks also experienced substantial loan losses, estimated to be in the order of SEK 30 billion for the first six months of 2009, with 44 percent of these losses directly attributable to the Swedish banks' operations in the Baltic Member States.
>
> [...] For the Baltic region the rapid increase of foreign bank presence has had considerable, but different consequences. On the one hand, it contributed to the growth of financial infrastructure, facilitating economic growth. [...]
>
> On the other hand, the high concentration of exposures and the lack of adequate risk management and regulation contributed to the building up of major imbalances. The easy access to foreign loans, denominated in euro, also resulted in the building up of a speculative property bubble as well as substantial current account deficits in the Baltic region. When the financial crisis hit, and sources of credit dried up, assets were re-valued and credit ratings were downgraded, leaving these Member States highly exposed to foreign exchange denominated debt, falling property prices and internal revaluations.[4]

4. The Report concludes "While integrated financial markets have brought clear benefits, the financial stability aspects have not received sufficient attention. In an integrated market safeguarding financial stability should be a common interest."[5]

5. As the Financial Integration Report notes, integration can expose both home and host countries to risks from poorly managed and poorly regulated institutions in other countries. Recent press attention has focused on the discussions between the United Kingdom, the Netherlands and Iceland about how Iceland might repay the compensation to depositors in Landsbanki provided by the British and Dutch governments. However, other cross-border institutions have also faced dangers, such as the Swedish banks noted above. Fortis bank needed to be rescued in Belgium and the Netherlands. We recently visited Germany, Austria and Hungary to explore the exposure of European banks to branches in accession countries. The difficulties there appeared to be limited, but that was, in large part, due to IMF intervention. Our Report takes account of the fact that financial services are increasingly international.

6. The financial crisis has seen significant public support extended to the financial system, and consequently, significant political interest in how the financial system operates. Stephen Hester, RBS, when he gave evidence to us, accepted that such scrutiny was necessary:

> until the banking industry can demonstrate that in times of crisis it does not need public support in the level that has been given, the banking industry I think has invited on itself this kind of scrutiny and intervention. One of the things that I think is most important—not for this reason, by the way, but for public policy reasons—is

4 European Commission, European Financial Integration Report 2009, January 2010 , p 37

5 *Ibid.* , p 38

> that the far-reaching reforms of the banking industry that are going on globally over the coming years do indeed get to the point where a crisis can happen and banks do not need to call on this level of public support. So I do completely understand for all of those reasons the level of scrutiny.[6]

This Report looks at how far the financial system will ever be able to move away from having the government as its final port in a storm.

7. **For the past two years financial services have been under unparalleled political scrutiny. As bank executives acknowledged, this will continue at least until the banking industry can demonstrate that in times of crisis it can survive without significant public support. One thing at least is now abundantly clear: the public will not stand for another bailout. The political case for action is as strong as the economic one.**

8. **Central banks will always have a function as lenders of last resort. In exceptional circumstances, governments may have to step in to address systemic crises. There must not be an assumption that this will always happen.**

Difficulties in policy making

Trade-offs

9. This Report is centred around the consideration of solutions to the problem that some banks have become 'too big (or too important) to fail', and to the distortion to the market the existence of such firms creates. We have encountered a number of trade-offs in our inquiry, such as that between the stability of the financial system, and economic growth. We identify several objectives that the financial system should meet, and then assess potential reforms against those objectives. However, the decisions on which reforms to accept will be swayed by society's preferences on the objectives. For instance, do we wish to protect consumers by implementing an upfront cost on firms to pay into a deposit protection fund, or are we prepared to have an ex-post fee, and allow the Government to pay out for consumer protection in the first instance? Do we wish to maximise the global flows of capital which international banks facilitate, or are we more concerned about the ability of individual countries to protect their own financial systems? Only by ranking the objectives can a decision be made.

Uncertainty

10. While such a ranking of objectives would be useful, one of the problems in our inquiry has been that the measurement of the impact of the reforms is difficult. We have repeatedly been told that it is impossible to quantify the effect of even a single reform, let alone the interplay between different types of reform. Moreover, even if it were possible to model the expected impact of a particular change under expected circumstances, there will always be uncertainty in the system, 'unknown unknowns', which mean that a definitive answer may

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6 Q 11, HC 259-i

always be unavailable. Those looking for easy, quantifiable, answers are likely to be disappointed.

Systems within systems

11. This Report focuses on the banking system, and a particular problem, 'too important to fail', within that system. The banking system itself though is part of a wider financial system, with other markets, institutions and instruments. The interaction between these different players will impact upon the banking system, for instance, some witnesses discussed the need for reform in the 'naked' Credit Default Swap markets, and the need for reforms to the over-the-counter market.[7]

12. The financial system is also part of a wider legal system, setting out matters such as permissible ownership structures and insolvency procedure. It is also affected by the fiscal system, which may or may not include particular taxation regimes for financial services. Again, examples were raised of interactions between these different systems. Lord Turner noted that:

> If you look at Mervyn King's and John Kay's standard textbook on UK Corporate Taxation, which I believe was first published in 1977, you will find discussion of how tax deductibility of interest is creating a bias in the tax system. This is one of the things that has been around for ever. All economists have identified that this must create an incentive for non-banks and banks to leverage themselves up. One of the reasons banks do not like us requiring them to hold a lot of equity is that it means we are forcing them to hold capital in a non-tax-deductible rather than tax-deductible fashion. Could you ever change it? I do not know. [...] it means that in all our other policies if we cannot change it we need to be aware that we have a very big bias in the system continually to try to select a higher level of leverage than is optimal in terms of the management of risk.[8]

13. In the time available to us before the election we have focused on issues relating to the banking system and its regulation. This of course cuts across the linkages between the banking system and others. We do not think these linkages are unimportant; readers are encouraged to look through the evidence provided by this inquiry for further discussion of these issues. However, too great an emphasis on system complexity can lead to inaction. Reform may have to come gradually, and any new system may require many iterations before it is fully satisfactory.

Conduct of the inquiry

14. This is the latest in a series of inquiries into matters relating to financial stability we have conducted over the past two years. Whether looking at the impact of the failure of the Icelandic banks, governance structures within the City or reforms to the Tripartite Structure of regulation, the Committee has tried to provide to the House a body of

7 Qq 512, 529

8 Q 511

evidence on these important topics, as well as a view on the relevant issues, and government policy in these areas. This inquiry is a continuation of that work, building upon our previous Reports and their conclusions.

15. Our inquiry spanned seven oral evidence sessions. We are grateful to Professor Charles Goodhart, Professor John Kay, Mervyn King, Governor, Paul Tucker, Deputy Governor (Financial Stability), and Andrew Haldane, Executive Director, Financial Stability, Bank of England, E. Gerald Corrigan, Managing Director, Goldman Sachs Bank USA, Douglas Flint, Group Finance Director, HSBC, John Varley, Chief Executive, Barclays, Alfredo Sáenz, Vice Chairman and Chief Executive, Santander, Lord Turner, Chairman, Financial Services Authority, and Professor Alexandre Lamfalussy, for sharing their views on this important subject with the Committee. We are also grateful to those who submitted written evidence.

16. We undertook two overseas visits in relation to this inquiry. On 30 November–4 December we visited Frankfurt, Vienna and Budapest and on 1–5 February we visited New York and Washington. We are extremely grateful to all those who hosted our visits. In particular, we thank the Foreign and Commonwealth Office. The help we have received from the Ambassadors and the staff they lead has been vital to our work. We are also extremely grateful to the staff of all the institutions we visited for their excellent assistance and support.

17. We would also like to thank Professor Geoffrey Wood of the CASS Business School, London, for his expert advice and assistance in this inquiry and on the other inquiries relating to the banking crisis.[9]

9 Relevant declarations of interest relating to Geoffrey Wood can be found in the Minutes of the Committee. See www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_formal_minutes_by_session.cfm www.parliament.uk

2 The objectives of banking system reform

How to design a banking system

18. Given the impact of the financial crisis on both the financial system, and the wider economy, we questioned witnesses as to what reforms there should be. Douglas Flint, Group Finance Director, HSBC, countered that he would first start with:

> defining the purpose of the banking system. Everything else is at the micro level until you have said what we are actually trying to achieve, and then make sure, as best one can, that one understands what the appropriate capitalisation of that system would be, and that the system can make the appropriate return on the capital that is being required of it to have, because I think it is very important that the system is capable of attracting the capital that supports the level of risk within it.[10]

The same point was made by Professor Goodhart, who noted that:

> One of the considerations that you have to have is actually what you want your banking system to do. One way or another [...] we are likely to make our banking system safer and smaller. The question is: will that be a good idea? How safe and how small do you want the banking system to be? If you make your banking system safer and smaller, what happens to the financing of your companies? You are going to push all the financial intermediation probably back on to the market. Will that make the world safer or will it make it more dangerous? For example, a lot of mortgage origination you can do through the market rather than through banks. Will that necessarily be safer?[11]

19. As Professor Goodhart implies, there are complex trade-offs between objectives and political and economic choices in deciding how to prioritise. Some of the questions he posed may only be answerable in the light of experience. In the rest of this chapter we explore some objectives against which we can both assess the banking system before and during the crisis, and any potential reforms currently under consideration. **Policy makers, nationally and internationally, will need to decide on their priorities for the banking system. A lasting framework will only come about once these decisions have been made.**

Objective 1: Protecting the consumer

20. For most people most of the time banking provides a basic utility function, which they expect to be well regulated and reasonably safe. More intensive customer education about the relationship between risk and returns offered, and the extent to which protection was available might reduce the amount of protection necessary, but in a modern democracy,

10 Q 390

11 Q 17

Governments cannot allow depositors in banks and building societies to lose significant amounts, and they have not done so.

21. No UK saver in a UK bank or building society covered by the Financial Services Compensation Scheme has lost any money from the failure of their organisation during the crisis. This has meant action by the Government to protect deposits above and beyond that of the deposit protection system in place prior to the crisis.[12] The Chancellor, in a written direction, explained why such support was needed:

> The Government has said that it will do everything it can to protect financial stability and ensure depositor protection. After the experience of the government's action to support both Northern Rock and Bradford and Bingley, most people understand this to mean that no depositor would lose money and that their deposits in UK outlets are safe. [...] the sight of people losing their deposits will undermine confidence in the financial system further, especially in today's difficult conditions. [...] There is a growing consensus in Europe and elsewhere that banks' customers deserve full protection in the event of bank failures.[13]

By providing this support, the Government gave an implicit guarantee for all retail savings in the UK.

22. Before the crisis, consumers seemed largely unaware of the risks that might accompany retail savings. The guarantee weakened or even removed any incentive for consumers to monitor for themselves the financial institutions with which they deposit their money, even though experience should have raised their awareness of risk. As Mr Haldane said:

> One of the consequences of the blanket guarantee on taking risk off the table is that the retail deposit market in the UK has become rather distorted, with firms playing leapfrog in the rates of return they offer to retail depositors, almost irrespective of risk—which is not a good outcome for depositors longer term.[14]

23. Professor Kay was adamant that we should “escape” from this position as soon as possible.[15] He preferred a limit to the protection afforded to depositors:

> The structure which I would like to see would be one in which people have deposits which were the deposits they needed to make the payment system function. That is essentially the utility and the bit of the financial services system we need every day.[16]

But in a speech in June 2009, Paul Tucker, Deputy Governor of the Bank of England, stated that “Nearly a decade ago I became convinced of the need for 100% insurance of a meaningful amount in order, as I put it in internal exchanges, ‘to take politics out of crisis

12 Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56-i, paras 217-266

13 Letter from the Chancellor of the Exchequer to Nick Macpherson, 8 October 2008

14 Q 111

15 Q 21

16 Q 20

management'."[17] Mr Tucker noted that politics had been brought into the handling of banking crises because of "the hardship that could still be suffered by regular depositors when their bank failed".[18] He told us that he believed it was "foolhardy" to think that households should take some of the risk when depositing with banks because he did not think it was "realistic to expect households to monitor their banks".[19] This is consistent with Professor Kay's position, though for larger deposits Professor Kay would like to see a system:

> [...] of the kind of money market funds that exist in the United States, where people would be investing in a diversified portfolio of short-term obligations and would be taking a little bit of risk and would either have to judge that risk themselves or employ the fund managers to assess the risks for them.[20]

And in our Report on Northern Rock, we also emphasised the need for consumers to be aware of the overall scope and limits of any depositor protection scheme. We recommended that: "For the [depositor protection] scheme to have the maximum impact in protecting financial stability, the details of the scheme must be well-advertised, both in national and regional media, and through the display of posters in individual bank branches".[21]

24. **A robust banking system must include a high level of protection for the retail depositor. Investors and wholesale depositors must price the risk, as the majority of consumers are in no position to undertake due diligence on the banks with which they hold deposits. It is noteworthy that audit reports are for investors rather than depositors. But an explicit provision of a guarantee on all deposits, without limit, is a step too far. There will be trade-offs even in deciding which limit is suitable, and whatever limit is chosen, there must be clarity about the limit of depositor protection. This will require constant consumer education and clear information within all financial institutions.**

Objective 2: Protecting the taxpayer

25. Resolving the banking crisis has been a significant drain on government resources, in two ways. First, there has been the direct impact of the provision of public money for deposit protection and recapitalisation, as well as the continued risk to the public purse from loan guarantees under the asset protection scheme. In a recent speech, Piergiorgio Alessandri and Andrew Haldane highlighted the direct costs from the bailout. In Table 1, they provide "a snap-shot of the scale of intervention to support the banks in the UK, US

17 A speech by Paul Tucker, Deputy Governor, Financial Stability, Bank of England, at the British Bankers' Association Annual International Banking Conference: Restoring Confidence – Moving Forward, London, 30 June 2009, pp 3–4

18 *Ibid.*

19 Q 86

20 Q 20

21 Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56-i, para 243

and the euro-area during the current crisis. This totals over $14 trillion or almost a quarter of global GDP. It dwarfs any previous state support of the banking system".[22]

Table 1: Support Packages

($ Trillions)	UK	US	Euro
Central Bank			
- "Money creation"	0.32	3.76	0.98
- Collateral Swaps	0.30	0.20	0.00
Government			
- Guarantees	0.64	2.08	>1.68
- Insurance	0.33	3.74	0.00
- Capital	0.12	0.70	0.31
Total (% GDP)	74%	73%	18%

Source: Bank of England Financial Stability Report,. June 2009. Figures for UK updated to November 4 2009.

Notes: (1) Exchange rates used: FSR Europe/US dollar exchange rate of 0.710. Sterling/US dollar exchange rate of 0.613. (2) Money creation includes both monetary and financial stability operations.

26. Protecting the taxpayer is not just about avoiding downside risks. It is about capturing the benefits that the financial system sector can bring. As the Mayor of London said:

> • The Financial Services sector has brought huge benefits globally. Through enabling globalisation it has brought hundreds of millions of people into the global market economy.
>
> • The sector provides services for all other sectors. Examples are payments services, money transmission, investment services, finance, mergers and acquisitions services and insurance. [...]
>
> • Economic contribution: In 2008, the FS sector contributed to around 24 per cent of London's total GVA (15.9 per cent coming directly from FS, the remaining 8 per cent indirectly from other sectors that FS assists).
>
> • Employment: More than one million people work in the industry, each contributing to GDP more than double the average for all employees. The industry accounts for around 8 per cent of UK output and contributes 14 per cent of tax revenues.
>
> • The sector maintains a liquid market for UK government debt, ensuring that the taxpayer pays the lowest cost possible for servicing the debt.
>
> • The insurance sector provides cover against disasters that could do immense damage to the wider economy.
>
> • The sector is innovative. New areas such as carbon trading and Islamic finance can help the environment and foster financial inclusion.[23]

22 A speech by Piergiorgio Alessandri and Andrew G Haldane, Banking on the State, Bank of England, November 2009

23 Ev 135

- An essential service provided globally: FS enables businesses and households to carry out transactions quickly, cheaply and reliably all over the world, through global payments, clearing and settlement systems for financial transactions.

This might appear to be a separate objective, but regardless of the benefits that financial services may bring, the Governor of the Bank of England was keen to stress that the market should determine the overall size of the financial system. He told us that:

> We do not sit round here and say, 'How big should the motorcar industry be?' or any other industry, and we should not do the same for financial services either. The objective here is not to maximise activity or employment in the industry. The objective is to create a financial sector that provides the services that the non-financial sector needs, it is an intermediate industry providing services to the real economy, and to do so in a safe and robust way, so it is designing the structure of it that is important, and then the market will determine how big it is.[24]

The banking sector can also impose indirect costs on the economy and the taxpayer, which we discuss in more detail in paragraph 36.

27. **The banking system provides many benefits, including—in the good times—considerable tax revenues for the Government. But the banking crisis has required unprecedented support from the United Kingdom Government, and other governments. While it is possible that much of this support may be recouped, there can be no certainty about this. In any event, Governments have had no choice about the timing of the support. We believe that one objective for the banking system should be to ensure that the market does not anticipate and price for direct Government bailouts.**

Objective 3: An appropriate correlation between risk and return

28. Banking is a business and those who fund businesses require a return on their investment. Mr Varley explained that:

> whatever the cost of capital is, it is the expectation and I would say entitlement of shareholders over time in any event to receive a return in excess of the cost of capital, and they will demand that if they are going to be suppliers of capital to banks.[25]

It should also be noted that as well as a return to shareholders, there are rewards to management and employees, which can also influence the risks being taken by financial institutions.

29. The resolution of the crisis has seen costs borne not just by the Government, but also by shareholders. In contrast, consumers have been protected, and perhaps more surprisingly, banks' wholesale creditors have, in the most part, not suffered during the crisis in the UK. The FSA explained that this was because:

24 Q 89

25 Q 220

> when very large banks get into trouble, the pattern of the last year has been to use government capital injections to rescue the bank so that it remains a going concern in its existing entirety, with common equity holders facing loss but debt capital or senior debt providers protected. This policy has been followed throughout the world for two reasons: (i) fears that any other approach would result in systemic knock on consequences; and (ii) operational difficulties of rapidly executing any other approach[26]

This misalignment has also arguably led to banks taking excessive risks and bank owners and customers expecting excessive returns. The Governor contended that the financial system had been engaged in some kind of "alchemy". He explained that:

> The basic problem is that you cannot really pretend to have a large financial system with assets that, on the one hand, are risky and desirably risky, we want the financial system to be able to take risks, but, on the other hand, pretend that the vast bulk of the liabilities which finance those assets receive safe returns. That would be alchemy and that is simply not available, so, one way or another, we have to reform the financial system in such a way that it is quite clear that, where risky assets are being financed, those who provide the finance know that their funds are at risk and it is not the taxpayer who has to step in.[27]

30. Given the strength of the United Kingdom's financial sector, there may be a further decision to be made about how great an emphasis there should be on the role of the financial services sector as a source of comparative advantage. As the Governor of the Bank of England said, this is not simply a choice between a lightly regulated and a heavily regulated sector:

> It is not to the benefit of the City of London to be known as a place with a fragile banking system which is neither safe nor robust.[28]

31. **Whenever one considers any regulatory reform, one must be wary of placing unacceptable burdens on the industry in question. But the payoffs in the banking system as revealed by the crisis suggest that there was too little risk taken by wholesale investors for the reward they received. The Government has been forced to protect them. Risk in bank investments must be correlated with return, as it is in other fields. Losses should not be borne by taxpayers and shareholders alone.**

Audit

32. If investors are to assess properly the level of risk they are prepared to take, they need clear and impartial information about the companies in which they invest. Company audits should provide such material, but as we concluded in our Report on *Banking Crisis: reforming corporate governance and pay in the City*, the current audit process results in

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26 Financial Services Authority, Turner Review Conference Discussion Paper, A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact, October 2009, Para 3.8

27 Q 76

28 Q 138

"tunnel vision", where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.[29] The recent revelations about Lehman's use of Repo 105 illustrates the extent to which audit reports can seemingly omit crucial information.[30] **We call for progress on our earlier recommendations, to ensure that audit reports are an effective tool for investors.**

Objective 4: Ensuring sustainable lending to the economy

33. Both Lord Turner and the Governor of the Bank of England defined the financial system as an "intermediate" one, in that its activities are not an end in themselves, but rather facilitate the activities undertaken by the real economy. Lord Turner considered that the intermediate sector contained:

> both the bureaucracy of the public sector but also the intermediate goods of the financial sector, and here the crucial distinction is between final goods purchased by consumers and intermediate rather than public and private goods.[31]

34. Banking is not a risk-free operation. Banks engage in maturity transformation, which is where a bank borrows short-term (either from the market or from depositors) and lends long-term. This maturity transformation has benefits for the real economy, but it also carries risks to the bank which is in danger of being unable to meet its commitments should it have a sudden need to meet its short-term liabilities. Mr Varley "particularly" regarded "maturity transformation/extension of credit" as one of the "core functions" banks should reliably undertake.[32]

35. Yet the banking crisis had a severe impact on the availability of credit to the real economy. We have been monitoring this since the crisis began. In our Pre-Budget Report 2008 we noted:

> The lack of bank lending remains the single most critical problem for the economy in the near term. The Government must ensure that the availability of credit, both to households and businesses, increases.[33]

Unfortunately, it is clear that problems still exist. We note, for example, the most recent lending figures from the Bank of England indicate "In 2009 Q4 the stock of lending to companies fell across all the main sectors of the economy for the third consecutive quarter".[34] Some of this may be the result of reduced demand, but we receive a flow of correspondence from businesses complaining about higher prices for credit, and reduced credit limits.

