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HOUSE OF COMMONS
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GENERAL COMMITTEES

Public Bill Committee

FINANCIAL SERVICES (BANKING REFORM) BILL

Sixth Sitting

Tuesday 26 March 2013

(Afternoon)

CONTENTS

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Saturday 30 March 2013

STRICT ADHERENCE TO THIS ARRANGEMENT WILL GREATLY FACILITATE THE PROMPT PUBLICATION OF THE BOUND VOLUMES OF PROCEEDINGS IN GENERAL COMMITTEES

The Committee consisted of the following Members:

Chairs: †Mr Peter Bone, Mr Jim Hood, Dr William McCrea, Mr Andrew Turner

† Ashworth, Jonathan *(Leicester South)* (Lab)
† Clark, Greg *(Financial Secretary to the Treasury)*
† Doughty, Stephen *(Cardiff South and Penarth)* (Lab/Co-op)
† Durkan, Mark *(Foyle)* (SDLP)
† Evans, Graham *(Weaver Vale)* (Con)
† Hands, Greg *(Chelsea and Fulham)* (Con)
† Jamieson, Cathy *(Kilmarnock and Loudoun)* (Lab/Co-op)
† Leslie, Chris *(Nottingham East)* (Lab/Co-op)
† Mills, Nigel *(Amber Valley)* (Con)
† Morris, James *(Halesowen and Rowley Regis)* (Con)
† Mowat, David *(Warrington South)* (Con)
† Qureshi, Yasmin *(Bolton South East)* (Lab)
† Rees-Mogg, Jacob *(North East Somerset)* (Con)
† Sharma, Alok *(Reading West)* (Con)
† Smith, Nick *(Blaenau Gwent)* (Lab)
† Stevenson, John *(Carlisle)* (Con)
† Thornton, Mike *(Eastleigh)* (LD)
Williams, Stephen *(Bristol West)* (LD)
† Wright, David *(Telford)* (Lab)

Neil Caulfield, *Committee Clerk*

† attended the Committee

Public Bill Committee

Tuesday 26 March 2013

(Afternoon)

[Mr Peter Bone *in the Chair*]

Financial Services (Banking Reform) Bill

2 pm

The Chair: Before the Committee resumes, it might be helpful if I remind Members that the deadline for tabling amendments for the next sitting, which is on Tuesday 16 April, is 4.30 pm on the previous Thursday, 11 April.

Clause 12

Scheme manager: appointment of accounting officer

Question (this day) again proposed, That the clause stand part of the Bill.

Cathy Jamieson (Kilmarnock and Loudoun) (Lab/Co-op): It is a pleasure to serve under your chairmanship again this afternoon, Mr Bone. When we adjourned just before lunchtime, I was in the process of saying that I would not prolong this stand part debate, and I intend to stick to that. I seek merely to make a few points on the Minister's comments in relation to clause 10, and I seek further information on the record.

For the benefit of those who have had exciting things to do over the intervening period and have perhaps forgotten that we reached clause 12, which is on the appointment of an accounting officer—the Financial Services Compensation Scheme chief executive—I briefly remind hon. Members that the clause amends the Financial Services and Markets Act 2000 to ensure that the FSCS constitution provides for the chief executive, as the Minister outlined. He also made it clear that the FSCS chief executive will be the organisation's accounting officer and will sit on the board alongside the chairman. I had some questions on the line of accountability from the accounting officer to the Treasury, but to be fair, he addressed some of that when we considered clause 10.

The chief executive will be appointed by the Prudential Regulation Authority and the Financial Conduct Authority. If I understand the Minister correctly, the Treasury will have to approve the appointment. That answers one of my questions, but it begs the question in what circumstances the Treasury would see fit not to approve an appointment recommended by the PRA and the FCA. In that circumstance, who would have the final say? What would the procedure be if the PRA and the FCA were unable to reach an agreement in some hypothetical situation, or if they were to favour different candidates? It would be helpful if the Minister responded to those points.

The Minister addressed some of this when we considered clause 10, but it would also be helpful if he reminded the Committee of the circumstances that might lead to the removal of the chief executive and the procedures through which such a decision would be approved by the Treasury. I work on the assumption that, if the Treasury has to approve the appointment, it will also have some say in the chief executive's removal.

The Financial Secretary to the Treasury (Greg Clark): I will attempt to refer to the hon. Lady's points. There are no changes to the arrangements for the appointment of the FSCS chief executive. The designation of FSCS accounting officer will simply be an addition to the chief executive's current responsibilities, just as, at the moment, the Treasury and the regulators must have confidence in the chief executive on appointment.

On the circumstances in which it might not be seen fit to appoint an individual, it is hard to imagine that the FCA and the PRA might recommend someone who did not meet with the Treasury's favour. Having said that, if the accounting officer becomes, in effect, a subordinate accounting officer to the Treasury's accounting officer, it is only reasonable for the concerns of the latter to be addressed if they have no confidence in the other's ability to discharge their strict responsibilities as an accounting officer under another accounting officer. The PRA and the FCA have a memorandum of understanding that governs their relationship. We would expect them to seek agreement on these matters and, through negotiation, reach a sensible outcome. I cannot see circumstances in which the Treasury's right of veto in this regard would regularly and routinely used. It would be used in exceptional circumstances where the accounting officer of the Treasury did not feel that the person below him or her in the hierarchy was capable of discharging those functions.

On the removal of the accounting officer, both the appointment and removal would need to be approved by the Treasury, but of course the chairman of the PRA would be responsible for initiating procedures if, on behalf of the organisation, they felt that the chief executive was not doing the right job.

Question put and agreed to.