29 Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, Ninth Report of Session 2008–09, HC 519, para 221

30 Lehman Brothers Holdings Inc. Chapter 11 Proceedings, Examiner's Report, Section III.A.4: Repo 105

31 Q 467

32 Q 205

33 House of Commons, Treasury Committee, *Pre-Budget Report 2008*, Second Report of session 2008-09, HC 27, para 17

34 Bank of England, *Trends in Lending,* February 2010

36. **The banking system is one of the main conduits for lending to the real economy. As such, the objective should be for it to provide a steady and appropriately priced supply of credit. However, the present crisis was preceded by cheap and plentiful credit. We have now seen a significant and sudden reduction in the availability of credit to the real economy. Reform to the banking system must try to ensure that the market for credit operates efficiently, and prices credit more reliably.**

Costs of financial instability

37. Another result of the interplay between the financial sector and the rest of the economy has been an indirect second cost to Government from the recession caused by the banking crisis. Lord Turner told us that the "overt public rescue costs, while very significant, may turn out to be small relative to the overall costs produced by financial instability."[35] He thought that while it was "quite possible that the total overt costs of the UK's big bank rescues will not exceed 5% to 10% of GDP", following this crisis "UK fiscal debt will rise by about 50 percentage points of GDP and many people have lost jobs, houses and income".[36] This larger loss was due to "volatile credit supply first under-priced and too easily available and then severely constrained".[37]

38. **The costs of a banking system crisis are not limited to the overt or immediate payments to the banking system or for consumer protection via the Financial Services Compensation Scheme. As a result of the banking crisis, the economy was pushed into recession. This loss in output is resulting in job losses, hardship and lower living standards for many, as well as placing considerable stress on the Government's balance sheet.**

Socially useful activity

39. One of the concerns has been that some activity within the financial sector has not served any purpose for the real economy. Mr Haldane provided the following cautionary note on the growth of the balance sheet of the financial sector: "Too much of the balance sheet growth was re-financing stuff within the financial system rather than financing stuff in the real economy."[38]

40. Lord Turner has been more critical of some of the activities that the banking sector has undertaken. He has referred to some of them as "socially useless".[39] When we asked Lord Turner to define what would make a product "socially useless" he replied:

> it is reasonable for society to ask: are we getting these plumbing bits of the economy as efficiently and as at low a cost as possible? Are we getting only those things that are useful? Just as you can ask whether a quango performs a useful function for society, it

35 Q 460

36 Q 460

37 Q 460

38 Q 155

39 Prospect, *How to tame global finance*, Issue 162, September 2009

> is also possible to ask whether or not an intermediate function like a derivatives market has value. Having said that, to determine in concrete terms what is valuable or not is incredibly difficult, but at least if you are aware that the financial system is capable of generating activity that does not have value added for the economy—there is a sound set of economic theories about why the financial system is capable of creating for itself rent-extraction possibilities—you are on your guard [...] It does not provide you with a nice, easy rubric to determine what is and what is not socially useless—I do not believe that is our role—but it means we are not open to the alternative argument that everything that exists must exist.[40]

However, when we questioned Lord Turner as to whether it was possible to identify 'socially useless' packages in advance, he replied "I cannot say that I would necessarily have spotted them in advance".[41]

41. **It is important that banks can function as intermediaries in the real economy. The nature of the services offered will vary over time. Only 'useful' products will survive. However, the financial system can at times develop products which are ultimately dangerous rather than useful, and which survive for long enough for those dangers to materialise. We do not believe that it is possible to define in advance whether or not a particular product or activity will be useful, or will be a source of long-term profit for its issuing bank. However, when a new product becomes well established, regulators should analyse how far it helps the bank to perform its intermediary role, and take action to ensure that any risks identified are correctly priced. This should be an important role for regulatory authorities.**

Reducing moral hazard

42. Faced with the financial crisis in the UK, the actions of the Tripartite authorities (the Bank of England, the Financial Services Authority and HM Treasury) have illuminated the extent to which it is possible to balance the different objectives of the financial system as outlined above under the current regulatory system. In practice, it has been possible to protect depositors, and to take some limited action to preserve banks' intermediary functions. It has not been possible to avoid government bailouts, or to prevent the financial crisis impinging on the wider economy.

43. Their actions have also illuminated several examples of moral hazard within the system. Moral hazard matters because it reduces the incentive for market participants themselves to balance risk against reward. Effective consumer protection means that consumers do not have to worry where they store their money, as the Government will foot the bill in case of failure. And moral hazard has not been limited to the consumer sphere. In certain cases, due to the need for speed or the systemic implications of action, the Government was unable to ensure that wholesale creditors suffered from the failure of the banks they have money invested in. Accordingly, these actions have reduced the need for firms to monitor the banks in which they hold stakes. Indeed, as Mr Haldane told us, there is empirical

40 Q 467

41 Q 483

evidence that moral hazard is misallocating potential costs from the banks to the Government:

> rating agencies typically assign two sets of ratings to banks, one, the so-called 'stand-alone rating' which tells you how risky a bank might be without any state support, but then what they do is take that rating and ratchet it upwards based upon their guess as to the likelihood of the State providing support to that institution and that is called the 'support rating'. [...] What we have seen in consequence of the crisis is really two things: one is that the gap between those two ratings has grown or, in other words, there has been an expectation, at least among the rating agencies, of banks generally being more likely to receive support; and point two is that that difference between the support and stand-alone ratings has grown by more among the bigger banks, so the expectation of a bail-out post the crisis is particularly strong among the larger institutions. Of course, to the extent that those ratings translate, as you would expect them to, into the cost of borrowing by institutions, those moral hazard indicators will translate into a lower cost of funds for banks and, other things equal, bigger profits.[42]

Conclusion

44. **The current financial system and its safety nets have developed in an ad-hoc way. There has been little explicit consideration of the trade-offs implicit in the policies of regulators and governments.** So, for example, the market has been left to develop mortgage products, without restrictions on loan-to-value ratios. This has an immediate advantage for customers, but in the long-term it may have adverse consequences for those same customers, and the wider banking system.

45. **The current policies have had the following effects:**

- **Consumers who are depositors in bodies covered by the Financial Services Compensation Scheme are completely protected;**
- **The real economy—households and non-financial firms—has been provided with a volatile flow of credit;**
- **The system's cost base does not currently cover the cost of the Financial Services Compensation Scheme upfront, let alone the cost of wider support for the financial system.**

This has meant that during the crisis, the Government has had to act to balance these provisions. It has paid upfront for consumer protection and supported the economy when credit has become unavailable. This is the ideal opportunity for Governments, regulators, financial market participants and representatives of the real economy to decide whether or not they are prepared to accept these trade-offs. There is a danger that Governments will constrain the activities of financial markets so much that

42 Q 100

valuable economic activity is lost. That must be avoided. However, the result of the crisis has been that the expectation of a bailout has increased, and banks profits may be boosted by this. That must be changed.

Ending too important to fail?

46. The moral hazards in the banking system are largely generated by the perception that many financial firms are 'too important to fail' and have to be supported by the government. This crisis has now provided empirical evidence to support this perception, making the implicit, explicit. **As we explored earlier, it is essential that government support for banking should be minimised to protect the public purse. This will not be easy, given the key role that banks play in national economies, and the global economy. But even apart from reducing taxpayer exposure, there are sound reasons for reducing expectations that Governments will protect banks from losses.**

47. **As we have seen from our discussion of the objectives for reform, the classification of some banks as 'too important to fail' leads to these firms carrying too low a burden of cost upon themselves, while the Government is forced to step in to cover that burden. In the reforms we consider next, tackling this problem will be key.**

3 Evolutionary reform

48. There has been a great deal of emphasis on using existing tools to make the system safer. The G20 Pittsburgh Leader's statement made the following progress report: "Substantial progress has been made in strengthening prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges, and reinforcing international cooperation".[43] This chapter examines some of these evolutionary reforms.

Better risk management

49. We were told that the quality of risk management had been one of the factors determining whether or not a firm survived. Mr Corrigan, Managing Director, Goldman Sachs, made a distinction between risk monitoring and risk management. He suggested that risk monitoring at some financial firms appeared not to have been sufficient and this would have made it harder to manage risk in general. As he said:

> [...] one of the clear lessons that emerges is that we must all, first of all, do a better job of recognising the distinction between risk monitoring and risk management. They are two different things. Risk monitoring has to do with getting the right information to the right people at the right time. Risk management has to do with what you do with the information once you have it. I would suggest, Chairman, that casual observation across major financial institutions over the period of the crisis suggests to me that there were important failures in risk monitoring that by their nature suggest to me that risk management would suffer accordingly.[44]

50. However, our inquiry raised questions as to whether there were limits to the effectiveness of current risk measurement practices. Professor Goodhart told us that "speaking as an economist, I do not think we economists have done very well in actually providing a proper measurement of risk or an analysis of the dangers of default and how the financial systems should be constructed. The theory and analysis in this field is not as good as it should be."[45] Professor Kay was even more pessimistic. He stated that "last week I gave a talk whose essential theme was that I no longer believed the theories of risk and risk measurement and management that I have been teaching for 20 years of my life".[46] The Governor was also cautious as to how effective attempts to measure risk would be:

> in any risky activity—which we want people to engage in: we want innovation, we want the real economy to be prepared to take risks—things will happen that we cannot even easily define or imagine, let alone measure today. If that is the case, the idea that you can always approach regulation in terms of saying, 'We know all the risks that are being taken. We can calibrate them precisely, measure them and work

43 Leaders' Statement: The Pittsburgh Summit, September 24 – 25, 2009

44 Q 289

45 Q 69

46 Q 70

> out the precise capital requirement,' it simply will not work. For some risks, you can behave in that way; but for other things, unexpected events will come along, and the lesson from that is to create a resilient system.[47]

51. In contrast, Mr Varley of Barclays was confident that:

> I think we can measure risk. In a sense, who am I to contradict such august commentators. I just talk about risk in Barclays. Can we measure it? Yes. Do we measure it? Yes. Do we conduct stress tests on a very regular basis so that we can model the impact of a macroeconomic set of assumptions on Barclays loan books and market risk? We do that on a very regular basis. We have to be able to do that.[48]

Mr Sáenz of Santander, was however more nuanced in his reply, noting the need for judgement, and failures in the past:

> For measuring risk there are two main elements. First, we can measure risk with models, with analytics, with systems we have at hand in our organisations, depending on the kind of risk. There are many kinds of risk: credit risk, market risk, liquidity risk, reputational risk, operational risk, so if you think about the main risks we are talking about, which are the credit risk, the liquidity risk and market risks, all three can be reasonably measured with the tools, with analytics, with models, but always with personal judgment. I would like to insist that personal judgment in measuring risk is important so prepared, educated, trained people in the risk management area are fundamental to measuring risk.[49]

52. Lord Turner felt that improvement in risk measurement was possible, but that perfection was not. He too thought that judgement would always be necessary:

> Within institutions we were often led astray in the past by apparently sophisticated mathematical tools like value at risk which purported to suggest that we had a precise fix on how much risk there was on trading books. Both bank management and regulators took far too much assurance from that apparent mathematical precision and failed to realise the inherent uncertainties and pro-cyclicalities of that approach. We can get better at it but we will never achieve perfection because the key point is that in the trading area in particular however we define the probable distribution of future potential risks it is inherently uncertain and not susceptible to precise mathematical modelling[[...].[50]

53. In effect, there are two different approaches to risk. One deals with what might be called the "mathematical" components of the risk, analysing the impact of various defined scenarios, and looking at their likelihood. The other recognises that, however thorough the modelling, there can be no *certainty* about future events, and that nothing can be ruled out. Risk is knowable; uncertainty is not.

47 Q 171

48 Q 216

49 Q 406

50 Q 462

54. **It is clear that many financial companies could and should improve their risk monitoring and their risk management. But we agree with those who consider risk measurement is an incomplete science, and that there will always be significant uncertainties. Judgement will always play a role, and error is always a possibility, whether it be by firms or regulators. The possibility of the failure of a bank, or number of banks, always remains. Indeed, over time, it is certain that such failures will occur. While it may always be desirable to reduce risk, the primary objective of reform should be to ensure that the system is resilient if failures occur.**

55. **We must also be wary of 'survivor bias'. The firms that have made it through the crisis have much to teach us on how to build more resilient banks. But we must also recognise that a shock or event of a different nature would probably have resulted in different survivors.**

56. **Better risk management may go some way to meeting our objectives, but it cannot remove the risk that Governments will have to provide support for the sector. It can only guarantee a stable flow of lending to the economy if financial firms can consistently immunise themselves from the enthusiasms of the market or the failures of their own judgments. We do not believe this is possible.**

Better supervision

57. Better supervision was also proposed as a way to reduce the risk of future crises. Mr Sáenz told us that in his view supervision was "even more important than regulation".[51] He went on to note that Santander had in its head office in Madrid "roughly 60 people permanently standing there and following [its] operations".[52] This meant that "90% of the entries [Santander] do into [their] ledger are supervised real time by [their] supervisors in terms of affecting the P & L, affecting the capital, affecting the reserves, affecting the tax consequences of this entry, affecting whatever and affecting how you account for it".[53] Mr Sáenz, was confident of the benefits of such close supervision. He told us that:

> if the kind of supervision we have had been in place in Lehman Brothers then at least the measurement of the consequences of the bankruptcy would have been much better enumerated and we would have known much better what was going on after the intervention or after the bank collapsed, and all these things would be much more at hand. The kind of purpose that the living wills now are trying to give, I do not mean that it would be completely solved but the degree of understanding and knowledge of the institution would have been much better.[54]

He considered that post-liquidity crisis bail-out and management would be much easier as a result of better supervision.[55]

51 Q 414

52 Q 415

53 Q 415

54 Q 420

55 Q 421

58. Others were also keen to criticise the previous application of the regulations. Mr Corrigan identified a failure of regulators to act early enough, despite having the capability. He told us that "in virtually all jurisdictions the authorities already have the capability to step in, order an institution to shrink its balance sheet, cut its dividends, et cetera I think that one of the failings of the past has been that this so-called doctrine of prompt corrective action, stepping in early, was much more a slogan than it was a practice. We have to change that."[56] These sentiments echo the arguments we made at the time of our report into Northern Rock, where we saw great merit in the 'prompt corrective action' approach.[57]

59. Regulation of cross border entities relies on cooperation between regulators in different countries. On our visit to central and eastern Europe we were told that as a result of the crisis, colleges of regulators were working far better than before. Formerly, meetings had largely been formal and infrequent. Now there was much more engagement. Cross border regulation has improved as the risks posed by cross border banks have become more obvious.

60. However the Governor of the Bank of England warned against relying on regulators to ensure that the financial system was completely secure, as it was inevitable that at some point, everyone would get something wrong. He provided the following example to illustrate his point:

> if you take Citibank, the biggest bank in the world, five years ago, if we had all gone to New York, we would have been met by people on Wall Street who felt that Citibank was the model to follow and they were worried about whether they could keep up with it. In that intervening period with Citibank, there have been regulators all over it. There were dozens of regulators living and working inside the building, not just living in a separate building reading annual reports, but they were actually in the building. Look at the senior people who worked in Citibank. Four of the most respected people in the world of finance were at the top of Citibank: Bob Rubin, former Treasury Secretary, Chief Executive of Goldman Sachs; Sandy Weill, one of the most streetwise Wall Street people; Bill Rhodes, who has seen every emerging market debt crisis for 40 years; Stan Fischer, one of the world's most respected economists and number two at the IMF. Those four people did not set out to destroy Citibank. Things happened and events changed in a way that they realised too late that they were taking large risks. Now, the regulators did not spot it and the people in the management did not spot it. I think we have to accept that, when you get a very large, complicated institution like that, from time to time, through no one's fault, things will happen which means that the strategy that they took turns out to have been badly wrong.[58]

More damning was comment by John Kay, who in a note commenting on questions regularly asked of him, when asked whether better regulation would prevent major

56 Q 308

57 Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56-i, para 192

58 Q 104

financial institutions from engaging in excessive risk taking in future, replied "If you believe that, you will believe anything".[59]

61. We note a single regulatory system has its own dangers. As we have seen, some of the regulatory assumptions in use before the crisis have proved mistaken. The more consistent a system is, the greater the danger if it is consistently wrong. Hector Sants, Chief Executive of the FSA, in a speech in November 2009, acknowledged the limitations of the regulator, and expressed a desire to achieve a more desirable culture in financial services:

> I believe it is important to recognise that there are limits to what regulatory rules can achieve. It would be a mistake not to recognise that some of the failures which have occurred have their roots in issues of culture and behaviour. However, whilst progress has been made in the global debate on prudential rules, this fundamental question of ensuring the development of the right industry culture, has not been adequately addressed—no doubt because of the difficulty of both defining the problem and the solution. However, this must be tackled if we are to truly address all of the issues. Real reform requires both change to the regulatory rules and change to the industry's culture. Expressions of acceptable ethical frameworks exist in a variety of guises. There are numerous thoughtfully articulated industry codes. The problem is not so much about defining the ethical framework but rather the issue of identifying and encouraging the right cultures which ensure their application. The FSA believes that such issues are potentially so important to improving governance that we, as the regulator, should try to take them into account. We recognise that there is no single ideal culture across the financial services industry, and that all cultures are likely to have good and bad aspects. Our aim would, therefore, be to seek to facilitate the creation of good cultures and intervene when bad ones seem to be creating unacceptable outcomes.[60]

62. **A more active and effective regulator will, of course, be beneficial, as would a change in the culture of financial services. But we must accept we will never have a perfect regulator. So while better supervision may reduce the probability of firms failing, it will not eliminate it. Regulators are as prone to herd thinking and belief in current wisdom as those they regulate, and are under pressure to be so. The chance of a catastrophic failure within the financial system will remain, and Governments will remain obliged to provide emergency support.**

63. One of the concerns about relying on 'better' supervision is that firms and consumers begin to believe that the regulator, rather than the firm, should be monitoring the risks being taken in the firm. When we asked Lord Turner about this, he replied that:

> I think there are enormous dangers if we get it wrong that both regulators will not be good at making these decisions and that in some circumstances we can increase

59 'Narrow banking: FAQs', John Kay, p 3, www.johnkay.com , Jan 2010

60 Financial Services Authority, Speech by Hector Sants, Chief Executive, FSA, Bloomberg, 9 November 2009

> moral hazard. For instance, if we have product regulation at retail level there is a danger that the regulator has said, "Trust me, that is a good product." [...][61]

Moreover, the more intensive regulation is, the more the regulator has to make difficult choices on the basis of inadequate information:

> [...] we do not have easy answers. We have gone through a period of believing in wholesale markets and that because something is the product of a free market it must be a good development. That has been our very strong assumption in the FSA. We have therefore been insufficiently searching about some of the risks involved in complex structured credit and CDS and over-amenable to arguments that we should not regulate because if we do liquidity will be driven out of the market. We have to shift that philosophical assumption to being willing to accept that there may be some things that are socially or economically useful but without having any easy algorithm, rubric or rule that tells us what it is. I think we are just in a much more difficult space and people do not like that; they like nice easy assumptions.[62]

64. The more the regulator is expected to make difficult judgement calls, the greater the lack of clarity about who is in fact responsible, regulator or market participant. This reduces the incentive on market participants to consider and assess the risks they take. Moreover, such an approach increases the likelihood that company failure will be seen as regulatory failure, for which some market participants should be compensated. We fully support the principle that victims of maladministration by public bodies should be compensated. However there is a real difference between the losses caused directly by the actions or failures to act of public bodies, and losses attributable to the misfortune or mismanagement of a private body. The more regulators are expected to second-guess those they regulate, the more blurred this distinction becomes.

65. **Regulators can never be fully effective. Individual companies are responsible for their own actions. We must be careful, when considering a more active regulator, not to overly raise either consumers' or financial firms' expectations of its role. The regulator can not and should not replace due diligence by market participants. A system which assumes that regulators can be completely effective reduces the incentive for market participants to monitor the risks they are taking, whether they are banks, investors in banks or counterparties. Furthermore, such unattainable expectations raise the risk that should financial firms fail, the regulator will be found liable, and the Government will once again have to foot the bill. This, in turn, reduces incentives for consumers to monitor their own risks and ensure they understand their investments. The regulator is not the first but the last line of defence.**

61 Q 488

62 Q 488

The Basel reforms

Capital and liquidity regulation reform

66. As a result of the worldwide drive for reform, the Basel Committee on Banking Supervision is consulting on capital and liquidity reform. On 17 December 2009, it described its proposals in a press release. They included:

> 1. Raising the quality, consistency and transparency of the capital base. This will ensure that the banking system is in a better position to absorb losses on both a going concern and a gone concern basis [...]
>
> 2. Strengthening the risk coverage of the capital framework. In addition to the trading book and securitisation reforms announced in July 2009, the Committee is proposing to strengthen the capital requirements for counterparty credit risk exposures arising from derivatives, repos and securities financing activities. The strengthened counterparty capital requirements will also increase incentives to move OTC derivative exposures to central counterparties and exchanges. The Committee will also promote further convergence in the measurement, management and supervision of operational risk.
>
> 3. Introducing a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. The leverage ratio will help [...] introduce additional safeguards against model risk and measurement error. [...]
>
> 4. Introducing a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress. A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks. In addition, the Committee is promoting more forward-looking provisioning based on expected losses, which captures actual losses more transparently and is also less procyclical than the current "incurred loss" provisioning model.
>
> 5. Introducing a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio. The framework also includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system wide level.[63]

67. We note that even the Basel reforms will depend on reforms in other systems, such as in international accounting standards. Despite this, the Governor of the Bank of England explained why capital and liquidity reform would be useful:

63 Press release: Bank for International Settlements, “Consultative proposals to strengthen the resilience of the banking sector announced by the Basel Committee”, 17 December 2009

> The banking sector is running with a much smaller amount of capital and a tiny amount of liquid assets in comparison to the banking system of 40 years ago, and that inherently makes it more unstable, so more capital makes some sense. It is not an answer in itself because the only logical capital requirement that removes all risk is a 100% capital requirement.[64]

Mr Sáenz felt that liquidity reform, currently being worked on in Basel, would be of particular importance:

> my personal experience[...] is that in the field of credit risk or other risks we have been very accurate in general but in the liquidity risk we have had some flaws. In fact the recent crisis has been a liquidity risk translated to, let us say, a credit risk, and in the liquidity field we have to work harder in the future..[65]

68. However, others stressed that the Basel process would not be a panacea. Professor Kay was adamant that this reform would not be suitable. He explained that "frankly, in saying we need better rules from Basel is just the familiar story, that when the snake oil does not work, people tell you that what you need is more snake oil and there ought to come a point at which we say, 'Well, I think we'll try something else instead.'"[66] When it was put to him that experience of the Basel II reforms "do not exactly give you a great deal of confidence that Basel III will solve the problem" even Mr Corrigan replied "I have some sympathy with that".[67] Mr King warned us that "It is all about recognising that tinkering with capital requirements may not be enough, that the structural changes will also be important".[68] He questioned the sufficiency of the reforms:

> the spirit, I think, of the reforms that are needed is not to pretend that, by imposing the right balance of taxes and capital requirements, banks will be persuaded not to take too many risks, but it is to recognise that from time to time things will happen that we cannot prevent or imagine or calibrate the risk of in advance.[69]

He also noted that "One of the reasons why capital alone will not work is because banks can just take more risks to offset a higher capital requirement, getting you right back where you were before".[70]

69. Mr Sáenz also drew our attention to the cost that the current Basel proposals may inflict upon the banking system, and how that would then impact on the real economy:

> Yes, we have rough draft figures—very rough ones—taking into account if all these elements that are being discussed under the Basel 3 umbrella are put in place, extra capital requirements with extra liquidity requirements et cetera et cetera, all these

64 Q 94

65 Q 406

66 Q 17

67 Q 325

68 Q 163

69 Q 101

70 Q 94

> elements, without knowing exactly what will be the thresholds for every element, I will be very honest, it will be a heavy burden on the profitability of the banking system or the banking industry. There are several consequences that we all have to determine, firstly how will this affect the supply of credit because it is not easy to have that weight. Secondly, how will it affect the cost of credit, not only the supply? Maybe the cost is not so important, it depends who you are; if you are a competitor the cost is important, so that is the second element. Thirdly, what is going to be the profitability of the industry and ourselves with the new requirements. I would say that altogether it is an equation that is difficult to give a final say on.[71]

Professor Lamfalussy though was unfazed by the potential costs of reform. When asked whether a higher cost of capital was a concern, he replied "I think it would be very helpful to increase the cost of capital."[72]

70. Mr Varley though was keen to reassure us that the process of strengthening the financial system via items such as the Basel process could be made to work:

> I do not think we should be fatalistic about this crisis. We should have confidence that we can create an infrastructure in capital and in liquidity, in regulation broadly defined, that creates much greater resilience in the future. I feel that we should be self-confident about our ability to do that because the learnings have been so painful."[73]

71. **Capital and liquidity reform is on its way. It will, at best, ensure a lower probability of default, and a lower loss given default, for financial firms. Higher capital and liquidity requirements will also impose a cost on firms and their customers. They may go some way to meeting our objective of an appropriate correlation between risk and reward. We also consider that more emphasis on anti-cyclical capital requirements should go some way to ensuring a more stable supply of credit to the real economy. We welcome this even though the changes will also result in lower profits to banks and higher costs to consumers. Banks taking advantage of differing regulatory environments may limit the scope for such action.**

72. **However the financial crisis occurred despite repeated attempts to reform the capital and liquidity regimes. The lessons of this and preceding crises can be used to improve the capital and liquidity regimes, but that will at best be only a contribution to the wider structural reforms that are required.**

Leverage ratios

73. The Basel Committee is consulting on a leverage ratio. In its written evidence, the British Bankers' Association acknowledged that excessive leverage appeared to have had a role in the crisis:

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71 Q 456

72 Q 575

73 Q 186

> While the circumstances of each failure differs, a common theme appears to be high leverage with undue reliance on short term wholesale funding. Banks that are less reliant on short term funding have found it easier to restructure their business mix.[74]

Mr Corrigan pointed out that financial firms were themselves were taking action in this area. He noted though that:

> institutions both in the United States and elsewhere and through the [Bank for International Settlements] discipline are now publishing and paying more attention, as they should, to so-called leverage ratios. Again, if you look at leverage ratios at the end of, say, 2009 at Goldman Sachs, which is broadly representative of other firms as well, they are now in the range of 12% or 13%, which is about half of what they were prior to the crisis.[75]

74. If excessive leverage is a potential source of weakness, demanding that financial firms meet a given leverage ratio could act to limit the weakness. Piergiorgio Alessandri and Andrew Haldane made a case for such a ratio in their speech in November 2009. They noted that:

> This is an easy win. Simple leverage ratios already operate in countries such as the US and Canada. They appear to have helped slow debt-fuelled balance sheet inflation. The Basel Committee is now seeking to introduce leverage ratios internationally. To be effective, it is important that leverage rules bite. They need to be robust to the seductive, but ultimately siren, voices claiming this time is different. That suggests they should operate as a regulatory rule (Pillar I), rather than being left to supervisory discretion (Pillar II). It is important, too, that leverage limits are set at the right level. Such limits need to be fundamentally re-evaluated. We have sleepwalked into a world in which leverage of 20 or 30 times capital is the rule rather than the exception.[76]

Professor Goodhart was also supportive of the concept of a leverage ratio on top of the Basel proposals for liquidity and capital regulation. He explained that:

> I think it is very sensible for Basel to adopt a leverage ratio as well, because a leverage ratio effectively says we cannot measure risk very well but what we do know is that, if credit is expanding wildly, there are potential dangers around there; so I think there is advantage in a belt and braces approach where you do try and measure risk as best you can, which is, if you like, Basel II. Then you add to that a leverage ratio which says, 'We are not very good at doing this but we know that if credit is expanding wildly there can be problems ahead', so you put the two together.[77]

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74 Ev 126

75 Q 317

76 A speech by Piergiorgio Alessandri and Andrew Haldane, Banking on the State, Bank of England, November 2009, p 12

77 Q 72

75. Others though were critical of the concept. When asked whether he thought there should be leverage ratios, Mr Flint replied:

> No, I do not believe so. I say that because a leverage ratio is simply one accounting number over another, and while I think it is a useful metric, the complexity of getting definition over the scope of consolidation and the risk would be that leverage would be taken in the products rather than on the balance sheet. It is a useful tool to look at but it is not a panacea. One could get seduced into thinking that one had made a great leap forward in terms of control when in fact it had not done very much. It is worth looking at. I think the three things to look at are capital ratios on an unweighted basis, which is your leverage ratio, capital ratios on a risk-weighted basis, and then liquidity, which is probably best expressed through the ratio of advances to deposits, ie to what extent are you dependent on wholesale funding?[78]

Mr Sáenz told us a leverage ratio:

> [...] is acceptable but it is not very sophisticated because the leverage ratio is a very basic kind of ratio so it does not qualify the kind of risks you have in the assets, and that means that the weight is similar. In high risk or low risk the weight is similar and you have the collateral. In a battery of different ratios I would say one of them, but at the bottom of the list, would be the leverage ratio. But I and in general my colleagues, at least in Europe—in the States it is different, in the States they like that, maybe because of their history and because they have had the habit of living with that leverage ratio for a long time—do not see the interest, what special information will give you this leverage ratio. We do not think it is very practical.[79]

Mr Corrigan of Goldman Sachs, when asked whether he supported leverage ratios, told us that:

> Yes, but not in statutory terms. In the United States there is a statutory provision in the House Bill that as a matter of law they establish a 15% leverage ratio. I do not like the idea of that being a matter of law at all because who knows what the future will bring. I certainly do believe that Basel capital rules could be broadened out to include a leverage ratio. A leverage ratio only deals with so-called balance sheet leverage. In other words, the ratio of capital however defined to assets. A leverage ratio does not deal with what I like to call "embedded leverage". That is the leverage that is embedded in various classes of financial instruments, including certain classes of derivatives. We have to be very careful that, while we institutionalise some form of leverage ratio, we all are sensitive to the fact that embedded leverage may well be more of an issue than a so-called balance sheet leverage. This is where this idea of higher capital liquidity standards becomes so very, very important.[80]

78 Q 391

79 Q 457

80 Q 346

76. **Given that capital and liquidity reform will not be sufficient, and that leverage appears to be an indicator of potentially increasing risk, we support the introduction of a leverage ratio. Such a ratio does not adjust for risk, and thus is not satisfactory on its own, but it is a useful addition to (inevitably imperfect) risk weighted measures.**

Levies

77. One of the reforms announced by the Obama administration in January 2010 has been a Financial Crisis Responsibility Fee. The fee is designed to last for 10 years, or longer if necessary, to ensure the full pay-back of money in the Troubled Asset Relief Programme (TARP), the US measures to combat the crisis in the financial system.[81] According to the White House press release, the fee "would be levied on the debts of financial firms with more than $50 billion in consolidated assets, providing a deterrent against excessive leverage for the largest financial firms".[82] In this, it has some parallels with the Basel Committee's leverage rations. Over sixty percent of revenues, from the measures, expected to be $117 billion over about 12 years, and $90 billion over the next 10 years, will probably be provided by the 10 largest financial institutions.[83] We discussed the US levy's impact with Douglas Flint, HSBC. He noted that:

> We have only seen the sketchiest of details. Clearly if there is a levy on wholesale funding, there would be a cost to us of paying that levy, although we have, relative to virtually all of our peers, significantly less wholesale funding in our business model than anyone else, so there would be, on the first level, a cost to pay. I think one would need to analyse what the levy was designed to achieve. I am not saying it is not an idea worth considering, I think it is, but it would have a modest cost to us.[84]

78. The US fee is an example of an ex-post fee, paid after a financial crisis, to cover the cost of the Government's actions to assist the financial sector. Professor Kay was in favour of such a redistribution, but had a cautionary note: "I am in favour of getting back as much of the costs of what we have done in the public purse from the people who are responsible for it, but in relation to any of these kinds of levy proposals we have to ask who is actually going to pay the actual costs of these levies in the end. We need good answers to that."[85] Paul Tucker was supportive of the US levy. He told us: "I quite like what the President has done, because I aired similar thoughts in a speech nine or ten months ago".[86] He then outlined some of the benefits of a more permanent ex-post levy, than that proposed by the President:

> I think that is the least we should do, for two reasons. First, unless we can rule out the state ever having to step in and support the banking system as a whole, which I

81 The White House, Office of the Press Secretary, President Obama Proposes Financial Crisis Responsibility Fee to Recoup Every Last Penny for American Taxpayers, 14 January, 2010

82 *Ibid.*

83 *Ibid.*

84 Q 373

85 Q 67

86 Q 109

> frankly doubt, then we have to think about how the state will put some of the cost of that back on to the banking system. I suspect it would never be all of the cost, because the serious cost comes in the macroeconomic deterioration. Secondly, if the better banks, whoever they are, know that if the weaker banks fail they are going to pick up some of the tab, then it is not enough for them to cut their own exposures because the mess is going to come back to them via another route, and I think that is a fairly healthy thing. That is a minimum set of provisions. I would call it 'capital of last resort.' Unless you can rule out capital of last resort, then we had better think about how we would organise it when we do it. This is essentially for finance ministries.[87]

79. However, Professor Goodhart was in favour of an ex-ante levy, rather than one designed to recoup losses after the event. He explained his thinking as follows:

> I would have liked the levy to be more finely directed so that the levy goes to the short-dated wholesale liabilities rather than to the longer dated. Again, if you are going go down this kind of route, it ought to be *ex ante* rather than *ex post* [...].[88]

The Governor of the Bank of England also discussed an ex-ante insurance levy's advantages:

> the idea of a levy is not dissimilar to raising capital requirements, though it has merit in that it can bite in helping to produce revenues that might reduce the national debt in good years in order to help finance recoveries, if they are necessary, in bad years. If you were going to have a levy like that, I think its purpose would be looking forward as an *ex ante* proposition, it would be a tax on the balance sheet excluding insured deposits, as the US has done, but it would also, I think, make sense to exclude contingent capital and to perhaps differentiate between broad classes of maturity structure of the debt liabilities in order to penalise the sorts of debt instruments which are responsible for the possibility of runs on the bank which justifies or provokes the intervention.[89]

80. In a speech in November 2009, Mr Tucker presented some problems with an ex ante levy:

> One possibility is to establish a fund in advance. Another is to raise a levy on the surviving banks. An argument in favour of the former is that it would raise contributions from risky banks before they fail. And it would allow the levies to be related to the size of their uninsured creditors, as some in the US have suggested. But I do just wonder whether it would be realistic to raise, and over the decades sustain, a sufficiently large fund.[90]

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87 Q 160

88 Q 68

89 Q 101

90 A speech by Paul Tucker, Deputy Governor, Financial Stability, Bank of England, at SUERF, CEPS and Belgian Financial Forum Conference: Crisis Management at the Cross-Road, Brussels, The Crisis management menu, 16 November 2009, pp 13–14

The Governor also set out the potential risks, as well as the potential advantages in such a levy:

> The risk again, as with capital requirements, is that you encourage people to take even bigger risks so that, as with any kind of tax or levy of this kind, the right thing to do is obviously to try to make the levy specific to the risks of the individual bank, and that becomes very difficult and you start to chase your tail. It is worth doing some of it, but I come back to the point that one of the great difficulties in relying on regulation of the asset side of the balance sheet here is the idea that regulators can get it right.[91]

In its written evidence, the ABI was also less than supportive of the idea of a levy:

> We are similarly wary of the introduction of a systemic risk levy because it would be extremely difficult to pitch a levy correctly, and to calibrate it to reflect the relative level of systemic significance of individual institutions. Moreover it could be difficult to ensure that any fund was actually used for the intended purposes. The proceeds could be used to pay down government debt or held in a separate fund which would invest in government securities. The accumulation of large funds could therefore simply lead governments to become less disciplined in their fiscal policy. More broadly if these levies are intended over time to cover the cost of a bail-out, they will create a moral hazard for regulators as well as banks. Both will know that there is money in the pot to cover their mistakes.[92]

Even Professor Goodhart warned that there were difficulties in an ex-ante levy:

> [...] One of the problems here, though, is that the markets' measures of riskiness are not actually at all accurate. Adair Turner continually points to the fact that CDS rates generally were at their lowest just before all this blew up in 2007, so that if markets could measure risk properly, then it would be relatively easy to use market mechanisms to apply to the levies. The problem here is that it is not just we cannot assess risk accurately, the markets cannot either, and that is one of the key difficulties.[93]

81. **The US proposal for an ex-post levy on the financial system to repay the Government for the support provided during the banking crisis has some attractions. It would meet the objective of reducing the costs to the US Government.**

82. **An ex-ante levy, with ring-fenced resources, would also ensure there were resources in place at a time of crisis. Such a levy would, though, place additional costs on financial firms, and their customers.**

83. **Ex-ante levies have also been mooted as a measure to curtail risk-taking. But it has been suggested to us that in the face of such a levy financial institutions may take on**

91 Q 101

92 Ev 139

93 Q 68

more risks, both because they believe they are covered by insurance and to recover at least some of the costs of the levy. There are also other proposals to curtail risk taking, and the cumulative effect of all these proposals must be considered, before determining whether such a levy is desirable to curtail risk-taking.

Deposit protection

84. We have previously recommended creating an ex-ante fund to pay for deposit protection in our Report *The run on the Rock*. Our conclusion then was as follows:

> We believe that the 'pay as you go' approach to funding depositor protection, as currently used by the Financial Services Compensation Scheme, has two fundamental disadvantages. First, it does not create the requisite depositor confidence in the availability of a source of prompt funding, so fails to contribute towards financial stability. Second, a 'pay as you go' approach could cause significant pro-cyclicality problems. Such an approach could mean obtaining funding from banks at the worst possible time, whereas a pre-funded model could obtain most of its funding at times of plenty. [...]. The principle that must underpin a future scheme is that it should be capable of coping with any foreseeable bank failure. We recommend accordingly the establishment of a Deposit Protection Fund, with ex-ante funding. [...]. The establishment of a pre-funded scheme would be a significant cost to the institutions involved, but it seems only right to us that the costs of bank failure should be borne by the industry rather than the taxpayer, as would currently be the case. To ensure that the Fund is adequately resourced from the outset, we recommend that it be financed initially by a Government loan, which would then be repaid over time as banks' contributions accumulated.[94]

85. **Given that one of our objectives is to reduce the role for the Government in the financial system, and that protecting the consumer in the face of bank failure will always remain a priority for government, we continue to recommend that the deposit protection system should be pre-funded, despite the costs it imposes on firms.**

Contingent capital

86. The Governor of the Bank of England suggested the increased use of contingent capital. He explained both how such capital would work, and why it was necessary, in evidence to the Economic Affairs Committee of the House of Lords:

> we at the Bank feel quite strongly that contingent capital—that is capital which banks raise which, when the bank starts to run out of money automatically converts to equity—is a very important part of the capital structure of the banking sector going forward because it does provide a way in which we are much less dependent on some regulator working out precisely what the right Basel ratio is; there is a big cushion of capital that can be converted to equity when necessary and the people who supply that—the creditors—will know that there are circumstances when they would bear

94 Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56-i, para 263

> the burden and would not just be bailed out by the government. So capital is one leg.[95]

Lloyds Banking Group recently issued some contingent capital, known as Enhanced Capital Notes. In a statement in November 2009, Lloyds stated that it would raise “Significant contingent core tier 1 capital” which would equate to additional core tier 1 capital of 1.6 per cent if the Group's published core tier 1 capital ratio fell below 5 per cent.[96]

87. Douglas Flint of HSBC appeared lukewarm about the impact contingent capital would make on banks. He noted that:

> I think it is an interesting concept in theory. I have yet to convince myself that there is a sufficient pool of capital out there that would be interested in buying such capital to make it a credible solution, other than for institutions that are already in difficulty and are converting existing subordinated debt or other debt to something that is contingent, ie, their bondholders are in a stress situation. I do not believe there is sufficient capital looking for that type of hybrid equity and debt return to be a meaningful part of the capital structure of banks. In theory it is an interesting idea, I just do not think it is big enough to be real.[97]

However, Mr Corrigan of Goldman Sachs was more positive. He told us that:

> I think that the concept of contingency capital has a lot to be said for it. We have had a little experience again here in the UK with contingent capital in the very recent past. The thing that I worry a little bit about—you talk about belts and suspenders; this is going to be real belts and suspenders—is that if we institutionalise contingency capital I would hate to see it work in the direction of reducing the amount of core capital to keep in the first place. Again, it is one of those slippery slope things that we have to be careful with but if we can guard against the concern that it results in lower core capital to begin with I think it is a worthwhile concept.[98]

88. **Contingent capital has significant support in the Bank of England. It has also been used by Lloyds Banking Group. Yet market participants remain wary, either concerned there will be little demand if they issue such capital, or worried that it could diminish actual core capital. Experience will show whether these fears are justified. If contingent capital does place more risk back onto the financial market, rather than the Government, it seems likely to be useful in a crisis, and in addition gives its holders an incentive to monitor the banks in which they are invested, with the result that movements in the price of the debt on the market would be a source of information for the bank itself and for its regulators.**

95 Oral Evidence taken by the Lords Economics Affairs Committee, 24 November 2009, Q 29

96 RNS Number : 8298B, Lloyds Banking Group PLC, 3 November 2009

97 Q 403

98 Q 347

4 Structural reform

Are large banks good for the economy?