Clause 12 accordingly ordered to stand part of the Bill.

Clause 13

Fees to meet Treasury expenditure relating to international organisations

Question proposed, That the clause stand part of the Bill.

Greg Clark: I think that most Committee members would agree that the cost of dealing with the failure of banks—indeed, the regulation of financial services—should fall on the sector rather than on ordinary taxpayers. That principle is followed in the FCA and the PRA, which are financed by a levy on the industry, which was established in the Financial Services Act 2012. Other regulators can cover the costs of their international work from the industry, but it is an anomaly that so far the Treasury is not able to meet its costs.

The clause is restrictive about those costs. Tempting though it is, this is not a mechanism to fill the coffers of the Treasury and finance all sorts of imperialistic tendencies that it might fall prey to. It is limited to the expenses that come from certain prescribed organisations, which I will mention, that need to be specified to Parliament. The costs are limited to the membership of organisations set out in proposed new section 410A(2) of the 2000 Act. It is proposed that only the global Financial Stability Board should be named from the outset. Any other organisations that would be added in future must have a role in the scrutiny and promotion of financial stability of financial services. Currently, the FSB does not levy a charge on its constituent members—it is funded by the Bank for International Settlements—but in future it may introduce membership fees. The clause is forward-looking and would prevent the Government's having to return to get primary legislation if, in future, that body started to levy charges.

We have published draft regulations already and will consult the Bank, the PRA and the FCA about who should be subject to fees. For example, there is a question about whether the insurance sector might need to be covered or ought to be exempt. However, the power in the clause is relatively straightforward.

Chris Leslie (Nottingham East) (Lab/Co-op): The "imperialistic tendencies" of the Treasury imply that there is an emperor somewhere within. I do not know whether there is a Napoleon complex or something else that we should explore there, but I will set that to one side.

It clearly makes a degree of sense for the Treasury to be able to recoup some of the expenses related to the membership of various international organisations. I might have missed it or misheard the Minister, but I do not think that he listed the international organisations in question—it is all very well saying, "For example, the Financial Stability Board or the Basel Committee on Banking Supervision," but are there others?

Greg Clark: There is only one. Only the Financial Stability Board is specified from the outset, and currently it does not charge fees.

Chris Leslie: That answers my next question, which was about how much the fees are. I want to take the opportunity to ask the Minister about some of the fees that the Treasury has to pay to international organisations. We have recently spotted that the fees for international financial organisations that should have been attributed to the financial year 2012-13 are actually budgeted for the next financial year. For example, under the rather ambiguous title "Exceptional inter-period flexibility", to which the Chancellor referred in his Budget speech, we saw that the fees for the World Bank and other organisations such as the United Nations and some EU institutions may well have been cast into 2013-14. That raises questions about whether we will have to affiliate twice in that one financial year.

In particular, the UK's contribution to the European Investment Bank was reclassified. That mysteriously appeared on page 130 of the Office for Budget Responsibility report, yet there was no rationale explaining who made that decision, when or for what purpose. However, it handily reduces the spending totals for 2012-13. I am sure that the Treasury did not resist that too much. We must keep a little watch on what is going on with these fees and subscriptions to international institutions.

If I were one of those institutions, I would be wary of doing a deal with the current occupants of the Treasury, considering their "imperialist tendencies," because they do that thing where they say, "The cheque is in the post. Don't worry, we will pay your fee for 2012-13." Whether they are actually posting the envelope containing the cheque is another matter.

I was told many years ago—obviously I never actually sought to undertake this practice—that if one folds a cheque before paying it, somehow it takes an extra day to clear because a folded cheque does not go through the machines in the clearing system rapidly enough. Has the Chancellor taken to folding his cheques down the middle just to kick the borrowing figures one year further down the road? That is the questions that the Financial Stability Board and the Basel Committee may well need to ask.

I know that there are currently no fees, but this is quite an important issue given what is happening. If there are new organisations that are likely to charge fees, it would be helpful to know what they are and whether there would be proper, normal conventions on how they should be paid or whether we be going into the dimension of inter-period extraordinary flexibility.

Greg Clark: I know that the hon. Gentleman used to represent a Yorkshire constituency; I do not know whether that is where he learnt this trick of folding cheques to have an extra day's interest. As a Yorkshireman myself, I am sure that God's own county would be proud of his little contribution to financial efficiency. I cannot quite work out whether he is concerned that these powers are going to give occasion to let the Treasury rip with the public finances, or thinks that we are too mean in paying our expenses to international bodies.

2.15 pm

Remarkably, the Treasury, as befits its reputation, manages to have most of the subscriptions to international bodies paid for by other organisations, whether it is the regulators or other Government Departments, so the occasion to fold up the cheques that are in the post is limited. However, we see coming down the road a particular bill that might be presented from the global Financial Stability Board. With characteristic alacrity, seeing the impending bill that might be presented, the Treasury has anticipated it and taken action so that the cheque can be forwarded straight on to the industry to be picked up. I am not aware of any other financial organisations that need to be designated so that fees are incurred. Certainly there are none that we intend to be covered by the Bill. I have a note about all sorts of organisations that the Bank of England and the FSA pay subscriptions to, but I am delighted to say that the Treasury is not part of it.

Question put and agreed to.

Clause 13 accordingly ordered to stand part of the Bill.

Clause 14

AMENDMENTS OF SECTION 429 OF FSMA 2000

Question proposed, That the clause stand part of the Bill.

Greg Clark: This is a technical clause, which sets out the parliamentary procedure that will apply to regulations made under new sections 142K and 410A of FSMA on funding for international organisations. It sets out that the affirmative resolution procedure will be used for all regulations, except those that only specify the name of an international organisation that comes within the scope of new section 410A, which will be subject to the negative resolution procedure.