89. As well as proposals for incremental reform, there are proposals for structural reform, ranging from radical restructuring to variants of current practice. The reforms discussed in this section, in one way or another, seek to place restrictions on how banks operate, and targets large, international interconnected banks. In their written evidence to us, Barclays and the BBA mounted a defence of large, integrated banks. The BBA stated that "[...] requiring large banks to radically alter their business structures may limit their ability to service large global clients and would inevitably increase operating inefficiencies resulting in a further source of cost for end-users".[99] Barclays told us:

> Frontier Economics, in a recent independent study for Barclays, found that integrated global banks bring a number of benefits to the financial and economic system including:
>
> financial efficiency benefits—reflecting the greater risk diversification, reduced financial intermediation costs and increased financial stability benefits that universal banks offer;
>
> bank customer benefits—reflecting the ability of integrated global banks fully to meet the corporate finance needs of companies (e.g. access to capital markets);
>
> international trade and investment benefits—reflecting the role of integrated global banks in international trade (through trade finance, foreign exchange and other trade services) and in international investment (through direct cross border investment and international capital markets);
>
> competition and innovation benefits—reflecting the propensity of universal banks to expand and enter new product and country markets, so increasing the spread of innovation and best practice; and
>
> UK specific benefits—reflecting the contribution of financial services to the UK economy, even after the costs of the financial crisis and the leading role of UK domiciled universal banks in the global financial system.[100]

90. Mr Corrigan told us that:

> it is a little hard for me to envision a world in which we did not have financial institutions of size and financial institutions that have large amounts of capital to commit to the market place. If you look at one of the examples I use in the statement, it is in the aftermath of the crisis we had a situation in which private partners, thank goodness, had been able to raise something in excess of half a trillion dollars in fresh

99 Ev 131

100 Ev 103

> capital for banking institutions. The amount of risk that a small number of institutions had to be willing to 'fess up to accomplish that is very large. It is a little hard for me to see how that would happen if we had a world of just narrow banks.[101]

Mr Varley was also keen to point out that:

> The fundamental point I am making is that investment banking is real economy work. What is it that Barclays Capital does? It offers risk management and financing products to those it serves. Who is on the list of those it serves? The British Government, the French Government, the South African Government, John Lewis, Network Rail and Harvard University. These are real economy players. This is not some activity that takes place in the corner of a room which you might designate as proprietary trading; this is risk management work and it is financing work that lies at the heart of industry and governments to create employment. That is why it is important that these businesses exist within a universal bank.[102]

91. However, not all the witnesses were as sure of the benefits of large banks. Professor Kay provided the following commentary:

> a large part of the synergies which we are talking about in these global banks are to do with tax, regulatory arbitrage and the kind of cross-subsidy we were talking about earlier, so from a public policy point of view we should not have very much sympathy with these synergies—the difference between the structure of HSBC and Barclays that you were describing is a lot more noticeable to Barclays than it is to the customers of either of these two banks. Going on from that, if one talks of other industries, people are endlessly talking in these industries about the desire of large corporations to buy from a single global supplier. I have heard that every year in telecoms, for example, since telecom privatisation began. Most of the evidence is that most of their customers do not: they want to pick and choose who are the best suppliers for particular goods. There are some synergies of that kind, but I do not think we should go overboard about that.[103]

The Governor of the Bank of England stated that: "I do think that I would like to see an outcome in which the size and variety of activities contained within these big institutions, if they are going to be financed in the way they are, is a lot less. To have a small number of big institutions dominating world banking is not a healthy position to be in, and I think the implicit subsidy is in part responsible for that".[104] And Mr Haldane has questioned whether large banks are a necessity:

> [...] the economics of banking do not suggest that bigger need be better. Indeed, if large-scale processing of loans risks economising on the collection of information, there might even be diseconomies of scale in banking. The present crisis provides a

101 Q 308

102 Q 268

103 Q 45

104 Q 165

case study. The desire to make loans a tradable commodity led to a loss of information, as transactions replaced relationships and quantity trumped quality. Within the space of a decade, banks went from monogamy to speed-dating. Evidence from a range of countries paints a revealing picture. There is not a scrap of evidence of economies of scale or scope in banking—of bigger or broader being better—beyond a low size threshold. At least during this crisis, big banks have if anything been found to be less stable than their smaller counterparts, requiring on average larger-scale support. It could be argued that big business needs big banks to supply their needs. But this is not an argument that big businesses themselves endorse, at least according to a recent survey by the Association of Corporate Treasurers.[105]

Or, as Mr Corrigan conceded, although "It is a little hard for me to see how that [recapitalisation] would happen if we had a world of just narrow banks. You can turn around and say maybe we would not have had the problem in the first place."[106]

The advantages of diversification

92. As well as claiming that that larger financial institutions provide economic benefits to their customers, banks also asserted that larger firms benefited from being more diversified. Mr Flint of HSBC explained that:

> What I think works is scale and diversification. The reason we have been able to deal with situations that have arisen is that we have a very diversified business model by geography, a very diversified model by type of business that we do and, therefore, when one piece is doing badly other pieces have been doing well and there has been demonstrably enough value to be able to accommodate stress in one part of our system. Against the popular "too big to fail", we think there is a very strong argument "for being large enough to cope".[107]

In a speech, Mr Haldane made the following observations:

> [...] business line diversification can be a double-edged sword. During the upswing, banks enjoyed windfall gains from bets at the race-track. This boosted their buffers. But when those bets turned sour, these same activities put at risk banks' day job—the provision of loan and deposit services to the real economy. 9500 sub-prime mortgage products at the height of the boom might well have been too many. But zero is surely too few.
>
> There is a second important downside to diversification. While it might be sensible for an individual firm to diversify its business lines to reduce its risk, if this same strategy is followed by all banks the end-result may be greater fragility across the whole system. Why? Because in their desire to look different than in the past, banks' business strategies may end up looking identical in the present. The financial system

105 Speech given by Andrew Haldane at the Association of Corporate Treasurers, Leeds, Credit is Trust, 14 September 2009, pp 10-11

106 Q 308

107 Q 386

> could then become more prone to herd-like upswings and lemming-like downswings. There is more than a hint of this behaviour during the run-up to crisis. Banking strategies became a whirligig. Building societies transformed themselves into commercial banks. Commercial banks tried their hand at investment banking. Investment banks developed in-house hedge funds through large proprietary trading desks. Hedge funds competed with traditional investment funds. And to complete the circle, these investment funds imported the risk all of the others were shedding. In their desire to diversify, individual banks generated a lack of diversity, and thus resilience, for the financial system as a whole.[108]

Professor Kay was also sceptical of the benefits of diversification that banks were suggesting:

> Big banks can reduce risks by diversification They can, but that is not what happened. Diversification can reduce risks, but that does not mean that all diversifications reduce risks. In particular, the diversifications by narrow banks such as RBS and Halifax into proprietary trading and low quality corporate lending greatly increased the risks to which they were exposed. Diversification led to their failure.[109]

We note that Mr Haldane concluded:

> [...] recent crisis experience highlights some of the costs of bundling banking services. Given that, there is an intellectually defensible case for some unbundling of these services. This would reduce the risks of spill-over between privately and socially beneficial banking activities. And it would help prevent banks making individually rational but collectively calamitous strategic choices.[110]

93. **We have received evidence asserting the benefits of large banks in two areas: their ability to serve the wider economy, and their ability to diversify risk. Yet there are strong counter arguments to these assertions. We recommend that the Tripartite authorities commission research on the alleged benefits of diversification, and whether the market might be better served by a larger number of providers, with more specialised firms.**

Subsidiaries

94. Banks may offer a range of products. They may operate in a range of countries. One possible change discussed was a requirement that international firms should operate as constellations of subsidiaries, rather than being allowed to operate via branches.

108 Speech given by Andrew Haldane at the Association of Corporate Treasurers, Leeds, Credit is Trust, 14 September 2009, pp 12-13

109 John Kay, Narrow Banking FAQs, pp 4-5

110 Speech given by Andrew Haldane at the Association of Corporate Treasurers, Leeds, Credit is Trust, 14 September 2009, pp 12-13

(Subsidiaries are separate legal entities, while branches are legal extensions of the Head Office of a bank.[111])

95. The banks which gave evidence to us had a variety of views on whether or not operating through subsidiaries was advantageous. Mr Varley, representing Barclays, explained that they operated "both branch and subsidiary structures within Barclays, partly as a result of [their] long history".[112] He was cautious in accepting that a move to a subsidiary structure would be helpful. He explained that:

> Sometimes [...] in the creation of a solution to one crisis are the seeds of a problem in the next crisis. I am struck by the fact that three years ago if we had been having this conversation, you and I might well have said to each other, 'We would expect'—if we know roughly what is going to be happening in the world over the course of the coming two or three years—'Central and Eastern Europe to have a major problem at some stage over that period.' I certainly would have expected it. The fact that liquidity was able to flow, not through subsidiary structures but through branch structures, the fact that liquidity was able to flow freely into Central and Eastern Europe, as it did over the course of the last two years, American money, British money, Italian money, French money, Belgian money going in to support those economies prevented those economies collapsing. Had they collapsed in 2008, say, or 2009, that would have been a very damaging development for the global economy.[113]

96. Mr Flint of HSBC, a bank which uses a subsidiary structure, was more cautious about the benefits of a branch based system. He told us that:

> There is no question that there is much more flexibility in a branch structure in terms of moving liquidity and obviously capital is fungible because it is a branch. I am not sure whether that is a good argument for a branch structure. I think there are equally good arguments in terms of risk and control that come with a subsidiaries structure—i.e. there are more reference points in the flow of liquidity and in the flow of capital that comes from a legal framework surrounding that[114]

Mr Flint also noted that subsidiary structures could be weakened, or branch structures improved:

> Obviously you could have a subsidiary structure—and indeed there were elements of this in the Lehman situation where you had subsidiaries and then they cross-guaranteed each other— and you could destroy the integrity of the structure. Then you could have a branch structure that also puts checks and balances and brakes in place.[115]

111 Ev 114

112 Q 188

113 Q 196

114 Q 362

115 Q 365

However, he went on to explain that the advantages of a subsidiary system: "There is no question in my mind that a subsidiarised structure, in the event of having to deal with severe stress situations, makes it easier to see how you would deal with them. More importantly from our perspective, it gives us a better management and governance structure internally."[116]

97. Mr Sáenz of Santander, which also operates a subsidiary system, stated that the advantage was that "the UK unit has capital in the UK, has funding in the UK, has assets in the UK and of course if instances of mismanagement have arisen it is up to the regulators to tell the mother company how it has to deal with that problem".[117] When asked whether branches, as Mr Varley pointed out, allowed liquidity to flow into the crisis situation in Eastern Europe, he replied that perhaps branches were responsible not only for solving, but also for causing that crisis:

> The subsidiary model has a very important element which is that the local management is accountable for what is happening in this particular unit. This is very important. When you have a branch the accountability of the management is quite different and the origin of this situation that you mention I think has been the overstretch of the previous cycle that put these branches into problems when the crisis appeared. You cannot judge the situation by the way they have solved the problem when the crisis came but you have to judge the origin of that situation previous to the crisis. My point is that in those branches the over-extension and overstretch of the behaviour in the previous period produced the consequences that had to be solved by the mother company.[118]

98. The Governor of the Bank of England thought that the move towards subsidiarisation was "inevitable", telling us that "We are likely to see, over the next few years, a movement in the direction of subsidiaries rather than branches because that makes it a whole lot easier for the national regulators to do their job".[119] And Lord Turner appeared to consider such an approach was likely in future:

> It could well have an important role to play. It also strongly overlaps with the issue of living wills, resolution and recovery plans. Within that one of the options available to a large global group is to say that you do not necessarily need to think of it as one integrated global group. To a degree it has separate legal subsidiaries, for example Santander Mexico, Santander Brazil and HSBC Hong Kong which have stand alone sustainability where there is at least the option that if in 15 years' time there is any terrible crisis there is burden-sharing between different fiscal authorities as to what to do about different elements. I think it highly likely that the more banks either by geography or function have somewhat separable legal entities where one can see the possibility of resolving this one or that one in a different way, or selling this one and keeping that one, the less we need to go down the route of capital surcharges based

116 Q 365

117 Q 434

118 Q 435

119 Q 133

> solely on size. [...] if we have an institution whose structure is a cat's cradle of complicated legal entities we could end up saying that if it wants to structure itself like that we will hit it with a higher discretionary capital requirement at global level because it has created a system that either will fail in total or not at all.[120]

99. The distinct legal structure of a subsidiary may seem to suggest that a subsidiary could be left to fail, without hurting the rest of the group. Many witnesses however warned that in view of the potential damage to the reputation of the overall group, no firm would be keen to let this happen. Professor Goodhart gave the following example:

> Bear Stearns had a couple of hedge funds which were effectively separated and the hedge funds had gone quite largely into these sub-prime mortgages and got into difficulties. Bear Stearns felt for reputational risk reasons that it had to support these hedge funds, which both denuded Bear Stearns of quite a lot of capital and, in a sense, just underlined the problem that Bear Stearns was getting into.[...] In an institution with a lot of subsidiaries, people know that they are all of a part, and if one goes down it infects the other.[121]

When asked whether the markets would believe he would let a subsidiary fail, Mr Sáenz stated that:

> What the market believes in the practice of our profession is that any kind of problems in a subsidiary are attributable to the management who are managing the unit so you are accountable for that and responsible for that. If the UK subsidiary goes badly it is under our management and the reason for that is mismanagement. We have to face that situation and put in more capital and do what the supervisors require us to do because it is the name of the game.[122]

The Governor agreed that it would be difficult for groups to let subsidiaries fail, noting that:

> [...]for some of the big institutions a lot of their value is bound up in the reputation of human capital in the bank, and if one national subsidiary fails, that is going to threaten the credibility of other national subsidiaries.[123]

However, Mr Sáenz hinted there could be cases when a subsidiary might be left to fail:

> I would not like to mention any names but to my mind there have been some cases in the last ten years where the reasons for the failure of the bank were not due to the mismanagement but due to the events or acts produced by the governments in a brutal way. In this case there could be a good reason to take a different position.[124]

120 Q 507

121 Q 43

122 Q 432

123 Q 133

124 Q 432

100. The use of subsidiaries may also shield the countries in which banks operate from the effects of crisis in another country. Mr Tucker gave a striking example:

> The key thing about the legal structure of subsidiarisation around the world is essentially to do with resolution rather than to do with risk in the group per se. There is not such a bank, but let us take a UK bank that has a big operation in India—and we will take India because it is outside the European Union. It is insignificant here but it is very significant in India. It operates as a branch there and gets into difficulty, and so the FSA and we say, "We can just put that into administration and close it." That does not create much economic damage in the UK, but in India it could create a great deal of economic damage. That means that countries which are host to banks which are integral to their financial services industry probably do have an incentive to subsidiarise in order that when the shit hits the fan (to use a rather ugly expression) the local fiscal authority have the tools at their disposal that they need.[125]

101. **The first benefit from subsidiarisation would lie in ensuring that local regulators, if informed and competent, have greater control over subsidiaries, and are able to impose the policy trade-offs that their country requires. If it becomes necessary for a subsidiary to be closed down, it will be helpful to have access to its capital, and as international firms will be less complex, resolution may be easier.**

102. **We accept that there are powerful reputational incentives on banks not to let subsidiaries fail. However, regulators might step in to prevent a parent company attempting a rescue which threatened the viability of the overall group to the disbenefit of a group of taxpayers in a particular country.**

103. **The use of subsidiaries may also prevent regulatory disputes. If the head office of an international group is closed down by its own country regulator, the knock-on effects in other countries can be severe. While the use of subsidiaries may not entirely prevent this (as can be seen in the case of Lehman's failure), it may give host country regulators more influence. In a world without seemingly effective cross-border financial supervision and cooperation, subsidiarisation may be necessary to protect individual countries' fiscal bases and financial systems.**

Europe

104. Reform of the financial services sector will have to take account of the United Kingdom's' position as a constituent of the European Union. We have already reported on some of the proposals to strengthen European Union financial regulation. Among the current proposals at various stages of development are the following:

- A new systemic risk board, comprising representatives of each central bank and the ECB, with links to EU and national regulators;
- three European supervisory authorities, with stronger powers to ensure consistency of practice across the union;

125 Q 117

- new regulations relating to the sale of alternative investments, clearing houses for derivatives etc;
- as we discuss, consideration of harmonisation of European resolution and insolvency proceedings, and possibly the introduction of a European Resolution authority.[126]

105. The drive in Europe appears to be toward a system which is both more integrated, and more strongly regulated. As the European Financial Integration Report 2009 says:

> The realisation of a Single Market in financial services is an important means of increasing the competitiveness of the EU economy as a whole. By reducing financial barriers between Member States, productivity gains are expected, which in turn generate a more efficient and competitive EU financial sector. This is important, not only for the financial sector itself but also for all other sectors that rely on access to competitive sources of funding.[127]

106. We discussed the impact of the 'passporting system' with Professor Lamfalussy, who might be described as the father of the current system. His views were clear:

> We have a major problem with the cross-border banks, and that has to be dealt with specifically. There are about 45 banks, or banking groups, which really count in the European Union, of which 30 or so have their headquarters inside the euro area and the others have them in the rest. That is a question that has to be addressed that has not been addressed so far. There were attempts of various kinds and it has been conveniently swept up under the carpet.[128]

When we later asked whether it was inevitable that we would have to change European law to allow national regulators to impose more subsidiarisation he responded:

> I would certainly welcome it. What your Governor said was absolutely right, and maintaining the current ambiguity in this particular case is not healthy. I do believe that playing with the subsidiaries rather than branches is the right direction.[129]

107. Lord Turner was pessimistic about the likelihood of change:

> Essentially, we took the single market concept of freedom of establishment of services across the border and assumed that if that applied to coffee shops, ski instructors and retail stores it ought to apply also to banks. Therefore, it takes us right back to the fundamental assumption. I think it would require treaty-based changes which are immensely difficult to roll back from that situation. The simple fact is that if the FSA today tried to insist rather than encourage a particular bank

126 See paras 151-153. For details of reforms see the European Financial Integration Report, Annex 1: Policy Achievements in 2009

127 Brussels, 11.12.2009, SEC(2009) 1702 final, Commission staff working document, European Financial Integration Report 2009

128 Q 530

129 Q 540

from an EEA country to set up a subsidiary it would be subject to infraction procedures by the European Commission.[130]

108. We are not competent to say whether reform would require treaty amendment. However, limitation on the right to establish companies in the EU can be subjected to restrictions in a Member State if justified by pressing reasons. A change of this nature would merely ensure that a bank has to be structured in a way which satisfied the host state's regulators. In other cases where international companies provide potentially hazardous goods in a variety of countries, we do not expect restrictions on the ability of the national regulator to ensure those goods are safe. Moreover, financial services may present systemic risks which other goods do not.

109. As we have seen, decisions about what financial system might be desirable depend on precisely what assessment is made of the necessary trade-offs between different objectives, each of which may have some desirable outcomes. For example, there is a trade-off between the benefits of integration and the increased risk of contagion it may bring. European discussion appears to be based on an assumption that financial stability will be safeguarded by better, stronger, regulation; there is little sign that current thinking is prepared to consider structural reform.

110. **The financial crisis was not wholly the product of European banks, or European regulatory systems. However, it was exacerbated within the EEA by a system which placed undue faith on the harmonisation of regulatory structures, and discouraged national regulators from inquiring into banks headquartered in other Member States. While also considering wider international reform, there are powerful arguments for strengthening the role of national regulators within the single market.**

111. **We stress that, if achievable, better coordination between regulators of international institutions is desirable, and consistent thoughtful frameworks for regulation are likely to be helpful. However, as we have said earlier, we do not believe that regulation will prevent financial crises. We believe that the financial system should contain what the Governor of the Bank of England described as "firebreaks and firewalls", to lessen the impact of crisis when it inevitably occurs. We agree with the Commission that the "overriding policy objective is to ensure that it should always be possible— politically and economically—to allow banks to fail, whatever their size" We believe that it would be desirable to revisit the principles of European regulation to assess the extent to which they achieve this.**

112. **One possible reform would be to allow national regulators to require that foreign owned banks operated as subsidiaries rather than branches. As we have pointed out, requiring international banks to operate through subsidiaries would not solve all problems. However, it deserves serious consideration. It would be perverse if the European Union ruled it out on the questionable basis that the right of banks to operate through branches rather than subsidiaries was essential to financial integration. As Professor Lamfalussy said, the problems posed by cross-border banks**

130 Q 525

were conveniently swept under the carpet. The scale of the crisis means that Europe now has no choice but to confront those problems, and, if necessary, revise the Treaty. It cannot help European financial integration if the Governments and populations of Member States associate cross-border banking with financial instability.

Narrow banking

113. Subsidiarisation is an attempt to segment global banks in legal entities by geographical area. Narrow banking attempts to segment such groups by type of business, rather than geography. The proposals for narrow banking have come in different forms, some of which we examine below.

Professor Kay's proposals

114. Professor Kay's proposals are set out in his paper *Narrow Banking: The Reform of Banking Regulation*, in which Professor Kay envisages a split between deposit taking institutions, and the rest of the financial system. Professor Kay outlined the following characteristics of his narrow banks:

> Narrow banking implies the creation of banking institutions focussed on the traditional functions that the financial system offers to the non-financial economy:
>
> - payments systems (national and international), for institutions of all sizes;
>
> - deposit taking, from individuals and small and medium-sized enterprises.
>
> Only narrow banks specialising in these activities could describe themselves as banks. Only narrow banks could take deposits from the general public (deposits of less than a minimum amount, say £50,000). Only narrow banks could access the principal payments systems (CHAPS or BACS), or qualify for deposit protection.[131]

Professor Kay's proposals also suggested that the liabilities of the narrow banks should be matched by safe assets:

> The most effective way to ensure that public subsidy to failed financial institutions is not required is to insist that retail deposits qualifying for deposit protection should be 100% supported by genuinely safe liquid assets. Ideally, this means government securities, since nothing else has assured safety and liquidity. The model presented here does not require this restrictive view of asset quality. But this restriction is both feasible and desirable.[132]

115. Professor Kay explained why he considered there was a need for deposit liabilities to be matched with safe assets:

> It seems to me that if we are going to have deposit protection we need to minimise the taxpayer risk from deposit protection. That means ensuring that deposits are

131 John Kay, Narrow Banking, p 52, www.johnkay.com, September 2009

132 John Kay, Narrow Banking, p 58

backed by safe assets—and not just partly backed by safe assets but wholly backed by safe assets. The blunt fact is that in the world we have got into over the last 20 years, where the rating agencies would attach triple-A ratings to anything, the only thing we can be sure are safe assets are government securities of various kinds. I see narrow banking and deposits that go with narrow banking being backed by genuinely safe assets of that kind. That is also the only protection I can see against the kind of thing that happened.[133]

Professor Kay then told us why he preferred this 'structural' type of regulation, over a 'behavioural' one:

> for the last 20 years I have looked quite a lot at the whole process of regulation, deregulation, privatisation in British utilities and transport—is that one very clear conclusion from regulatory history is that if you can regulate structure it is almost always better to try to regulate structure than behaviour; that is, to put in place structures that give firms roughly the incentives to do the kinds of things you want, rather than engage in detailed monitoring of the activities they engage in. That has been true across the utility sector. Almost all the industries where we think regulation is going wrong are those where we have ended up trying to regulate behaviour, and there we end up, as we do in financial services, with a regulation that is at once extensive and intrusive and yet not very effective, and subject to what people call regulatory capture.[134]

116. One of the other areas explored was whether the narrow banking model as envisaged by Professor Kay would be able to support lending. In his paper, he provided the following explanation:

> Narrow banks might, but need not, engage in lending activities appropriate to retail financial institutions, particularly consumer lending and mortgage finance. They might, but need not, lend to small and medium size enterprises. Funding for these lending activities would have to come entirely from wholesale markets, and the banks' own capital. There are already specialist institutions which offer credit cards and mortgages based on wholesale funding. An expansion of such finance could take the form of securitisation, or be achieved through more traditional forms of money market funding. Since there would be no regulatory advantages to one form of finance over another, market forces would determine the outcome.[135]

Professor Kay also envisaged that the rest of the system, outside of narrow banking would be essentially unregulated. He explained that:

> The long term objective would be to dismantle all other financial services regulation. Capital requirements would be abandoned, and the licensing of wholesale market activities by public agencies would relate only to the approval of individuals and

133 Q 23

134 Q 16

135 John Kay, Narrow Banking, p 62

> institutions as fit and proper persons. Issues such as market abuse that did not fall within the scope of the criminal law would be a matter for private activity by self-regulatory institutions.[136]

117. Lord Turner was concerned about the impact Professor Kay's proposals would have on credit extension. He told us that he believed that "if you did what John Kay suggests and deregulated the rest of the system the rest of the system would include the whole of credit creation and extension and we would find that was just as risky and volatile as it is today."[137] As such, Professor Kay's proposals would appear to carry a trade-off with our objective to provide sustainable lending to the real economy. This view was also expressed by Professor Goodhart, who noted that:

> I do not think [Professor Kay] appreciates sufficiently that it is not just about deposits, it is not just the liability side, it is the asset side. It is the provision of credit for our companies and mortgages for our people that are so important. You can have a development whereby the system is unable to provide sufficient credit and the economy will go down, whatever happens to the deposits and whatever happens to the payment system.[138]

118. Professor Kay also stated in *Narrow Banking* that "In a free market, narrow banking would have emerged spontaneously and immediately". Professor Goodhart however told us that:

> We have had narrow banks many times. Indeed, Parliament arranged for two narrow banks going back to the 19th century—the Post Office Savings Bank was one, the Trustee Savings Bank was another—which operated exactly along the lines that John wanted. Neither of them was very successful. In competition with other banks which could take more risk and therefore offer a higher rate of deposit, the Post Office Savings Bank and the Trustees Savings Bank had a losing role.[139]

He went on to add that:

> [John Kay] says that the market is being constrained by deposit insurance. But deposit insurance only came in in the 1990s, after BCCI. There was none before then. The narrow banks were able to compete and effectively lost out. The problem is that if you required narrow banks to hold entirely riskless assets, those assets would have very low rates of return. Also, the services that narrow banks like the Post Office Savings Bank could offer were relatively limited. In competition with the other commercial banks, effectively they lost.[140]

Professor Kay however rejected Professor Goodhart's conclusions:

136 John Kay, Narrow Banking, p 65

137 Q 503

138 Q 30

139 Q 26

140 Q 8

> [...] we had narrow banks, which were called building societies. Not only did they compete, they were steadily winning market share at the expense of other banks. We mistakenly, in retrospect [...] allowed them to diversify their activities, which they did—unsuccessfully in every single case—and failed. That is a large part of the problem which we have in the UK financial services sector today. This kind of solution is perfectly feasible. [...]We have had narrow banks, they have worked in this sense, and this kind of proposal can work in the future. It is going back to a world which worked perfectly well in the past..[141]

119. Another problem identified by those critical of Professor Kay's proposals was that of the 'boundary problem', which Professor Goodhart explained as follows:

> The boundary problem is very simple. If you impose constraints and/or various kinds of burdensome regulations and taxes on one sector, it means there is a tremendous incentive for people to do the same kind of business over the boundary in the unregulated sector [...]. When it is unregulated the results may be considerably worse [...] if you are going to regulate, control, or constrain the banking system so much, you will shift the business elsewhere, possibly into the market; possibly into various other kinds of hedge funds. The end result may be that you will have a nice little protected sector at one point, but you will have a potentially dangerous unregulated area at another. I think my concern is that we will never actually avoid crises in the financial system, but if we make the banking system a great deal safer, what we will do is we will have the next crisis occurring in a shadow banking system or in a part of the unregulated market. You have to look at the financial system as a whole rather than concentrating just on one small part of it because of the boundary problem.[142]

Professor Kay was, unsurprisingly, keen to defend his proposals against this criticism:

> [...] it is true of any form of regulation, whatever form of regulation we have, that we will get regulatory arbitrage in which people seek to do the same kind of thing in a rather different and differently regulated way. In whatever kind of regulatory structure we set up we are going to get problems of that kind. We have had them in spades over the last two decades. Indeed, a very large part of what has set up the problems which we have encountered in the last two years has been regulatory arbitrage in which people reconfigured and restructured transactions in order to reduce what they perceived as the regulatory burdens. [...] What I think we have to do is to try and find a relatively narrow area that is guaranteed, be very clear about what that is and be clear also that everyone understands what is guaranteed and what is not. At the moment I think we are in a terrible position where we really think everything is guaranteed but we are not quite sure [...].[143]

141 Q 27

142 Q 48

143 Q 49

120. **Professor Kay's reforms are ambitious, and would further alter the architecture of the financial system. We recognise that while his proposals demand a radical restructuring of banking, that may be needed in respect of the radical changes which have already developed in an ad hoc way, with ill consequences, over the last two decades. We also recognise that, if they worked as intended, his proposals would protect consumers who used narrow banks, and reduce the role of the Government in a financial crisis, insofar as it proved possible for the Government to let firms in the wider banking system fail. There would be a likelihood of a significant transfer of risk into the unregulated sector. We would need to address whether the resulting financial system could provide sustainable lending.**

The US reforms

121. On 21 January 2010, the President of the United States of America announced a set of possible changes to the US financial system. They were as follows:

> 1. Limit the Scope—The President and his economic team will work with Congress to ensure that no bank or financial institution that contains a bank will own, invest in or sponsor a hedge fund or a private equity fund, or proprietary trading operations unrelated to serving customers for its own profit.
>
> 2. Limit the Size—The President also announced a new proposal to limit the consolidation of our financial sector. The President's proposal will place broader limits on the excessive growth of the market share of liabilities at the largest financial firms, to supplement existing caps on the market share of deposits.[144]

122. The proposals were heavily influence by Paul Volcker, the Chairman of the President's Economic Recovery Advisory Board, and the President referred to them as the Volcker rule.[145] *The Economist* referred to the proposals as "Glass-Steagall lite",[146] after the Glass-Steagall Act (the US Banking Act 1933), which was introduced after the 1929 US stock market crash. The Act created the Federal Deposit Insurance Corporation (FDIC) and prohibited commercial banks from engaging in investment banking; the latter was intended as a means of protecting bank depositors from the additional risks associated with security transactions.[147]

Banning proprietary trading

123. We discussed the proposal to ban proprietary trading extensively with our witnesses, and with those we met on our visit to the United States. Proprietary trading is trading on behalf of the firm, rather than on behalf of a client. Mr Sáenz told us that "whatever you call it, proprietary trading or market-making, in fact it is a high risk activity. It is some kind

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144 The White House, Office of the Press Secretary, 21 January 2010, President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers

145 The White House, Office of the Press Secretary, Remarks by the President on Financial Reform, 21January 2010

146 The Economist online, Obama and the banks, Glass-Steagall lite , Barack Obama proposes limiting the activities of big banks , 22 January 2010

147 HM Treasury, Reforming financial markets, Box 5.A

of speculative activity, that is quite clear".[148] But one of the concerns about the US reforms was whether or not it would be possible to identify what proprietary trading actually was, in a legal or regulatory sense. Mr Tucker highlighted this point:

> no-one has the faintest idea how to define proprietary trading. The positions that blew up half a dozen of the biggest banks in the world were not especially proprietary positions in the way that would normally be understood in the bars; they were large parts of securitisations that the banks had chosen not to distribute. This is going to put on hold for a second the very narrow banking approach. Let us say that I run a bank which is funded by retail deposits. I originate a load of loans for my customers and I securitise nearly all of them but I still have deposits to invest and so I have to buy assets from the market. I have become an asset manager. Is that proprietary trading or not? I do not know. I agree with the spirit behind the President's proposals. Coming from the level that it does, from the President, it is the spirit in it that is important. I take him and Paul Volcker to be saying that banks should be less risky businesses if they are going to be funded by insured deposits and if they are going to be highly leveraged, and I agree entirely with that. We will learn a lot from how they go about legislating this and defining proprietary trading.[149]

However Mr Tucker appeared to be mildly supportive of the efforts to combat proprietary trading in deposit holding institutions. He told us that:

> I think the spirit of the thing about proprietary trading and principal investment is the most important thing; it is to do with reducing the riskiness of banks and leveraged institutions that borrow short. Proprietary trading, principal investing may be one way into that, but it would not be the only way into that; banks do plenty of other things that are very risky. If we look back through the past and, I am sure, if we look into the future, there will be banking crises driven not by proprietary trading, but driven by bog-standard over-extension of loans to the commercial real estate sector, and that has happened again and again. So some of the relatively easy wins are technocratic—to shift the risk weights on lending of various kinds so that banks are taxed more, in effect, for holding them.[150]

124. The banks acknowledged that a ban on proprietary trading might make the system safer, but were less keen to acknowledge that the effect would be large. Mr Varley outlined the following position for Barclay's:

> I understand why it is that [Mr Volcker] alights on proprietary trading as a source of risk if combined with other activities. I do understand why he does that. I do not know whether he regards this as a silver bullet. I sort of doubt he does. I certainly would not regard it as a silver bullet. Could you trace the origin of this crisis to that combination? You could not. Proprietary trading for most banks in the world is a marginal activity. If I look at Barclays, you can imagine there is a lot of contention for

148 Q 448

149 Q 116

150 Q 81

> capital within Barclays. I want all of our capital, every penny of our capital in Barclays, to be serving client and customer business. I do not want capital directed into proprietary risk-taking. [...] Is he right to say that the isolation of proprietary risk-taking from retail deposits would lead generally to a safer society? That is true, but I do not think that it would have saved the system.[151]

He downplayed the amount of proprietary trading occurring at Barclays:

> If I look at Barclays, it is completely inconsequential. Indeed, in my definition, in any event, I would not point to any activity in Barclays and describe it as proprietary risk-taking, although Mr Volcker may take a somewhat different view. But he and I would agree, if he were privy to the detail of Barclays' activities, that it is completely irrelevant.[152]

125. Mr Sáenz also downplayed the amount of proprietary trading occurring at his company, Santander, telling us that "We have negligible proprietary trading, almost nothing, we do not deal with those kinds of activities and our business model is traditional commercial banking—when I say commercial I mean individuals and small to medium-sized companies and some large corporations in our footprint where we have commercial activities, and this is our business model". [153] In spite of this he did not favour a structural break between commercial banking and proprietary trading, but rather told us "I would be in favour of any kind of extra requirements of capital for the more risky activities like proprietary trading, so rather than say there should be a clear separation I would advocate additional capital requirements".[154]

126. Mr Sáenz also shared Mr Tucker's concerns about the regulators' ability to define proprietary trading. He gave us the following example:

> I do not think there is such a clear-cut differentiation between proprietary trading and dealings on behalf of your customers. If you like I can give you some examples. It is what our people in the treasury department call "market-making" so proprietary trading is on one side, the customer is in the middle and in between is something that is called, in our profession, market-making. What market-making is, is if I take a position with you as a customer and I want to hedge, to cover, that position that I have opened in a deal with you, I can do it in two ways. I can either cover it immediately back to back with another counterparty with you as a customer and another customer or another bank, that is one way, or another way is to do market-making, so-called. There I leave it open for a few days in order to see if I have a vision, a view, about the future course of the market in order to make this hedging in a more profitable way. There are two days that the positions I opened with you are open. The question is, is that proprietary trading?[155]

151 Q 224

152 Q 227

153 Q 410

154 Q 410

155 Q 447

Mr Flint argued that some definitions of proprietary trading would have real world effects:

> If you were to have a system where banks were not allowed at the end of the day to end up with a net position, ie no proprietary or principal position, the inevitable consequence is that the bid offer spread, ie the price, of intermediation would go up because people would only deal on the basis of a price that they knew they could get out on the other side, which would mean that ultimately clients would find that too expensive and would either not hedge their risk or would do it outside the banking system. You could end up with a multiplicity of unregulated entries providing the platforms through which risk is managed. At the moment what the banking system does is provide a platform for risk management for non-banking institutions and it does so as principal.[156]

127. Lord Turner, like Mr Sáenz, felt that a reduction in proprietary trading could be achieved by raising capital requirements on such activities and considered that to be "the general direction of change".[157] In our conversation with Mr Volcker on our visit to the United States, he did indeed appear to combine a legal and capital surcharge approach, telling us that:

> Now, once you say that, how do you prevent the trader from engaging in essentially speculative activity under the cover of saying this is customer related? Now I don't think there is any very bright line you could draw, but I think you can have the law strongly state that we don't want proprietary trading in the bank and the supervisor should be directed towards guarding against the rise of proprietary trading in whatever guise it may arise. And I think any sophisticated supervisor sitting at a trading desk examining trading results over a period of time could reach some reasonable judgement as to whether this is an unduly expansive interpretation of customer trading. And you don't have to make the decision in black and white. You could say 'look, you look a bit out of bounds and we have the authority, and will apply the authority, to demand a much higher capital allocation against this activity'. And if it gets big enough, the capital allocation will get very large and make that business unprofitable, so the bank would naturally have to pull back, I don't think that's simple, but it's not impossible.[158]

128. **There is a consensus that proprietary trading is a riskier activity than others banks undertake, and therefore may require closer control in deposit-taking institutions. There is a strong case in principal for such control. However, the definition of proprietary trading appears to be a 'grey area'. This may well mean that bold structural reform is difficult to implement, although Mr Volcker was confident that these definitional objections could be overcome. In practice, Mr Volcker's proposals may be implemented by higher capital charges on activities regulators deem risky.**

156 Q 376

157 Q 494

158 Ev 149-150

The structure of bank ownership liability

129. Since the crisis began, there has been a great deal of work on effective corporate governance within financial institutions. Our own inquiries into the topic suggested that companies' ownership had not provided effective control. In this inquiry we questioned whether a change in the actual ownership structure was required. In a speech in Leeds in September 2009, Mr Haldane noted that limited liability had changed the risk/reward payoff for owners of a firm:

> Limited liability means that returns to shareholders are capped below at zero, but not above. That provides a natural incentive for owners to gamble, pursuing high risk/high return strategies from which they import the return upside but export the risk downside to depositors or the public sector. During this crisis, the pursuit of those strategies has resulted in the public sector picking up the cheque for the downside in an effort to reduce risks to depositors.[159]

Mr Haldane told us that "the value of limited liability to the equity holder is particularly great when a bank is taking on risky activities—essentially because, when those risks are realised, the losses are not borne by the equity holder, but the higher returns for taking that risk are borne by the equity holder".[160]

130. Professor Goodhart outlined the reasons there had been a move towards limited liability:

> Back in the 19th century we had a mechanism of controlling risk which actually worked quite well. That was unlimited liability for the shareholders and of course the managers were shareholders. We got rid of it. Why did we get rid of it? We got rid of it because what resulted were relatively small institutions which were not able or prepared to take on very large risk in supporting industry. The UK looked at France and Germany and the countries in the Continent which were developing universal banks which were much bigger, and they saw themselves and their banking system falling behind. They said to themselves, effectively, 'What we have to do is to provide a condition in which our banking system provides the support for growing industry and is prepared to take up much larger positions much riskier positions, much longer term positions.' In order to get sufficient capitalisation to do that, you needed to move from unlimited liability to limited liability, which everybody recognised was going to make the financial system much, much riskier, and there were attempts to offset that by increasing accountancy and transparency and all that sort of thing. And of course it did make the world a bit riskier.[161]

131. Professor Goodhart noted that "there are many who feel that the shift in the major American investment house from partnerships to limited liability companies was not a step