The list of international organisations will be technical in nature. The reason why the negative resolution procedure is preferred is that some international organisations—in fact, the Financial Stability Board is the only one—have been known to change their names from time to time. The FSB was renamed from the Financial Stability Forum. Very occasionally, it will be necessary to tweak a name on the list, and that is the reason for the negative procedure. I hope that satisfies the Committee.

Chris Leslie: I do not object to the technical nature of the clause. I am just perplexed that we need the provision for negative statutory instruments just because of a potential name change, which I would have thought would apply to a number of different aspects of the Bill. It would be useful, if we will not have an opportunity through the affirmative procedure to study and scrutinise the payment of the fees for international institutions—a negative resolution is a bit insubstantial—for the Minister to commit to a written ministerial statement if and when those sums become apparent, so that at least we can flag them up to the House. It is a shame that we will not have them all under the affirmative procedure. Otherwise, the Minister is almost in a good place on the matter.

Greg Clark: I have no objection to that at all. It seems a very sensible way of keeping the House informed, and I am happy to commit to it.

Question put and agreed to.

Clause 14 accordingly ordered to stand part of the Bill.

Clause 15

Accounts of Bank of England and its wholly-owned subsidiaries

Question proposed, That the clause stand part of the Bill.

Greg Clark: Sometimes, in financial crises, swift, decisive action is needed to support one or more institutions. The Bank of England, as the UK's resolution authority, may be called on to provide financial support to an institution in an emergency. When it does so, it may choose to create a special purpose vehicle separate from the bank's own balance sheet, for the purposes of good order. Clause 15 will allow the Bank to direct such wholly owned subsidiaries to disregard the disclosure requirements under the Companies Act 2006. The reason for avoiding the disclosure of information is that the provision of liquidity assistance, for example, could need to be covert in order to prevent a witch hunt to discover which institution is being aided in that way.

The use of the power specifically requires that it must be necessary, not just convenient, to meet the financial stability objective. That is quite a rigorous test. The norm, rightly, is that disclosure should be the default and not simply a matter of whim or volition on the part of the Bank to hide the flows of funds. The test is that the use of the power must be necessary to meet the financial stability objective. The Treasury must be consulted, and can if it wishes compel disclosure, overriding the Bank's own view.

As Committee members will know, there is a crisis management memorandum of understanding between the Bank and the Treasury. That MOU requires that in any circumstances of emergency assistance, the Chancellor must tell the Chairs of the Treasury Committee and the Public Accounts Committee that action is being taken, notwithstanding the fact that it is not in the public domain. The Chancellor has a responsibility through the MOU to keep Parliament informed. A draft of the MOU is published and is available for scrutiny by Parliament. The MOU for these purposes is between the Bank, the Treasury and the PRA.

I hope that the provisions of the clause will commend themselves to the Committee. As I said, they are for use in exceptional circumstances and are subject to a rigorous test that they are necessary for financial stability.

Chris Leslie: This is a slightly unusual, eyebrow-raising clause. Obviously, the Bank of England operates a rather mysterious part of our constitution generally. It is the magic money tree that the Prime Minister said he did not want to use in his infamous speech the other day, and it has been tempting for the Chancellor to shake it occasionally, creating money. The process has left many people scratching their heads about how it works.

Setting that aside, it is important that many of the normal conventions of company law, transparency and accountability apply to the work of the Bank of England. After all, the Chancellor will essentially be vesting all the aspirations of his aspiration nation in the new Governor, Mark Carney, when he arrives, trusting and hoping that he will ride to the rescue of the economy. We must keep an eye on what is happening with monetary policy more broadly. Clause 15 is one of those interesting little clauses that are worth peeking inside.

I do not think there are existing subsidiaries of the Bank of England that are already long standing, although maybe there are. It is often the case that large entities have dormant subsidiaries or other sub-company structures. I am not sure whether there is anything at present other than the Bank of England that is incorporated, or whether it has subsidiaries that might fall within the scope of the amendment. I understand what the Minister says about the need in a crisis, for commercial sensitivity reasons, not to have instant disclosure and availability of some of our inter-financial interventions, but a strong dose of ex post scrutiny is necessary once the tide has subsided a little, just to go over what the intervention was.

Will the Minister assure the Committee that although the normal company law scrutiny arrangements will not apply in these exceptional circumstances, there would still be a general expectation on the Bank of England to make a report? I am not sure how many years down the track that should be—perhaps not quite a 30-year rule; but it would be appropriate if two, three or four years later, once the crisis has subsided, we could know about the liquidity injections and other forms of assistance that might have been hidden beneath the protection of exclusion from company law availability. Those are my main anxieties. In particular, there should be an opportunity for ex post scrutiny further down the track.

Greg Clark: The hon. Gentleman makes perfectly reasonable points. The Bank's arrangements are that when it is called upon to give this assistance, it tends to create a special purpose vehicle as a wholly owned subsidiary of the Bank in order to section it from the rest of the Bank's activities. Such vehicles would be wound up when no longer needed. They have been needed in the past: for example, the emergency liquidity assistance provided to Royal Bank of Scotland during the last crisis is a good case. Knowledge at the time that such assistance was being provided might have occasioned an even more rapid, and possibly even more disorderly, consequence than the unfortunate one that resulted, and it is possible to imagine such circumstances in the future.

The clause is restrictive in that it can be used simply for narrow circumstances. It is not available, for example, to hide some of the monetary policy mechanisms that the Bank might use. They have to be disclosed in the normal way.