159 Speech given by Andrew Haldane at the Association of Corporate Treasurers, Leeds, Credit is Trust, 14 September 2009, pp 14-15

160 Q 148

161 Q 17

in the right direction with regard to risk-taking”.[162] When we questioned Mr Corrigan on this, he explained why the banks, such as Goldman Sachs, had moved away from the partnership model:

> there is more than a grain of truth in your hypothesis that, other things being equal, the private partnership model had an awful lot to commend it. That I think is the reason why the decision by Goldman Sachs and others, including some private banks here in the UK, to give up their private status and become publicly held companies went on for years and years and years at times before the decision was made to take that step. I think that it is probably true that the core reason why most of what had been private, financial groups in the UK and in the US tradition made the shift from private to public was access to capital. They concluded, as the world was changing, as the scale of transactions was changing, as the risk factors were changing, that they needed more capital than they could accumulate as a private company.[163]

Mr Haldane however warned against an immediate return to unlimited liability. He remarked that “I do not think now is the time for us to return to a system of unlimited liability. Given the lending that is needed to support the real economy, the risks of pursuing that track just now are frankly too great.”[164]

132. **Banking has progressively been shedding unlimited liability as part of its ownership structure. This may well have increased the riskiness of the financial system, and led to a greater level of financial activity. It is interesting to note that limited liability is particularly beneficial to those undertaking riskier transactions.**

The Government’s position

133. In July 2009, the Government published its White Paper on *Reforming financial markets.* In that document, it rejected limits on banks’ size or complexity (the latter being an approach similar to Glass-Steagall). It provided the following explanation for its decision:

> Proponents of formal limits on the size or activities of banks focus on the need to protect the core banking system from risks to depositors, the taxpayer and wider financial stability arising from risky investment activities. They also believe that, as firms grow to a certain size, they become beneficiaries of implicit or explicit guarantees by governments, which they use to justify or subsidise certain forms of speculative activity. The approach assumes that smaller, less complicated institutions should be easier and less costly to wind down.
>
> There are strong counter-arguments to all these points. First and most significantly, there is little evidence to suggest that artificial restrictions on a financial institutions’ size or complexity, including introducing a distinction between commercial and

162 Q 32

163 Q 307

164 Q 149

investment banking activity, would automatically reduce the likelihood of firm failure:

- a fundamental assumption of the Glass-Steagall approach is that there is in fact an absolute size below which a firm can be safely left to fail. Events of the last 18 months have demonstrated that this is clearly not the case. Banks of all sizes—not just institutions above a certain size—have encountered difficulties, challenging the assertion that only larger banks are likely to fail or have systemic consequences. Caps on size, therefore, may not be an effective way of managing risk;

- moreover, some institutions that failed engaged solely in commercial lending or investment banking activity, while one of the most significant failures of all—AIG in the US —was not even a bank. The existence of Glass-Steagall provisions would have failed to address these two points;

- crucially, the Glass-Steagall approach does not guard against systemic risk contagion between firms, which as recent events show can easily travel between pure deposit-taking institutions (large or small) and large investment banking institutions;

- while many large, universal, banks lost money on trading activities, they also suffered losses as a result of bad lending, poor corporate governance and risk management procedures. The latter are examples of basic problems that can exist across both "narrow" and "broad" banks, again transcending the Glass-Steagall divide.

Second, the aggregate economic costs in the event of failure would not necessarily be reduced. Separating commercial banks from investment banks would not address counterparty risk exposures between banks, nor tackle liquidity problems arising from the cessation of interbank lending in the event of a single firm failing. Lehman Brothers was an investment bank, but its failure led to wide and varied knock-on effects to the rest of the financial system.

Third, there are benefits to the economy in having access to the services of large, broad institutions, which can use scale and scope to provide for risk diversification, as long as there are sufficient regulation and other safeguards as discussed earlier. Additionally, some large or complex banks are by nature likely to be international in business coverage, facilitating more cross-border investment and trade, and broader and larger banks provide a vital form of intermediation between the capital markets and the real economy; as a result some efficiency of allocation would be lost.

Fourth, there are practical challenges to implementing this approach. It would be extremely difficult to identify any optimum threshold for the size or scope of financial institutions, let alone to mitigate the moral hazard problems that come with specifying this threshold to the market.

Finally, a Glass-Steagall-style separation would need to be applied across all countries to be effective. In the absence of any global consensus on this approach, and on what

> the appropriate threshold for bank size or breadth might be, the introduction of these restrictions could inhibit the growth and continued competitiveness of the UK financial market, and might encourage even sound UK financial institutions to move to other countries.
>
> For the reasons set out above, the Government does not believe that Glass-Steagall style provisions, with artificial limits to firm size or breadth, would constitute a suitable response to the question of how to effectively manage the risks of systemically significant institutions [...][165]

Conclusion

134. **The Government has ruled out structural reforms such as narrow banking in its changes to the regulatory structure of the financial system. President Obama's proposals do include structural reforms, which suggests that the Government's conclusions are not universally accepted. The debate on banking reform should remain as wide as possible. Structural reforms should not be ruled out.**

135. **As a counter to structural reform, it has been argued that narrow banks also failed during the current crisis. This, in part, may be due to how those 'narrow banks' were allowed to interact with the wholesale markets. Moreover, this argument focuses on the system which existed before the crisis. Global responses to that crisis have created a new set of problems, in that markets now expect Governments to support the banking system. Structural reforms may be one way significantly to alter those expectations.**

165 HM Treasury, Reforming financial markets, paras 5.30-5.36

5 Allowing banks to fail

136. Many of the reforms discussed so far in this Report will go some way to making the system safer. However, they do not address the central problem, which is that Governments find themselves forced to choose between saving institutions or risking financial stability. That problem in turn results in moral hazard: the knowledge that Government will be forced to intervene to save the financial system, and that intervention is likely to take the form of saving individual firms, reduces the risks that market participants are taking, and so reduces market discipline. No reform is adequate unless it is credible that banks can fail and that Governments can and will force them to fail if necessary.

137. One of the key failings of the current system is that it is extremely difficult to allow systemic institutions to fail smoothly. There are several reforms to ensure that this can happen already in development. Indeed, the United Kingdom Government has led the way in introducing legal frameworks to deal with bank resolution, and has already used that framework in the case of the Dunfermline Building Society. However, much detail still needs to be put in place before we can be confident that it will be possible to ensure that a large, international bank will fail smoothly.

Living wills

138. There has been much debate about 'resolution and recovery' plans to deal with banking difficulty. Resolution is a matter for national authorities; recovery, it seems to us, is a matter for the management of individual institutions. In this Report, we are concerned with the resolution, rather than recovery, plans of banks, the so-called 'living wills', which determine how the authorities and a bank would deal with the bank's failure. The problems were exemplified by the death-throes of Lehman Brothers, where the failure of a US company affected many other countries.

139. Action to ensure that orderly wind down of banks, both within individual countries and of cross-border institutions, will clearly produce significant benefits for regulators, other national authorities, and ultimately for the whole economy by leading to more stable banking systems. The reduction of moral hazard is not the only ex-ante benefit of the introduction of living wills. As Professor Goodhart outlined, the information about the structure of banks that such an exercise would provide would also be useful. He told us:

> [...] it will enable people to understand, the regulators and everyone else, including within the banks themselves, to understand much more clearly what the jurisdictional arrangements are, and to try to relate the jurisdictional arrangements to the way that the bank functions.[166]

Professor Portes was also supportive of living wills. In written evidence, he stated that:

166 Q 44

The only potentially effective policy instrument here is the excellent ªliving willº proposal that big banks be required to elaborate detailed, pre-packaged resolution procedures that would apply when regulators judged that the bank had gone beyond the stage where prompt corrective action could save it. These would be agreed ex ante with all the bank's regulators, which would require some degree of ex ante acceptance of burden sharing across regulatory jurisdictions. But this would not be in the form of burden-sharing rules that would apply uniformly, regardless of the particular circumstances of the institution. [167]

140. Living wills appeared to attract support from market participants as well as regulators. Mr Varley told us that:

[...] a feature of a broader regulatory regime change, should be the introduction of resolution regimes and living wills. I would say we are at the front of that process rather than at the back-end of that process. Barclays is one of the pilot banks for the purposes of the FSA in looking at living wills and resolution. I do believe that as a result of the generation of living wills it will be possible for banks to fail more smoothly”.[168]

Mr Sáenz of Santander, also proudly told us that his bank had recently submitted its living will to the Bank of Spain:

We have presented our first draft and we will have to interact with the Bank of Spain a bit more in order to fine tune the elements of these living wills. [169]

Mr Corrigan was also keen to emphasise the benefits of a resolution regime: “it is very hard [...] to see how we can really satisfy ourselves and our critics that we can fix too big to fail without a very well designed and well executed framework of resolution authority.”[170] However, he also noted the difficulty of attempting to create such a regime, explaining that “We have never done it in the history of mankind. We have never orchestrated and arranged the orderly wind-down of a large, much less complex, institution.”[171]

141. One of the intrinsic problems with resolving international banks is that bankruptcy laws are not international. Professor Goodhart explained that:

One of the great difficulties in this field is that the really serious problems arise when you get a cross-border failure. Lehman's was a particular example of that, where the failure of Lehman Brothers International Europe (which I always think of as Lehman's London) resulted in a chaotic mess. But the difficulty is that, when you get a failure, you find that your international financial institutions which were

167 Ev 110

168 Q 186

169 Q 438

170 Q 306

171 Q 306

> international in life become national in death, and all the national laws are very different.[172]

142. The Governor of the Bank of England pointed out that this was not a new problem:

> You will remember BCCI. This Committee spent a lot of time worrying about BCCI and the consequences. One of the real difficulties in resolving BCCI was the incompatibility of the US bankruptcy law and the UK bankruptcy law. Just two countries —not a vast number. Just two different bankruptcy laws. I see no prospect in the immediate future of that changing. They are inherent in the legal frameworks. It is going to be very difficult to handle the failure of institutions that span frontiers. A first step is to have a simple, clear, broad-brush approach to how you would break up an international institution that failed and different parts of the world would take responsibility for different bits of it. That is doable, in my view, and I think we will make progress in our international meetings in that direction.[173]

143. Mr Varley was aware of the concern over cross-border resolution, but told us that

> there are initiatives which I welcome which will engender good cross-broader collaboration on resolution. For example, the Bank of England has recently signed a Memorandum of Understanding with the Federal Deposit Insurance Corporation which is designed to ensure that, were a bank which had businesses in both countries in a situation where it looked as though it was going to fail, there would be collaboration between the central banks and the supervisors.[174]

144. In a speech in October 2009 Mr Tucker provided the following update on international work in this area:

> Speaking as chair of the Financial Stability Board's working group on the resolution of cross-border firms, I can update you on the work already in train. Basically for the top roughly 25 banks and dealers, the authorities will work with them over the next 6-9 months to produce recovery and resolution plans. The effort will build on the existing supervisory colleges, but typically at a more senior level, and involving resolution authorities and central banks as well as line supervisors. After official level exchanges, there will be engagement with those firms, also at a senior level (say group CFO). The desired outputs will cover two things. First, recovery plans for 'de-risking' a group where it can and should be maintained as a going concern. Second, a resolution plan when a firm needs to be wound down and put to rest, but with essential economic functions maintained somehow.[175]

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172 Q 7

173 Q 133

174 Q 186

175 Paul Tucker, Deputy Governor, Financial Stability, Bank of England at Barclays Annual Lecture, London, 22 October 2009

Mr Tucker also provided a note of caution over living wills. He stated that "However good, those de-risking and wind-down plans will sometimes prove flawed".[176]

145. **There is wide support for 'living will' type resolution regimes. If they work, they allow the Government to inflict losses on all creditors of a bank because it will be possible for the bank to fail in an orderly way. This will remove some of the moral hazard, and ensure bank bondholders have to pay more attention to the banks' management and solvency. It should transfer some of the costs from the general body of taxpayers and will place them firmly within the financial sector. This may raise the cost of credit, but it will do so because risk is priced more accurately.**

146. **Moreover the creation of living wills will make many financial firms, and their investors, think about how they operate their businesses. That would be an initial, potentially large, benefit, as with the mapping of a bank's structure to a regulator.**

147. **We look forward to the FSA's eventual announcement that all UK banks have in place an effective living will.**

Living wills and company structure

148. John Kay has written that if living wills and a proper resolution regime were put in place, it would begin to take on aspects of the structural reforms, 'Narrow banking', that he advocates. He explained that:

> If [plans for 'living wills', combined with a proper resolution regime for insolvent financial institutions] were implemented sufficiently fiercely, they probably would. To be effective, they would require radical restructuring and simplification of the corporate structures of financial conglomerates. That outcome would effectively amount to narrow banking—in particular, such a regime would require that the assets, financial and operating, needed to run a retail bank would be separated by a firewall from the rest of a financial conglomerate. If you can do that, you have effectively established a narrow bank.[177]

149. Mr Sáenz's description of Santander's ability to prepare a living will lent some weight to this proposition:

> Why have we been able to submit these living wills to the Bank of Spain in such a short period of time? It is because of the simplicity of our format. It is very simple, it is very easy to unwind and as a consequence it is very easy also to put on paper the kind of actions to take in different scenarios of stress.[178]

Professor Portes also thought:

176 Paul Tucker, Deputy Governor, Financial Stability, Bank of England at Barclays Annual Lecture, London, 22 October 2009

177 'Narrow banking: FAQs', John Kay

178 Q 438

> Many policymakers who have opposed such rules therefore seem keen on the living will. It would have the additional, important benefit of forcing the banks to unwind some of the most complex features of their organisational structures—the many and interlocking subsidiaries and branches whose primary purpose is often tax avoidance and whose secondary effect is to hinder effective control and risk management by the centre.[179]

150. **As a general proposition, we consider it likely that if an institution is too complex to prepare for an orderly resolution, it is too complex to operate without imposing unacceptable risks to the states in which it does business. Regulators should take account of any structural difficulties in the preparation of a living will. Living wills, fully applied, will necessarily lead to the structural reform of the banks.**

International resolution authorities?

151. The Governor told us "It does make sense for countries to find ways of working together to deal with the resolution of those institutions and at international level there is a lot of activity in trying to think that through. I am not optimistic about where it will all go."[180] Some of those we met on our visit to the United States suggested there should be an international resolution authority. In written evidence, Mr Corrigan called for the creation of an Enhanced Resolution Authority. He wrote that "the promise of 'Enhanced Resolution Authority' will only be achieved if it is designed and executed—nationally and internationally—with great precision".[181] Mr Sáenz however felt that it would be "impossible" to achieve a global resolution authority.[182]

European Resolution and Recovery Schemes

152. If a global authority is impossible, what about a European one? In a recent Communication the European Commission proposed a European crisis management system which would extend to resolution and insolvency of cross border financial entities. We are in full agreement with the Commission's aims:

> A European framework for bank resolution must therefore be based on agreed and common objectives which should ensure that losses fall primarily on shareholders and junior and unsecured creditors rather than on governments and taxpayers. This is essential for the avoidance of moral hazard which arises from perceptions that banks that are too big or too interconnected to fail and are likely to be rescued by public financing. The overriding policy objective is to ensure that it should always be possible—politically and economically—to allow banks to fail, whatever their size.[183]

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179 Ev 110

180 Q 133

181 Ev 142

182 Q 446

183 Brussels, COM(2009) 561/4, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the European Court of Justice and the European Central Bank. *An EU Framework for Cross-Border Crisis Management in the Banking Sector*, {SEC(2009) 1389} {SEC(2009) 1390}

153. The Communication poses a number of pertinent questions, some detailed, some at a high level of generality, such as:

- What should be the key objectives and priorities for an EU bank resolution framework?
- What should be the scope of an EU resolution framework? Should it only focus on deposit-taking banks (as opposed to any other regulated financial institution)?
- If so, should it apply only to cross-border banking groups or should it also encompass single entities which only operate cross-border through branches?
- Is integrated resolution through a European Resolution Authority for banking groups desirable and feasible?
- If this option is not considered feasible, what minimum national resolution measures for a cross-border banking group are necessary.
- Is a more integrated insolvency framework for banking groups needed? If so, how should it be designed?
- Should there be a separate and self contained insolvency regime for cross-border banks?

On 19 March 2010 the idea of a European Resolution Authority was backed by the Managing Director of the IMF, Mr Dominique Strauss-Kahn.[184]

154. We welcome the fact the European Commission is addressing these issues. However, in its response the Tripartite Authority suggested that some proposals were likely to be over ambitious:

> Resolution and insolvency regimes should operate at a national level because of the fiscal implications. Also, national authorities are closer to markets and are therefore better placed to act and pay due regard to specific national market characteristics. We see difficulties in the proposals for integrated resolution through a European Resolution Authority and/or the introduction of a single European insolvency regime. These would be major undertakings and would have fiscal implications for Member States[...][185]

Other issues outlined in the detailed response include the many differing insolvency regimes across Europe, which may differ significantly in matters such as the extent to which debtors or creditors are protected.

155. **An international authority able to take the lead in the resolution of cross border financial institutions would make wind-down simpler and smoother. Unfortunately,**

184 Crisis Management Arrangements for a European Banking System "Building a Crisis Management Framework for the Single Market" Keynote speech by Dominique Strauss-Kahn, Managing Director of the IMF at the European Commission conference, Brussels, March 19, 2010

185 See Twelfth Report from the European Scrutiny Committee, Session 2009-10, HC 5-ix, Chapter 2: Financial Services

we simply do not believe that such an authority could be introduced in the near future. Even if nation states were prepared to surrender their interests to such an authority, which we doubt, the difference between bankruptcy laws in different countries would prove a significant barrier. The steps taken to put recovery and resolution arrangements in place in the United Kingdom should continue, even if negotiations to establish an international resolution authority are proceeding at the same time. This reform must be pursued regardless of what is happening elsewhere. The primary duty of the UK Government should be to protect the UK taxpayer and consumer.

6 The future

Choosing a balance

156. This Report has highlighted various trade-offs to be considered when considering potential reform of the regulation of the banking system. But there will be considerable difficulties in deciding what balance is appropriate, for it is not easy to quantify the costs and benefits of different solutions. Professor Goodhart was sceptical about the possibility of such quantification:

> It is a nice idea but in practice it is so difficult. When you are changing the structure it is very hard to work out exactly what is likely to happen. The unexpected consequences of a structural change can be fairly profound.[186]

Professor Kay agreed:

> I have spent part of my life inventing bogus numbers in order to justify particular policies, because there is a huge demand for these bogus numbers out there—but in the end we have to make these decisions on the basis of our own judgment and knowledge and your judgment and knowledge.[187]

157. However what seems apparent is that one single reform will be insufficient. Mr Haldane pointed out that "It is the package that is going to matter. It needs to be a package, because no one measure is going to be sufficient, even though it might be necessary."[188] The Governor of the Bank of England reiterated this point:

> I think the most important thing is that we are prepared to countenance radical reform, but I think the key thing to remember is that no one proposal or set of proposals will solve all problems [...]and they are not designed to. [...] If what we are going to do is to say, "We won't adopt anything unless it solves all the problems", then we are going to be stuck where we are, so I think we need to recognise that it will be a range of different policy instruments that will be required to solve the range of problems that the financial sector poses.[189]

A multifaceted approach underpinned the reform agenda proposed by the Governor of the Bank of England under the 'three-legged stool' analogy:

> There is a three-legged stool on which it makes sense to try to rest our approach; we should not rest it on just any one approach. One is structure and it is important not to lose sight of that. [...] The second is capital [...] The third is resolution[...] It will be difficult to push it far enough, but regulators must be tough enough on banks to say they do not believe their structure is simple or small enough for them to be able

186 Q 5

187 Q 6

188 Q 115

189 Q 79

> to allow them to fail and therefore they must change the way they organise their activities. We cannot end up in a situation where any regulator or government feels that an institution is just too important or big to fail [...][190]

158. Mr Corrigan felt that there was an element of uncertainty in both the types of reform discussed in this Report, whether it be the structural, or as we have termed it, evolutionary approach: "In either case you are hoping. In one case you are hoping that the regulators are going to do a better job in the future than they did in the past. In the other case you are hoping that this radical or at least fundamental restructuring of the financial system is going to work. Either way you are hoping".[191]

159. Economic theory suggests however that individuals may exhibit *projection bias* when considering what will bring them future utility (a measure of satisfaction). An article in the *Economic Journal* explains:

> When making decisions about future consumption, people must make predictions about the utility they will derive from it. While economic theory typically assumes away any difficulty in making such predictions, abundant empirical work has shown that predicting future utility is actually quite difficult; for a review see Loewenstein and Schkade (1999). A particularly robust finding in this literature is that people tend to bias their estimates of future utility towards their current utility, a phenomenon labelled Projection Bias by Loewenstein et al. (2003). While it is sensible to base predictions about the future on the present, Projection Bias is a bias because predictions of future utility are systematically off in the direction of current utility, i.e. they are predictably wrong
>
> In general, Projection Bias will lead to systematic errors when decisions are made in the presence of factors that influence current but not future utility. Prior research, for example, has shown that grocery shoppers buy more items if shopping while hungry (Gilbert et al., 2002), that current arousal influences predictions about future sexual behaviour (Ariely and Loewenstein, 2006) and that catalogue orders for winter clothing are more likely to be returned if ordered on colder days (Conlin et al., 2007).[192]

What this may mean is that when deciding where to trade-off between the different objectives we have outlined, there may be a bias to what is presently desired. **Given that the UK has just been through a financial crisis, the current desire is for a safer, more secure banking system. But the redesign of the system should be for the long term. We must not replace irrational exuberance with equally irrational restrictions. What is needed is a regulatory framework that will not flex according to the moods of politicians, the markets or even regulators. Given the lamentable consequences of the previous**

190 Oral evidence taken by the Treasury Committee on 24 November 2009, HC 34, Q9

191 Q 339

192 AU: Uri Simonsohn, TI: Weather To Go To College, SO: *The Economic Journal*, VL: 120, NO: 543, PG: 270-280, YR: 2010

regulatory approach, the Government should be prepared to embrace radical change, rather than settling for adaptation to an existing, failed model.