The point that the hon. Gentleman makes about ex post scrutiny is absolutely right. The Chairs of the Public Accounts Committee and the Treasury Committee will know immediately, but the memorandum of understanding, which is published between the Treasury, the Bank and the PRA, explicitly requires that such information will be laid before Parliament when the Treasury, having consulted the Bank, has decided that the need for confidentiality of the support operation has passed. The requirement is to consider and keep under review when that confidentiality requirement has passed. In some cases it might be a matter of months, but in other cases it might be more than that.

Question put and agreed to.

Clause 15 accordingly ordered to stand part of the Bill.

Clause 16

Orders and regulations

Chris Leslie: I beg to move amendment 30, in clause 16, page 20, line 28, after 'ring-fencing)' insert

'or section (*Bank bail-in regime*)(2) (bank bail-in regime)'.

The Chair: With this it will be convenient to discuss the following:

New clause 19—*Bank bail-in regime*—

'(1) The Bank of England must, at least once in every year, prepare an assessment of any progress which has been made towards the introduction of a bank bail-in regime in the United Kingdom or, once a bank bail-in regime has been introduced, of its operation.

(2) If a bank bail-in regime is not in force in the United Kingdom by the end of 2015, the Treasury must by regulations make provision for such a regime.

(3) an assessment under subsection (1) must include—

(a) an assessment of how much of the issued debt of banks would be covered by any proposed bank bail-in regime or is covered by the provisions of the bank bail-in regime in force;

(b) (if a bank bail-in regime is in force) an account of the sorts of companies within groups which have creditors who are covered by the bank bail-in regime and of the sorts of persons who are creditors who are so covered;

(c) a review of the descriptions of creditors who would be covered by any proposed bail-in regime or are covered by the provisions of the bank bail-in regime in force, and

(d) an account of progress towards international co-operation in relation to bail-in regimes.

(4) The Bank of England must send the assessment to the Treasury.

(5) The Treasury must lay the assessment before Parliament.

(6) The Bank of England must publish the assessment in such manner as they think fit.

(7) In this section "bank bail-in regime" means provisions under which losses incurred by a bank are to be met by certain descriptions of creditors of the bank should the bank encounter financial difficulties which might otherwise lead to the taking of action which would be likely to have implications for public funds.

(8) For the purposes of subsection (7) "action having implications for public funds" has the same meaning as in section 78(1) of the Banking Act 2009.

(9) In this section "bank" means a UK institution which has permission under Part 4A of FSMA 2000 to carry on the regulated activity of accepting deposits, other than a building society (within the meaning of the Building Societies Act 1986) or any description of institution excluded by virtue of subsection (2)(b) of section 142A of that Act from being a ring-fenced body as defined in subsection (1) of that section.'.

Amendment 31, in title, line 4, after 'insolvency;', insert

'to make provision in relation to a bank bail-in regime;'.

Chris Leslie: The amendments relate to the bail-in regime. We talked a little about the potential of bail-in arrangements earlier when looking at the preference given to depositors, but having seen the dreadful events in Cyprus, the issue has become more serious, with more popular understanding of what could befall depositors in a bank if there are particular difficulties. The amendments would provide for a bank bail-in tool to be created in the event of a bank finding itself in financial difficulties, and would ensure that there was a process for creating a bail-in arrangement that is robust and able to cope with a number of different circumstances.

2.30 pm

Our principal change would be to amend clause 16 to allow the addition of new clause 19, which would ensure that every year the Bank of England prepared

"an assessment of any progress which has been made towards the introduction of a bank bail-in regime in the United Kingdom or, once a bank bail-in regime has been introduced, of its operation."

New clause 19 would also ensure that proper assessment was undertaken by the Bank, particularly in respect of how much of the issued debt of banks would be covered by any proposed bail-in regime, and would make sure that such a review considered the sorts of persons who are creditors to be covered by that scheme. The Bank of England would then forward the assessment to the Treasury, which in turn would lay it before Parliament, so that the Bank and others could respond in due course.

The Parliamentary Commission on Banking Standards helped to inspire this group of amendments. It was very concerned that the Bill had been brought forward without an adequate bail-in arrangement. That is why we find ourselves in this slightly unusual terrain—I do not think that I have encountered this situation before in my many years of service on Bill Committees—where we are proposing an amendment not to a clause, but to the long title of the Bill. I am assured that we sometimes discuss the long title in Committee, at the very end: the long title would need to be amended to make the scope of the Bill cover the provisions in new clause 19; amendment 31 is therefore consequential to the new clause.

Even after ring-fencing, the failure of a large bank could still pose a risk to public funds. Both ring-fenced and investment banks have the potential to shake financial stability, which is why the Parliamentary Commission was so keen to advance a bail-in regime that would apply to both ring-fenced and investment banks. A bail-in regime is a regulatory tool that allows bonds to be converted into capital when a bank is in financial difficulty, which would allow for the resolution of banks without recourse to the public purse. It would work by capitalising a bank through the conversion of debt into equity or through debt write-down; it would occur when a bank is put into resolution, and so would need to be triggered by the regulator. It could allow some of the bank's operations to continue as a going concern, or could facilitate a solvent wind-down in resolution. There is a growing feeling that the banks and the bankers obviously contributed significantly, or even wholly, to the financial crisis and left the taxpayer to bear the burden. A bail-in tool would help to prevent that from happening in the future.