160. **This Report sets out a number of objectives against which to compare potential approaches. The Government must be clear in its response where it believes it has made the trade-offs against those objectives, in order to ensure the financial services industry serves the interests of the wider economy.**

The international agenda

161. Throughout this Report, we have seen areas where the contrast between the international nature of banking against the national nature of regulation and fiscal support has led to vulnerabilities in the financial system. A coordinated reform of the financial system would, to some, therefore be a desirable outcome. Lord Turner provided the following description of the international work currently being undertaken:

> I would describe it in three layers. There is an overall high-level political dynamic driven by the G20 and G20 summits of which there will be one in Seoul this year. Beneath that there is the Financial Stability Board (FSB) which brings together representatives of financial ministries, central banks and regulators from the G20 countries. It has the job of ensuring that the political desire and commitments of the G20 are translated into an integrated set of reforms. The third level is the Basel Committee. That committee as such does not specifically report to the FSB. None of these things, as it were, has firm reporting lines because none of them is treaty based, but it is the case that the FSB is continually reviewing where the Basel Committee has got to. The detailed work on how a capital requirement actually works, how it would be done, what should be the precise ratios and how it would be operationalised is done by the Basel Committee with regular reports back to the FSB. For instance, next Monday in Basel there is a meeting of the FSB steering committee. We will then review the full set of the work programmes in place and will hear from the Basel Committee on the progress it is making with the development of a new capital requirement. It is architecture that is working as best as possible and it is one that is created by political declaration and does not have a firm set of treaty-defined reporting lines.[193]

162. The banks considered there was a need for international consensus on reform. The BBA provided us with the following comments on the need for international coordination:

> There is significant advantage for the UK in banking reform being delivered within an international framework as this provides the best assurance of reforms enhancing financial stability at a global level. There is little or no ‘first mover advantage’ arising from national action and measures introduced in a piecemeal fashion may reduce the prospect of international agreement. The UK should align its change programme with the international timetable.[194]

193 Q 521

194 Ev 126

163. Given this desire by some for an internationally agreed reform plan, President Obama's proposals for the reform of the US financial system have caused consternation. Mr Varley voiced his concerns as follows:

> It is so important, it seems to me, given that risk is cross-border, given that risk is global, that the initiatives that are taken to create reform are consistent. What I lament about what has happened in the United States, is that the United States, in many senses the leader of the capital markets of the world, has gone in its own direction, whereas I think what we need is convergence of regulatory activity rather than independent regulatory activity.[195]

He went on to explain that

> I do see, and indeed I would share, a strong reaction to a unilateral move by the United States, because the language of G20 as the leaders emerged from Pittsburgh was, ªWe will move in convoy.º The importance of the convoy is that it is the best way of managing cross-border risk. What has happened here is that a member of the convoy, quite a big member of the convoy, has just left it and gone in its own direction. I do think that is bad for the world, struggling as it is to create consensus around a package of reforms that the world needs to prevent this happening again. There, I think there are strong feelings. I certainly hear them among my peers [...][196]

164. Professor Lamfalussy also raised his objections to the way in which the US were stepping out alone in making their reforms. He stated that:

> I am no longer in any supervisory, regulatory or political position at all, but the way in which the Americans have been acting is not acceptable. There have been discussions going on here and there; there is a work plan for the G20, and they suddenly come out with a plan which, as regards Volcker, was not new, because Volcker had said it a year earlier. No one took it seriously but it received the President's formal support, and that is not a good way of handling these problems. That is why I would urge that we in Europe, and this is not a euro area question it is for the European Union, speak with one voice and tell the Americans: "Look, you raise a number of very valid questions, let's sit down and see what we can do", and not wait until the Americans implement whatever they are going to do. No one knows what is going to happen to the Volcker plan exactly but something will happen, and if we simply wait until then we will have absolutely no bargaining power.[197]

165. When we met him in the US, Mr Volcker expressed his desire to have the UK act with the United States, a sentiment he repeated in his testimony to Senate Banking, Housing and Urban Affairs Committee later that day. He made the following comments to us:

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195 Q 224

196 Q228

197 Q 545

> But the fact of the matter is if you get the US and the UK, the two big financial centres agreeing on this, you are a long way towards getting the consensus you need. But I think it would be very nice, at the very least to get the Europeans, in addition to Britain, on board. If you get them on board there's nobody left really [...].[198]

166. Professor Kay was adamant that the UK should go it alone if necessary: "Saying we must wait for international agreement before acting is a recipe for inactivity, and most of the people who say it do so with that outcome in mind."[199] He expanded his views in oral evidence:

> We have to go it alone, and we have to go it alone in two ways. One is, essentially, if British financial institutions are to operate overseas, we make it clear that we want them to do that but we do not want, as the British taxpayer, to give people any impression that we are underwriting these activities [...] They must operate as subsidiaries and we will let these subsidiaries go, as the UK Government, if need be. Conversely, we do want banks from other countries to operate in the UK but, if they do so, as the world is now they are going to have to maintain assets in the UK which we could seize in the event of a failure of that institution, because there is no other mechanism by which we can ensure that UK depositors get paid if that happened. These are the things that are essential to safeguard the interests of UK customers and UK taxpayers. Just to repeat what I have said several times earlier: these are the things that matter, and the interests of UK financial institutions are secondary.[200]

167. In the 1970s the UK banking sector had a balance sheet of 50% of United Kingdom GDP; it is currently 500% of GDP.[201] During the financial crisis, governments have effectively stood behind the banking system. If international banking in the United Kingdom is to remain credible, reform must ensure that the tax payer is not expected to pick up the bill. As the Governor of the Bank of England said:

> it is not an attraction to a country to have a banking system which is five times GDP, if—if—there is a real risk that the taxpayer may have to bail it out. We have to get to a point where that risk is not realistic. Then it becomes credible for a country the size of the UK to be home to a very large international banking centre. It is not credible to be home to that if the British taxpayer is taking the risk of the whole of the balance sheet.[202]

168. **The United Kingdom can only benefit from constructive international agreement. It would help safeguard the position of the City of London, which is a crucial part of the UK economy. However, the prevarication on international agreement must not be used as an excuse to delay, or, at worst, prevent reform. Britain has a very large banking system relative to GDP compared to other countries, and its reform is anyway in our**

198 Ev 148

199 'Narrow banking: FAQs', John Kay, pp 6-7

200 Qq 12-13

201 Q 110

202 Q 139

own self-interest, even if it is not coordinated with reforms in other countries. A strong banking system is good for the country, and as the Governor of the Bank of England said "It is not to the benefit of the City of London to be known as a place with a fragile banking system which is neither safe nor robust."

The pace of reform

169. According to the *Financial Times* in January, in an invitation to one of their meetings, the Bank of International Settlements warned that "financial firms are returning to the aggressive behaviour that prevailed during the pre-crisis period".[203] Professor Lamfalussy was also concerned by "the growing reluctance of market participants—and this is an understatement—to support genuine reforms. A striking example is the powerful lobbying against the badly needed reforms of the CDS (the credit default swap market), standardisation, central clearing counterparty, trading on authorised exchanges."[204] And in a speech announcing his proposals for reforms to the US financial system, President Obama suggested that there was concerted resistance by the financial industry. He remarked that:

> My message to members of Congress of both parties is that we have to get this done. And my message to leaders of the financial industry is to work with us, and not against us, on needed reforms. I welcome constructive input from folks in the financial sector. But what we've seen so far, in recent weeks, is an army of industry lobbyists from Wall Street descending on Capitol Hill to try and block basic and common-sense rules of the road that would protect our economy and the American people.
>
> So if these folks want a fight, it's a fight I'm ready to have. And my resolve is only strengthened when I see a return to old practices at some of the very firms fighting reform; and when I see soaring profits and obscene bonuses at some of the very firms claiming that they can't lend more to small business, they can't keep credit card rates low, they can't pay a fee to refund taxpayers for the bailout without passing on the cost to shareholders or customers—that's the claims they're making. It's exactly this kind of irresponsibility that makes clear reform is necessary.[205]

The Governor warned that "Most of the changes that would be made would have the result that the profitability of equity in banks would be lower in the future than it is now. It is hardly surprising that the people currently in the industry will fight those proposals. After all, if you have an implicit subsidy from government, why would you want voluntarily to give it up?"[206]

170. When asked whether he agreed with the Bank for International Settlements warning, Mr Corrigan noted that the industry had taken a number of steps to strengthen the system

203 Financial Times, Top banks invited to Basel risk talks, 6 January 2010

204 Q 529

205 The White House, Office of the Press Secretary 21 January 2010, Remarks by the President on Financial Reform

206 Q 141

> If you take Goldman Sachs for example, these days our tier one capital ratio is something around 15%. Far more importantly, our tier one common equity ratio, which of course takes account of the quality of capital, not just the amount, itself is something like 12.5%. I think both of those numbers are at or near high industry standards, but I think as a general matter they are representative of industry standards today and both are substantially higher than would have been the case prior to the crisis. I would also note that institutions both in the United States and elsewhere and through the BIS discipline are now publishing and paying more attention, as they should, to so-called leverage ratios. Again, if you look at leverage ratios at the end of, say, 2009 at Goldman Sachs, which is broadly representative of other firms as well, they are now in the range of 12% or 13%, which is about half of what they were prior to the crisis. Finally and most importantly—I can only cite Goldman Sachs numbers because the others I do not think are particularly well known—what we call our core excess liquidity, which essentially is unencumbered government securities, cash, things like that, at the end of the past year were about $160 billion odd or 18% of the total balance sheet. If you take those three metrics as examples, recognising that roughly speaking they are representative of broad industry standards, I am not sure I would say that is business as usual;[207]

However, Mr Corrigan did acknowledge some concerns: "I will say that I do have some concerns that, if we are not very careful, at some point we can see animal spirits beginning to pop up here and there again. We have to be much more aggressive and vigilant in the future than we have in the past to deal with those problems earlier rather than later".[208]

171. Given the potential for the banking system to return to 'business as usual', we asked how much time would be needed to reform the system. Professor Goodhart told us:

> [...]while you want the banks to be safer and to have more capital and more liquidity, if you force them to do it too quickly, then you are going to get the banks continuing to de-lever and cut back on lending to ordinary people with spreads increasing. There is a problem, a trade-off, between the desire to get the banks to be in a better position and yet the desire to keep credit flowing to people in industry around the country. The way that everyone is dealing with this is trying to have a transitional period so that you say that you want the banks to reach a particular state by, shall we say, 2015 and move relatively steadily and slowly in the intervening period. I do not actually see a better way of doing it than that.[209]

Mr Tucker also considered that the reform would take time:

> The root of this, as the Governor said, is to ensure that, when a bank gets into distress, wholesale creditors take some of the pain. Shareholders are taking pain, management have taken some of the pain, insured depositors are insured and they are meant to be insured, and it is the people in between that matter. It is going to be a

207 Q 317

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> long endeavour, quite frankly, to get to a structure of a banking system that puts wholesale creditors at risk without them fleeing the system and damaging the recovery of the economy in the meantime, but that we have to do, and there is a whole range of ways of doing it.[210]

172. Mr Corrigan though was in favour of a more rapid reform programme:

> The fact of the matter is that when you look at the crisis of the past two years, and every single crisis in my professional lifetime, going back more than 30 years, the thing that has driven every crisis has been failures in credit origination and lending, whether it was the LDC debt crisis in the early 1980s, the real estate leverage finance crisis in the late 1980s or the experience of the past two years. Moreover, even if you think you can make it work, when you set out in effect to carve up or recreate, whatever words you want to use, the core of the financial system that transition—even the Governor admitted this in his appearance before your Committee—would take years. Part of my thought process is we do not have years to spare. What we have to do is to really attack in the short term this reform agenda that I spell out in my statement.[211]

173. **Banking sector reform will take time, as illustrated by Basel II. Knee jerk reforms are unlikely to stick, and as much international agreement as possible is needed. The risk is that as companies make adjustments in the meantime, there will be a slow resumption of unacceptably risky behaviour. That cannot be allowed. Both policymakers and market participants have to remain focussed on this issue until the necessary, durable, reforms have been completed.**

Future work

174. This inquiry has touched upon several areas which will be important when considering future bank reform, but for which a wider inquiry may be necessary. We discuss these briefly below.

Macroprudential tools

175. Lord Turner was keen to emphasise that solving the problem of 'too important to fail' may not conclude the work that is needed to be done. He told us that:

> [...] it is important to understand that addressing the "too big or important to fail" problem is a necessary but not sufficient response to the financial crisis. [...] it is quite possible that the total overt costs of the UK's big bank rescues will not exceed 5%-10% of GDP; indeed, it is possible that the figure will be much less. [...]. Following this crisis, UK fiscal debt will rise by about 50% of GDP and many people have lost jobs, houses and income. The key driver of these much bigger costs is volatile credit supply first under-priced and too easily available and then severely

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> constrained. It is important to realise that that problem might continue even if we successfully address the "too big to fail" problem. If the big UK banks which we needed to rescue in the autumn of 2008 had been multiple smaller banks we might still have had just as much over-exuberant lending to commercial real estate developers funded by risky short-term wholesale deposits. I believe that is the evidence which emerges from the US on this subject. Therefore, tighter capital and liquidity requirements on all banks and new counter-cyclical macro-prudential tools which can constrain credit supply in the upswing may be even more important than specifically fixing the "too big to fail" problem.[212]

176. Others also warned us not to forget the macroprudential aspects of reform. Mr Sáenz pointed out that:

> [...] at some point you have to connect and establish some connection between this kind of micro supervision and some kind of macro supervision. The micro supervision may be at an individual level but you have to connect the findings and the conclusions of this supervision with, let us say, some body that has a broader view about the systemic consequences of the behaviour and the numbers found out in the micro supervision. This kind of connection should be made in probably a more efficient way. That exists in a natural way in the instance where the central bank and the supervisor are the same. This has to be guaranteed when the central bank and the supervisor are different.[213]

Professor Portes also urged further work at the macroprudential level, but also warned of the implications that this might have:

> We know what to do for macroprudential regulation, an essential new component of a reformed regulatory regime: some combination of countercyclical capital ratios, liquidity ratios, leverage ratios, and perhaps mortgage loan-to-value ratios. The banks will complain that this is all too complex, too constraining, so the outcome is likely to be a relatively weak set of requirements, with the ratios set too low to make much difference. There is one important consequence of such macroprudential regulation, however, that has been somewhat neglected. Although business cycles may be more highly correlated across countries now than in the past, they are still to a considerable extent national, as are some asset price bubbles (eg, within the eurozone, we saw housing price bubbles in Ireland and Spain while German housing prices actually fell). That implies that the parameters of countercyclical macroprudential regulation have to be set at a national level, which in turn implies that the host regulator rules. That means that branches of global banks would be treated differently in different countries—an unsustainable position. Hence there will be pressure on cross-border banks to go from branches to subsidiaries.[214]

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This Report has been focussed on the issue of 'too important to fail'. Yet the debate on macroprudential tools demonstrates the links between the financial system and the wider economy. We recommend that the Committee in the next Parliament should undertake further work in this area.

Competition

177. Another aspect of the banking system that we touched on in this inquiry, but which deserves greater focus is competition. Professor Portes outlined his thoughts on this issue as follows:

> The banking sector was already overly concentrated before the crisis. It is now more so, and there will be many more failures of small and medium-size banks, with resulting further 'consolidation'. The remaining big banks have even more power. Far from being humbled by their egregious errors, they are vigorously—and successfully—opposing reforms that might reduce their profitability or their capacity to 'innovate', for which read 'generate new kinds of overly complex, opaque, highly profitable financial instruments and activities.' The banks are not just too big to fail, they are too big and too complex to regulate, even to manage effectively, or to control risk. But only Neelie Kroes has any apparent desire to break them up because they are oligopolists—the UK Competition Commission and FSA and US Department of Justice and financial regulators have no appetite for this, nor do finance ministries.[215]

178. Virgin Money submitted evidence to the Committee on the importance of competition. As a potential new entrant to the market, their views are of interest:

> It is vital that a competitive banking market emerges from the financial crisis. Competition has an important role to play in helping to mitigate risk, providing customers with more sustainable, straightforward banking services and, ultimately, rebuilding consumer trust.
>
> More effective competition, combined with robust depositor protection, will be particularly important in the future; a market comprising a greater number of smaller banks that, individually, pose less of a threat to financial stability than large banking groups, could help to dilute systemic risk.
>
> A competitive market for banking services also encourages innovation in product design, product distribution, pricing and customer service. Innovative, consumer-focused banking facilities that are sensible and safe are more likely to emerge in a competitive environment than one where the market is dominated by a small number of large, complex institutions.
>
> Reform of banking regulation must therefore avoid inadvertently curtailing competitive forces or establishing new barriers to entry. Competition and consumer choice in financial services, involving existing market participants and new entrants,

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> will be vital to delivering growth, prosperity and a good deal for consumers. This must not be overlooked in any redesign of the financial sector.[216]

179. The Governor of the Bank of England considered that new entrants might be deterred by the implicit subsidy given to existing, very large banks, due to the assumption that large banks would be rescued by the Government.[217] The Governor then explained that:

> This is a pretty good time to set up a new bank because the problem that existing banks have is the legacy problem of their balance sheet. A new bank starting up does not have that problem. Given the margins at present in much of the business, there is plenty of scope to set up a new bank and try to compete away the margins. The difficulty is whether you think that after five, six or whatever years it is before we get back to the more normal levels of margins, you will then be able to compete against the small group of very large banks that dominate the market. That is something for the competition authorities.[218]

When asked whether the Bank of England could intervene, the Governor of the Bank of England told us that "We are very enthusiastic about having more new entrants and encouraging more competition in banking. I am not sure we have any policy instruments at our disposal to do anything about it".[219] Mr Tucker, Deputy Governor of the Bank of England (Financial Stability) then explained how some of the reforms may aid competition:

> I think it is fair to say that the introduction of a resolution regime ought to reduce barriers to entry from the official side. If a new venture gets into difficulty and fails while it is still modestly sized, it is easier to put it to bed now than it was in the past. But I say that subject to a proviso, which is that it remains incredibly important that the deposit protection scheme, the financial compensation scheme, is able to pay out to depositors in a failed bank very quickly, within a week, because that way savers need not be deterred from putting their money with a new venture if they think it is going to be a safe venture, because they can get paid out by the insurance fund. That does not address the implicit subsidy for those that are too big to fail, but at one end of the spectrum, the barriers have been reduced slightly, arguably.[220]

180. We also questioned Lord Turner on whether the FSA should have any responsibility for competition. He replied:

> I do not believe we need to be a competition authority as it relates to our prudential responsibilities. If one goes over to the conduct of business and retail customer protection side obviously it is possible to ask questions about whether or not there should be an integration between the tools that relate to the creation of competition

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> and the other tools available to protect customers. At the moment we have a disconnect between the competitive tools residing in the OFT and Competition Commission and all other tools of customer protection that reside with the FSA. I believe that it is an open issue.[221]