As I understand it, the Government have accepted the principle of the bail-in. However—and this is a pity—they seem to have been dragging their heels a bit, not just in failing to put such an arrangement in the Bill but in the way in which they have been waiting for the European Union to determine this particular set of rules through the recovery and resolution directive—a directive that might not have been that well known until recent weeks. Events can move at great speed but, as we know, there is always the possibility with European legislation that it might take a phenomenal amount of time. Especially given the situation in Cyprus, there could well be wrangling and disagreements about how the process will work for quite a long time to come. I therefore think that Britain needs to settle its own bail-in arrangements at the earliest possible opportunity. It would be far better for us to have our home-grown variant. If Europe follows later down the line, let them follow where we have led, in my humble opinion.

The introduction of a bail-in regime would mean that a resolution of a failing bank could be carried out in just days, such as over a weekend, rather than over weeks, as we have seen in Cyprus. It would be far better to prepare and think about such things in advance. Hopefully the scenario will never occur, but a stitch in time saves nine, as my mother always said.

HSBC's evidence states that

"while ring-fencing adds clarity to different parts of the banking model and makes explicit the risks being borne by creditors to each portion, it has less practical impact on the 'sorting out' of failed banks: it is financial bail-in which provides the solvency support to allow for a more considered restructuring of the firms at the necessary granular level using the information from the resolution planning process rather than the structural separation of activities."

The Parliamentary Commission commented:

"An effective and credible bail-in tool would represent a major step towards eliminating the implicit guarantee and ensuring that the costs of resolving a failing bank are not borne by the taxpayer. It is notable that bail-in is at the heart of the resolution strategies currently being designed for large systemically important banks, and will remain important even after the ring-fence is introduced."

If the Government want to introduce a bail-in regime, now is the time to be getting on with it. Some paving provisions in the Bill would be sensible and prudent. Sitting back, not taking the opportunity, and waiting for the European Union to resolve the issue is not necessarily the wisest course of action. It would be better for us to shape our own destiny on such issues.

As the Parliamentary Commission highlighted, there are significant risks that the EU-wide measures could be watered down and delayed, and the measures really ought to be in place by the end of 2015. Standard Chartered bank, whose chief executive is Peter Sands, said:

"We strongly urge the Government to adopt a statutory regime for the application of bail-in covering all existing senior unsecured debt in issue irrespective of residual maturity. We believe this provides a good foundation for a global regime."

Sir John Vickers, who also gave evidence to the Commission, said that he believed that a European solution was possible but agreed that the UK should implement such a change in national legislation "in any event". Even the august incoming Governor of the Bank of England, Mark Carney—for it is he—acknowledged that, on its own, the ring-fencing arrangements would not be sufficient. He described the creation of a credible bail-in mechanism as critical and essential to prevent taxpayers from being on the hook.

When the Commission says to the Minister that Parliament needs assurances that bail-in is not a paper tiger—markets need that assurance too—the Bank of England's role to report on the development and functioning of the bail-in arrangement is an important recommendation. I hope that the Minister will accept that.

In our view, the report should include: the quantity and issue of debt, which can easily be subject to bail-in; whether bail-in-able debt is being issued over the correct part of the banking group; the distribution of holdings of bail-in-able bank debt in the rest of the financial system; and the feasibility of ways to bail in creditors beyond long-term unsecured bonds such as corporate depositors, uninsured household depositors and derivative counterparties. We would also like the report to include progress on tackling global legal barriers that might exist to the recognition of bail-in regimes.

Given the size of the UK's financial sector, which makes up an estimated 75% of the EU's financial services sector, taxpayers here face higher levels of risk than elsewhere in Europe. The implementation of a bail-in mechanism is therefore particularly important in our own jurisdiction. It is important that the Government show that steps are being taken before 2015 so that we can make some progress. I do not see any excuse for not doing what the Commission has recommended, and I commend its arguments to the Committee.

Greg Clark: I have a great deal of sympathy for the arguments of the Commission and the case that the hon. Gentleman put. Bail-in is incredibly important and the events of the past couple of weeks in Cyprus emphasise the importance of having sure knowledge in advance of what happens in the event of failure, and of which creditors are in line to have their capital bailed in to help a bank be resolved. The confusion of recent days reinforces the case for that knowledge.

Recent events also underline the importance of the international perspective. Even in a small country such as Cyprus, the international spread of banks raised questions for other jurisdictions, particularly for Greece. There are discussions about the resolution of the Greek branches, which are particularly exposed to both economies. International arrangements, given the international nature of some of the banks, are the first best solution. They commend themselves, and we should aim for them.

My reservations about the amendment are not to do with the desirability of having bail-in provisions. It is important that there should be those and that they are credible and reliably cover the kinds of creditors that need to be bailed in.

On the negotiations on the recovery resolution directive, the hon. Gentleman implied that we were the passive recipients of whatever comes out of Europe, but we feel particularly strongly about the issue for all the reasons that he identified. Most people in the EU would concede that we are one of the driving forces behind the dossier and its progress. I do not know about you, Mr Bone, but I spent my lunchtime looking at a note on the progress that we are making on the resolution and recovery directive, such is our constant desire to move it forward.

We are making progress. The Irish presidency of the EU has prioritised completion of the resolution and recovery directive and good progress is being made. Given that the Independent Commission on Banking recommended that the bail-in power should not come in until 2019, we see every prospect that it will be agreed at the European level well in advance of that. We hope to secure agreement under the Irish presidency, for which the issue is a priority.

Members of the ICB gave advice to the Parliamentary Commission. Martin Taylor, who was a member of the ICB, said:

> "A common international standard is also very desirable. If we can do that through the European work, that would be the best answer".

Sir John Vickers, whom the hon. Gentleman quoted, said that he had

> "no reason to think that the European processes would move as slowly"

as to require a separate approach. That continues to be our assessment, but the question is reasonable—what would happen if that stalled and our ambitions, expectations and the sacrifice of our lunch hours were in vain and we were not able to secure progress? Given that the Irish presidency lasts until June, we will certainly know on Report in the Commons how well we are progressing. By the time the Bill reaches the House of Lords, we will have a clear idea of whether the matter has been agreed.

My preference would be to consider the issue at that stage, rather than to establish a mechanism that triggers a review; agreement at a European level is identified by most commentators as being the most desirable outcome. If we are unable to agree, we will know that relatively soon, while the Bill is before Parliament. We could reflect then on the measures that we could include in the Bill to make sure that we had a credible bail-in mechanism that, for all the reasons the hon. Gentleman identified, is very necessary.

2.45 pm

Chris Leslie: I am glad to hear that the Minister spent his lunchtime looking over the resolution recovery directive papers that the Irish presidency had approved. I do not know whether he had the spaghetti bolognese on offer in the Members' Tea Room—100% beef, I am assured. It must be fun to dine with the Minister on occasion, although perhaps not today.

The Minister makes a point about waiting to see how the European arrangements progress and says that Britain can be in the driving seat of the resolution recovery directive. I hope so too, given the size of our financial sector relative to the remainder of the European Union.

I happen to think that the bail-in arrangements are mission-critical—not just to our future as a financial services industrial sector, but to the economic well-being of a nation state in its own right. Saying, "Well, we hope that these will come into force well in advance of 2019" does not quite cut it—that is six years from now. "Well in advance"? How long is a piece of string? We should make efforts to think these things through for ourselves and make progress under our own steam now. We do not know what is around the corner. Say, for the sake of argument, the eurozone situation becomes even more of a swirling morass. It is difficult to envisage what situations could occur.

To be prepared, it would be better to kick off rather than say, "Let's wait until June and see how well the Irish have done." I am not sure who is taking over the presidency after the Irish; perhaps the Minister can let us know. What I am saying is perfectly realistic. It is not asking a massive amount to say that the Bank of England should be encouraged to assess the progress being made towards introducing an adequate bail-in regime. That is all new clause 19 would do, incidentally; it does not specify the full details and dimensions of what that bail-in process would do. It just puts a needle into the Bill that says, "Come on. Let's encourage this process. Let's move it forward that little bit more." That would be a worthwhile area for the Bill to cover. The Parliamentary Commission has expressed strong views on the issue.

Greg Clark: As I said, we expect the EU negotiations to make progress during the life of the Bill in Parliament. If they failed to do so, against our expectations, we would want the Bill to reflect that.

If we accepted the new clause, we could end up with a paradoxical situation. We would have a requirement for the Bank of England to review within a year after Royal Assent, which is some months ahead, something that duplicated an aspect that we might have addressed with immediate effect. Far from advancing the discussion, it would be a curious and eccentric provision in the Bill to require a review of something that had already been addressed and whose powers had already been provided for.

Chris Leslie: That might not be the case. By extension, if further developments had taken place, it would be possible to remove the provision on Report or in the other place as the Bill progressed. Including the new clause would be a stitch in time to make it clear that bail-in is incredibly important.

The Commission has very strong views, and those who expressed their views in evidence to the Commission also felt that we need to move things forward rather than taking a wait-and-see approach. Such an approach might have been appropriate before Cyprus, but that situation is a wake-up call that we cannot ignore. I would like to press amendment 30 to a vote to make that point.

Question put, That the amendment be made.

The Committee divided: Ayes 7, Noes 10.

Division No. 6]

AYES

Ashworth, Jonathan
Durkan, Mark
Jamieson, Cathy
Leslie, Chris
Qureshi, Yasmin
Smith, Nick
Wright, David

NOES

Clark, rh Greg
Evans, Graham
Hands, Greg
Mills, Nigel
Morris, James
Mowat, David
Rees-Mogg, Jacob
Sharma, Alok
Stevenson, John
Thornton, Mike

Question accordingly negatived.

Question proposed, That the clause stand part of the Bill.

Greg Clark: Clause 16 provides that the Treasury shall exercise by statutory instrument the powers conferred on it by the Bill. That is the standard way in which powers given to the Government to make delegated legislation are exercised.

The clause also provides that the affirmative procedure should be used in relation to regulations made under clause 8, which we discussed earlier today, applying ring-fencing provisions to building societies. The affirmative procedure is used because the power given in clause 8 will permit the Treasury to amend primary legislation—in particular, the Building Societies Act 1986.

Subsection (3) of clause 16 sets out the parliamentary procedure that applies to orders made under clause 18, which permits the Treasury to make transitional or savings provisions in connection with the commencement of any provision in the Bill. In general, such orders will be subject to the negative procedure, as is usual for this class of statutory instrument. However, where provisions made under clause 18 will be included in the same statutory instrument as provisions made under sections that are subject to the affirmative procedure, they will also be subject to the affirmative procedure. That is necessary to enable provisions under clause 18 and other enabling powers in the Bill to be included in the same statutory instrument.

Question put and agreed to.

Clause 16 accordingly ordered to stand part of the Bill.

The Chair: With the leave of the Committee, we will take clause 17 stand part with clauses 18 to 20 stand part, unless any Committee member wishes to speak separately to clause 19, in which case I propose that we take clauses 17 and 18 stand part together.

Chris Leslie: I have one question for the Minister on one of those clauses.

The Chair: We can debate them together. Is that okay with the Committee? I call the Minister.

Greg Clark: This is an unexpected development, Mr Bone. I will describe the principle of clause 17—

The Chair: Order. Just so that the Minister is clear, what we have just decided is that we will debate clauses 17 to 20 stand part together and then deal with them at the end of the debate.

Clause 17

Interpretation

Question proposed, That the clause stand part of the Bill.