181. **The financial crisis has significantly reduced the number of banks and building societies operating within the United Kingdom. We believe the next Treasury Committee should undertake work in the area of competition and banking. It is clear from the Governor's evidence, and from the events of the past few years, that effective competition will be inhibited for as long as incumbent companies are too big—or too important—to fail. That is yet another reason why the financial system must be reformed, as quickly as practicable, to ensure that financial institutions are, like the rest of the economy, properly subject to the discipline of the market place.**

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Conclusions and recommendations

Too important to ignore

1. For the past two years financial services have been under unparalleled political scrutiny. As bank executives acknowledged, this will continue at least until the banking industry can demonstrate that in times of crisis it can survive without significant public support. One thing at least is now abundantly clear: the public will not stand for another bailout. The political case for action is as strong as the economic one. (Paragraph 7)

2. Central banks will always have a function as lenders of last resort. In exceptional circumstances, governments may have to step in to address systemic crises. There must not be an assumption that this will always happen. (Paragraph 8)

3. Policy makers, nationally and internationally, will need to decide on their priorities for the banking system. A lasting framework will only come about once these decisions have been made. (Paragraph 19)

Protecting the consumer

4. A robust banking system must include a high level of protection for the retail depositor. Investors and wholesale depositors must price the risk, as the majority of consumers are in no position to undertake due diligence on the banks with which they hold deposits. It is noteworthy that audit reports are for investors rather than depositors. But an explicit provision of a guarantee on all deposits, without limit, is a step too far. There will be trade-offs even in deciding which limit is suitable, and whatever limit is chosen, there must be clarity about the limit of depositor protection. This will require constant consumer education and clear information within all financial institutions. (Paragraph 24)

Protecting the taxpayer

5. The banking system provides many benefits, including—in the good times—considerable tax revenues for the Government. But the banking crisis has required unprecedented support from the United Kingdom Government, and other governments. While it is possible that much of this support may be recouped, there can be no certainty about this. In any event, Governments have had no choice about the timing of the support. We believe that one objective for the banking system should be to ensure that the market does not anticipate and price for direct Government bailouts. (Paragraph 27)

Risk and return

6. Whenever one considers any regulatory reform, one must be wary of placing unacceptable burdens on the industry in question. But the payoffs in the banking system as revealed by the crisis suggest that there was too little risk taken by wholesale investors for the reward they received. The Government has been forced to protect them. Risk in bank investments must be correlated with return, as it is in other fields. Losses should not be borne by taxpayers and shareholders alone. (Paragraph 31)

7. We call for progress on our earlier recommendations, to ensure that audit reports are an effective tool for investors. (Paragraph 32)

Sustainable lending

8. The banking system is one of the main conduits for lending to the real economy. As such, the objective should be for it to provide a steady and appropriately priced supply of credit. However, the present crisis was preceded by cheap and plentiful credit. We have now seen a significant and sudden reduction in the availability of credit to the real economy. Reform to the banking system must try to ensure that the market for credit operates efficiently, and prices credit more reliably. (Paragraph 36)

9. The costs of a banking system crisis are not limited to the overt or immediate payments to the banking system or for consumer protection via the Financial Services Compensation Scheme. As a result of the banking crisis, the economy was pushed into recession. This loss in output is resulting in job losses, hardship and lower living standards for many, as well as placing considerable stress on the Government's balance sheet. (Paragraph 38)

10. It is important that banks can function as intermediaries in the real economy. The nature of the services offered will vary over time. Only 'useful' products will survive. However, the financial system can at times develop products which are ultimately dangerous rather than useful, and which survive for long enough for those dangers to materialise. We do not believe that it is possible to define in advance whether or not a particular product or activity will be useful, or will be a source of long-term profit for its issuing bank. However, when a new product becomes well established, regulators should analyse how far it helps the bank to perform its intermediary role, and take action to ensure that any risks identified are correctly priced. This should be an important role for regulatory authorities. (Paragraph 41)

Reducing moral hazard

11. The current financial system and its safety nets have developed in an ad-hoc way. There has been little explicit consideration of the trade-offs implicit in the policies of regulators and governments. (Paragraph 44)

12. The current policies have had the following effects:

- Consumers who are depositors in bodies covered by the Financial Services Compensation Scheme are completely protected;
- The real economy—households and non-financial firms—has been provided with a volatile flow of credit;

- The system's cost base does not currently cover the cost of the Financial Services Compensation Scheme upfront, let alone the cost of wider support for the financial system.

This has meant that during the crisis, the Government has had to act to balance these provisions. It has paid upfront for consumer protection and supported the economy when credit has become unavailable. This is the ideal opportunity for Governments, regulators, financial market participants and representatives of the real economy to decide whether or not they are prepared to accept these trade-offs. There is a danger that governments will constrain the activities of financial markets so much that valuable economic activity is lost. That must be avoided. However, the result of the crisis has been that the expectation of a bailout has increased, and banks profits may be boosted by this. That must be changed. (Paragraph 45)

13. As we explored earlier, it is essential that government support for banking should be minimised to protect the public purse. This will not be easy, given the key role that banks play in national economies, and the global economy. But even apart from reducing taxpayer exposure, there are sound reasons for reducing expectations that Governments will protect banks from losses. (Paragraph 46)

14. As we have seen from our discussion of the objectives for reform, the classification of some banks as 'too important to fail' leads to these firms carrying too low a burden of cost upon themselves, while the Government is forced to step in to cover that burden. In the reforms we consider next, tackling this problem will be key. (Paragraph 47)

Better risk management

15. It is clear that many financial companies could and should improve their risk monitoring and their risk management. But we agree with those who consider risk measurement is an incomplete science, and that there will always be significant uncertainties. Judgement will always play a role, and error is always a possibility, whether it be by firms or regulators. The possibility of the failure of a bank, or number of banks, always remains. Indeed, over time, it is certain that such failures will occur. While it may always be desirable to reduce risk, the primary objective of reform should be to ensure that the system is resilient if failures occur. (Paragraph 54)

16. We must also be wary of 'survivor bias'. The firms that have made it through the crisis have much to teach us on how to build more resilient banks. But we must also recognise that a shock or event of a different nature would probably have resulted in different survivors. (Paragraph 55)

17. Better risk management may go some way to meeting our objectives, but it cannot remove the risk that Governments will have to provide support for the sector. It can only guarantee a stable flow of lending to the economy if financial firms can consistently immunise themselves from the enthusiasms of the market or the failures of their own judgments. We do not believe this is possible. (Paragraph 56)

Better supervision

18. A more active and effective regulator will, of course, be beneficial, as would a change in the culture of financial services. But we must accept we will never have a perfect regulator. So while better supervision may reduce the probability of firms failing, it will not eliminate it. Regulators are as prone to herd thinking and belief in current wisdom as those they regulate, and are under pressure to be so. The chance of a catastrophic failure within the financial system will remain, and Governments will remain obliged to provide emergency support. (Paragraph 62)

19. Regulators can never be fully effective. Individual companies are responsible for their own actions. We must be careful, when considering a more active regulator, not to overly raise either consumers' or financial firms' expectations of its role. The regulator can not and should not replace due diligence by market participants. A system which assumes that regulators can be completely effective reduces the incentive for market participants to monitor the risks they are taking, whether they are banks, investors in banks or counterparties. Furthermore, such unattainable expectations raise the risk that should financial firms fail, the regulator will be found liable, and the Government will once again have to foot the bill. This, in turn, reduces incentives for consumers to monitor their own risks and ensure they understand their investments. The regulator is not the first but the last line of defence. (Paragraph 65)

The Basel reforms

20. Capital and liquidity reform is on its way. It will, at best, ensure a lower probability of default, and a lower loss given default, for financial firms. Higher capital and liquidity requirements will also impose a cost on firms and their customers. They may go some way to meeting our objective of an appropriate correlation between risk and reward. We also consider that more emphasis on anti-cyclical capital requirements should go some way to ensuring a more stable supply of credit to the real economy. We welcome this even though the changes will also result in lower profits to banks and higher costs to consumers. Banks taking advantage of differing regulatory environments may limit the scope for such action. (Paragraph 71)

21. However the financial crisis occurred despite repeated attempts to reform the capital and liquidity regimes. The lessons of this and preceding crises can be used to improve the capital and liquidity regimes, but that will at best be only a contribution to the wider structural reforms that are required. (Paragraph 72)

22. Given that capital and liquidity reform will not be sufficient, and that leverage appears to be an indicator of potentially increasing risk, we support the introduction of a leverage ratio. Such a ratio does not adjust for risk, and thus is not satisfactory on its own, but it is a useful addition to (inevitably imperfect) risk weighted measures. (Paragraph 76)

Levies

23. The US proposal for an ex-post levy on the financial system to repay the Government for the support provided during the banking crisis has some attractions.

It would meet the objective of reducing the costs to the US Government. (Paragraph 81)

24. An ex-ante levy, with ring-fenced resources, would also ensure there were resources in place at a time of crisis. Such a levy would, though, place additional costs on financial firms, and their customers. (Paragraph 82)

25. Ex-ante levies have also been mooted as a measure to curtail risk-taking. But it has been suggested to us that in the face of such a levy financial institutions may take on more risks, both because they believe they are covered by insurance and to recover at least some of the costs of the levy. There are also other proposals to curtail risk taking, and the cumulative effect of all these proposals must be considered, before determining whether such a levy is desirable to curtail risk-taking. (Paragraph 83)

Deposit protection

26. Given that one of our objectives is to reduce the role for the Government in the financial system, and that protecting the consumer in the face of bank failure will always remain a priority for government, we continue to recommend that the deposit protection system should be pre-funded, despite the costs it imposes on firms. (Paragraph 85)

Contingent capital

27. Contingent capital has significant support in the Bank of England. It has also been used by Lloyds Banking Group. Yet market participants remain wary, either concerned there will be little demand if they issue such capital, or worried that it could diminish actual core capital. Experience will show whether these fears are justified. If contingent capital does place more risk back onto the financial market, rather than the Government, it seems likely to be useful in a crisis, and in addition gives its holders an incentive to monitor the banks in which they are invested, with the result that movements in the price of the debt on the market would be a source of information for the bank itself and for its regulators. (Paragraph 88)

Are large banks good for the economy?

28. We have received evidence asserting the benefits of large banks in two areas: their ability to serve the wider economy, and their ability to diversify risk. Yet there are strong counter arguments to these assertions. We recommend that the Tripartite authorities commission research on the alleged benefits of diversification, and whether the market might be better served by a larger number of providers, with more specialised firms. (Paragraph 93)

Subsidiaries

29. The first benefit from subsidiarisation would lie in ensuring that local regulators, if informed and competent, have greater control over subsidiaries, and are able to impose the policy trade-offs that their country requires. If it becomes necessary for a subsidiary to be closed down, it will be helpful to have access to its capital, and as international firms will be less complex, resolution may be easier. (Paragraph 101)

30. We accept that there are powerful reputational incentives on banks not to let subsidiaries fail. However, regulators might step in to prevent a parent company attempting a rescue which threatened the viability of the overall group to the disbenefit of a group of taxpayers in a particular country. (Paragraph 102)

31. The use of subsidiaries may also prevent regulatory disputes. If the head office of an international group is closed down by its own country regulator, the knock-on effects in other countries can be severe. While the use of subsidiaries may not entirely prevent this (as can be seen in the case of Lehman's failure), it may give host country regulators more influence. In a world without seemingly effective cross-border financial supervision and cooperation, subsidiarisation may be necessary to protect individual countries' fiscal bases and financial systems. (Paragraph 103)

Europe

32. The financial crisis was not wholly the product of European banks, or European regulatory systems. However, it was exacerbated within the EEA by a system which placed undue faith on the harmonisation of regulatory structures, and discouraged national regulators from inquiring into banks headquartered in other Member States. While also considering wider international reform, there are powerful arguments for strengthening the role of national regulators within the single market. (Paragraph 110)

33. We stress that, if achievable, better coordination between regulators of international institutions is desirable, and consistent thoughtful frameworks for regulation are likely to be helpful. However, as we have said earlier, we do not believe that regulation will prevent financial crises. We believe that the financial system should contain what the Governor of the Bank of England described as "firebreaks and firewalls", to lessen the impact of crisis when it inevitably occurs. We agree with the Commission that the "overriding policy objective is to ensure that it should always be possible— politically and economically to allow banks to fail, whatever their size" We believe that it would be desirable to revisit the principles of European regulation to assess the extent to which they achieve this. (Paragraph 111)

34. One possible reform would be to allow national regulators to require that foreign owned banks operated as subsidiaries rather than branches. As we have pointed out, requiring international banks to operate through subsidiaries would not solve all problems. However, it deserves serious consideration. It would be perverse if the European Union ruled it out on the questionable basis that the right of banks to operate through branches rather than subsidiaries was essential to financial integration. As Professor Lamfalussy said, the problems posed by cross-border banks were conveniently swept under the carpet. The scale of the crisis means that Europe now has no choice but to confront those problems, and, if necessary, revise the Treaty. It cannot help European financial integration if the Governments and populations of Member States associate cross-border banking with financial instability. (Paragraph 112)

Professor Kay's proposals

35. Professor Kay's reforms are ambitious, and would further alter the architecture of the financial system. We recognise that while his proposals demand a radical restructuring of banking, that may be needed in respect of the radical changes which have already developed in an ad hoc way, with ill consequences, over the last two decades. We also recognise that, if they worked as intended, his proposals would protect consumers who used narrow banks, and reduce the role of the Government in a financial crisis, insofar as it proved possible for the Government to let firms in the wider banking system fail. There would be a likelihood of a significant transfer of risk into the unregulated sector. We would need to address whether the resulting financial system could provide sustainable lending. (Paragraph 120)

Proprietary trading

36. There is a consensus that proprietary trading is a riskier activity than others banks undertake, and therefore may require closer control in deposit-taking institutions. There is a strong case in principal for such control. However, the definition of proprietary trading appears to be a 'grey area'. This may well mean that bold structural reform is difficult to implement, although Mr Volcker was confident that these definitional objections could be overcome. In practice, Mr Volcker's proposals may be implemented by higher capital charges on activities regulators deem risky. (Paragraph 128)

Ownership structure

37. Banking has progressively been shedding unlimited liability as part of its ownership structure. This may well have increased the riskiness of the financial system, and led to a greater level of financial activity. It is interesting to note that limited liability is particularly beneficial to those undertaking riskier transactions. (Paragraph 132)

The Government's position

38. The Government has ruled out structural reforms such as narrow banking in its changes to the regulatory structure of the financial system. President Obama's proposals do include structural reforms, which suggests that the Government's conclusions are not universally accepted. The debate on banking reform should remain as wide as possible. Structural reforms should not be ruled out. (Paragraph 134)

39. As a counter to structural reform, it has been argued that narrow banks also failed during the current crisis. This, in part, may be due to how those 'narrow banks' were allowed to interact with the wholesale markets. Moreover, this argument focuses on the system which existed before the crisis. Global responses to that crisis have created a new set of problems, in that markets now expect Governments to support the banking system. Structural reforms may be one way significantly to alter those expectations. (Paragraph 135)

Living wills

40. There is wide support for 'living will' type resolution regimes. If they work, they allow the Government to inflict losses on all creditors of a bank because it will be possible for the bank to fail in an orderly way. This will remove some of the moral hazard, and ensure bank bondholders have to pay more attention to the banks' management and solvency. It should transfer some of the costs from the general body of taxpayers and will place them firmly within the financial sector. This may raise the cost of credit, but it will do so because risk is priced more accurately. (Paragraph 145)

41. Moreover the creation of living wills will make many financial firms, and their investors, think about how they operate their businesses. That would be an initial, potentially large, benefit, as with the mapping of a bank's structure to a regulator. (Paragraph 146)

42. We look forward to the FSA's eventual announcement that all UK banks have in place an effective living will. (Paragraph 147)

43. As a general proposition, we consider it likely that if an institution is too complex to prepare for an orderly resolution, it is too complex to operate without imposing unacceptable risks to the states in which it does business. Regulators should take account of any structural difficulties in the preparation of a living will. Living wills, fully applied, will necessarily lead to the structural reform of the banks. (Paragraph 150)

International resolution authorities

44. An international authority able to take the lead in the resolution of cross border financial institutions would make wind-down simpler and smoother. Unfortunately, we simply do not believe that such an authority could be introduced in the near future. Even if nation states were prepared to surrender their interests to such an authority, which we doubt, the difference between bankruptcy laws in different countries would prove a significant barrier. The steps taken to put recovery and resolution arrangements in place in the United Kingdom should continue, even if negotiations to establish an international resolution authority are proceeding at the same time. This reform must be pursued regardless of what is happening elsewhere. The primary duty of the UK Government should be to protect the UK taxpayer and consumer. (Paragraph 155)

Choosing a balance

45. Given that the UK has just been through a financial crisis, the current desire is for a safer, more secure banking system. But the redesign of the system should be for the long term. We must not replace irrational exuberance with equally irrational restrictions. What is needed is a regulatory framework that will not flex according to the moods of politicians, the markets or even regulators. Given the lamentable consequences of the previous regulatory approach, the Government should be prepared to embrace radical change, rather than settling for adaptation to an existing, failed model. (Paragraph 159)

46. This Report sets out a number of objectives against which to compare potential approaches. The Government must be clear in its response where it believes it has made the trade-offs against those objectives, in order to ensure the financial services industry serves the interests of the wider economy. (Paragraph 160)

The international agenda

47. The United Kingdom can only benefit from constructive international agreement. It would help safeguard the position of the City of London, which is a crucial part of the UK economy. However, the prevarication on international agreement must not be used as an excuse to delay, or, at worst, prevent reform. Britain has a very large banking system relative to GDP compared to other countries, and its reform is anyway in our own self-interest, even if it is not coordinated with reforms in other countries. A strong banking system is good for the country, and as the Governor of the Bank of England said "It is not to the benefit of the City of London to be known as a place with a fragile banking system which is neither safe nor robust." (Paragraph 168)

48. Banking sector reform will take time, as illustrated by Basel II. Knee jerk reforms are unlikely to stick, and as much international agreement as possible is needed. The risk is that as companies make adjustments in the meantime, there will be a slow resumption of unacceptably risky behaviour. That cannot be allowed. Both policymakers and market participants have to remain focussed on this issue until the necessary, durable, reforms have been completed. (Paragraph 173)

Microprudential tools

49. This Report has been focussed on the issue of 'too important to fail'. Yet the debate on macroprudential tools demonstrates the links between the financial system and the wider economy. We recommend that the Committee in the next Parliament should undertake further work in this area. (Paragraph 175)

Competition

50. The financial crisis has significantly reduced the number of banks and building societies operating within the United Kingdom. We believe the next Treasury Committee should undertake work in the area of competition and banking. It is clear from the Governor's evidence, and from the events of the past few years, that effective competition will be inhibited for as long as incumbent companies are too big—or too important—to fail. That is yet another reason why the financial system must be reformed, as quickly as practicable, to ensure that financial institutions are, like the rest of the economy, properly subject to the discipline of the market place. (Paragraph 181)

Formal Minutes of the Treasury Committee

Monday 22 March 2010

Members present:

John McFall, in the Chair

Mr Graham Brady
Jim Cousins
Michael Fallon
Ms Sally Keeble
Mr James Plaskitt
Mr Mark Todd
Mr Andrew Tyrie
Sir Peter Viggers

Draft Report (*Too important to fail—too important to ignore*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 181 read and agreed to.

Summary agreed to.

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

Ordered, That the Chair 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 Committee (reports)).

Written evidence reported and ordered to be published on 19 and 26 January, 9 and 22 February, 2 and 16 March was ordered to be reported to the House for printing with the Report.

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[Adjourned till tomorrow at 9.30 a.m.

Witnesses

List of written evidence

Reports from the Treasury Committee during the current Parliament

Session 2009–10

First Report	Proposals for European financial supervision: further report	HC 37
Second Report	Work of the Committee 2008-09	HC 134
Third Report	Credit Searches	HC 197
Fourth Report	Pre-Budget Report 2009	HC 180
Fifth Report	Reporting contingent liabilities to Parliament	HC 181
Sixth Report	The failure of the Presbyterian Mutual Society	HC 260
Seventh Report	Administration and expenditure of the Chancellor's departments, 2008-09	HC 156
Eighth Report	The management of the Crown Estate	HC 325

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-I
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	HC 764
Twelfth Report	Banking Crisis: International Dimensions	HC 615
Thirteenth Report	Evaluating the efficiency programme	HC 520
Fourteenth Report	Banking Crisis: Regulation and supervision	HC 767
Fifteenth Report	Mortgage arrears and access to mortgage finance	HC 766
Sixteenth Report	The Committee's Opinion on proposals for European financial regulation	HC 1088

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