The Chair: With this it will be convenient to discuss clauses 18 to 20 stand part.

Greg Clark: Clause 17 is quickly dealt with. It defines key terms that are known to members of the Committee, such as the FCA and the PRA, and it defines enactment for the purposes of the Bill.

Clause 18 makes provision for the transitional arrangements to the new system. Members will agree that it is essential that the transition to ring-fencing be as seamless as possible to reduce uncertainty to firms in the financial services industry and their customers. The clause enables transitional orders to be made to provide, in particular, for the regulators to take such steps as are necessary in the lead-up to commencement, to enable them to exercise their powers on or after the day of commencement. The Delegated Powers and Regulatory Reform Committee is content with the provisions' using the negative procedure.

Clause 19 sets out the territorial extent of the Bill; there was a conversation earlier with the hon. Member for Foyle. The provisions apply to England, Wales, Scotland and Northern Ireland—with the exception of making depositors preferred creditors, because the insolvency arrangements apply only to Great Britain and not to Northern Ireland; insolvency is not a reserved matter with respect to Northern Ireland. The Northern Ireland Assembly has indicated that it intends to introduce depositor preference through its own Bill on insolvency.

Clause 20 deals with the commencement of the Bill. It gives the Treasury the power to bring clauses 1 to 15 into force by commencement order and to specify different days for different provisions to come into force. Members will be aware that Sir John Vickers and the Independent Commission on Banking set the start of 2019 as the deadline by which their recommendations should be in place. That was because they recognised that there was a balance between the costs and the organisational complexity of introducing ring-fencing. *[Interruption.]*

The Chair: Order. There is a Division in the House. The sitting will be suspended for 15 minutes.

2.58 pm

Sitting suspended for a Division in the House.

3.13 pm

On resuming—

Greg Clark: As I was saying, the Government agree with the timetable proposed by Sir John Vickers, which is in line with the Basel III timetable. Banks will be required to be ring-fenced no later than 2019. The provisions of the Bill relating to ring-fencing will be brought into force in sufficient time to allow that to happen. Depositor preference will be brought into force according to the same timetable.

Chris Leslie: I have a simple question on clause 17. Will the Minister give us a sense of when he expects the Bill to receive Royal Assent? Will it be by the end of 2013? What timetable does the Bill team currently envisage?

Greg Clark: The hon. Gentleman tempts me into territory into which I would be ill-advised to go, since Members of the House of Lords strongly guard their ability to scrutinise the legislation that comes before them and to take whatever time they need to scrutinise it. We certainly want to make important progress with the Bill, because everything needs to be in place by 2015, including the statutory instruments. The best I can do is remind the hon. Gentleman that this is a carry-over Bill, so the requirement is that it should be completed within a year of introduction, which is what the Chancellor said. That takes us to, at the latest, February 2014.

Question put and agreed to.

Clause 17 accordingly ordered to stand part of the Bill.

Clauses 18 to 20 ordered to stand part of the Bill.

New Clause 1

Leverage ratio

'(1) The Treasury may by order make provision about the tier 1 leverage ratio applicable to a relevant body so as to require the relevant body to maintain a minimum tier 1 leverage ratio.

(2) The Treasury may by order make provision about the tier 1 leverage ratio applicable to a ring-fenced body so as to require the Financial Policy Committee to create differing minimum leverage ratios for different classes of ring-fenced bodies, based upon the risk profile of their balance sheet.'.—*(Chris Leslie.)*

Brought up, and read the First time.

Chris Leslie: I beg to move, That the clause be read a Second time.

We now reach the Opposition new clauses, some of which were tabled on behalf of the Parliamentary Commission. As we said on Second Reading, the problem with the Bill is that it is very much a shell, which is to be populated with substantive measures. The Opposition are frustrated that the Government have not waited for the Parliamentary Commission to make full recommendations about the standards, culture and governance improvements that are needed in the banking sector.

New clause 1 would give the Treasury clear order-making powers in relation to leverage ratios in the banking sector. The Parliamentary Commission was certainly very forceful on this issue, but Sir John Vickers's commission, which reported the year before, was even more concerned to impress the importance of the issue on policy makers. A bank's leverage is the ratio of its assets to its equity capital. Its equity is equal to the value of its assets minus the value of its liabilities. Higher leverage rates magnify returns, because any growth in assets will be proportionately greater if the bank's equity is thin. However, the corollary is that any losses are also magnified if leverage is greater. A bank's equity can be wiped out by a smaller shock than would wipe out the equity of a less leveraged institution. Two banks with the same ratio of capital to risk-weighted assets, or RWAs, might easily have different leverage ratios.

The Government have said that they intend to provide the Financial Policy Committee of the Bank of England with a time-varying leverage ratio tool, but they do not want to do that before 2018. In the Opposition's view, that is inadequate. The Government's view would be subject to review in 2017, to assess progress internationally. Ministers say that they want to leave these things to other international institutions to determine, but Sir John Vickers's commission made it clear in its report that it

"supports the use of leverage ratios as a backstop, and recommends that all UK-headquartered banks should be required to operate with a minimum Tier 1 leverage ratio of at least 3% (and would favour international agreement on a higher ratio). Further, all ring-fenced banks should meet this requirement on a solo basis."

The commission went on to call for a tapering of the requirements

"when a bank crosses a size threshold…by increasing the minimum leverage ratio from 3% to 4.06% on a sliding scale as the RWAs-to-UK GDP ratio increases from 1% to 3%."

Reforms are needed not only to leverage, but to the risk weighting of assets, as we have debated. In the aftermath of the crisis, regulators introduced the risk weighting of assets as an antidote to the high-risk, high-reward culture pervasive in the banks, but the risk-weighting process has been partial, and it has been self-defined by some of the banks. In the EU, the zero risk weighting attributed to some palpably risky sovereign debts has brought the system into disrepute.

Leverage ratio powers, on the other hand, need to be taken in the Bill and to be phased in ahead of the EU plans for the end of the decade. As I said, that was one of the main conclusions of the Vickers report. Not to legislate for leverage restraint would be a significant omission from the Bill, which the Chancellor, once upon a time, claimed would "reset" the banking system. As Ministers said on the Floor of the House last month, the Government have the power to introduce a leverage ratio in their understanding of the legislation, but that power is ill-defined. It is not clear that section 4 of the Financial Services Act 2012, which amends the Bank of England Act 1998, would ensure that such clear action was possible on a leverage ratio. The new clause would put that legal question beyond doubt.

[Chris Leslie]

Most importantly, Sir John Vickers said that a leverage cap of 33 to 1—that is the other way of expressing the leverage ratio of the over-extended nature of some banks— was

"too lax for systemically important banks, since it means that a loss of only 3% of such banks' assets would wipe out their capital."

He recommended a sturdier 25 to 1 ratio for systemically important banks—in other words, 4% of equity capital—but the Chancellor has dismissed that particular concern.

It is essential that ring-fenced banks be supported by tougher capital requirements, including a leverage ratio. Determining that leverage ratio is a complex and technical decision that is best informed by the regulator. The Financial Policy Committee cannot be expected to work with one hand tied behind its back, so it is important to put in place the leverage ratio at the earliest opportunity.

The Parliamentary Commission was not convinced by the Government's decision to reject the Vickers recommendations to limit leverage that way. It stated that it

"considers it essential that the ring-fence should be supported by a higher leverage ratio, and would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III. Not to do so would reduce the effectiveness of the leverage ratio as a counter-weight to the weaknesses of risk weighting."

Sir Mervyn King, the current Governor of the Bank of England, said that the leverage ratio turned out to be

"a far better predictor of the institutions that failed in the crisis"

than measures of risk-weighted assets.

It is not good enough for the Government completely to leave the leverage ratio out of the Bill and to leave the regulators powerless. There are ways to overcome the impact that it would have on a minority of non-plc institutions—I know that some building societies have anxieties about it—and of developing a more sophisticated approach, and the best way would be to involve the regulator. We have suggested doing that in the new clause, which has different minimum leverage ratios for different classes of ring-fenced bodies, and our approach takes account of some of the concerns. In particular, building societies have a different equity structure, but that is no reason for not putting this safeguard in place. We feel strongly about it, as do the various commissions that have spent much time on the issues.

Greg Clark: The hon. Gentleman began by reflecting that the Bill is just a shell, and that the powers and provisions will be implemented through secondary legislation. Of course, his new clause conforms precisely to that description: all it would do is give a power to set leverage ratios. If he regards that as a problem—most observers seem to think that it is the appropriate structure for a Bill—the new clause does nothing to address it.

The question of leverage is clearly important. It is one of the very few areas on which the Government and the ICB have taken a different view, but there is some common ground. The Basel Committee and the Vickers commission have argued that risk-weighted capital ratios should be the primary capital constraint on banks, and that we should ensure a distinction between relatively safe assets, such as gilts from the UK, and relatively risky assets, such as property investments in some other country.

Jacob Rees-Mogg (North East Somerset) (Con): What worries me is that risk-weighting of assets was used before and the wrong risks were given to assets, based on models that were too short-term and did not understand that domestic mortgages could have a high level of risk.

Greg Clark: My hon. Friend is absolutely right, and I will come on to address the concern embodied in his intervention.

However one defines or looks at them, some assets are palpably more risky than others. Whether in the past authorities had adequate arrangements to assess them, some assets can nevertheless be considered safer than others, which is the point of risk weighting. We must be sure to avoid the adverse consequences of institutions that have relatively low-risk assets on their balance sheet investing their capital in more risky assets but having an identical level of exposure in terms of the leverage ratio.

The primary safeguard—Vickers recommends this—should be through risk-weighted assets. Vickers suggested, through the ICB's recommendations, that primary loss-absorbing capital should comprise 17% of systemically important ring-fenced banks and CRD IV provides the national flexibility to do that. As members of the Committee know, that dossier has been much debated in recent weeks, but one of the successes of our negotiations so far—scrutiny has not yet been completed in the EU institutions—is establishing the ability to implement the Vickers recommendations in that respect.

In response to the point made by my hon. Friend the Member for North East Somerset that risk weighting needs to reflect actual riskiness rather than a supposed view of the riskiness of assets, CRD III, which was introduced in 2011, significantly increased the risk weights on assets such as complex securitisations in particular to reflect the experience in the crisis that mortgage-based assets proved to be underweighted in terms of their riskiness, which contributed to many of the problems that we have seen.

It continues to be necessary to review that work. The Basel Committee and the European Banking Authority have begun separate reviews of risk weights and risk-weighting methods, with the Basel Committee due to report on those matters in 2014 and the EBA at the end of 2013. The methodology will never be perfect. These are approximations and attempts to glimpse something that is unknowable in an objective sense; it is an assessment made by others on the underlying assets. We are therefore supportive of a maximum leverage ratio for the reasons mentioned by both the hon. Member for Nottingham East and my hon. Friend the Member for North East Somerset. That maximum leverage ratio was, in fact, recommended in Basel III. Through the particular study of the experience of international banks during the last crisis, the Basel Committee established that 3% is the level of leverage ratio that would be consistent with providing the degree of protection that would have been appropriate if it had been applied in anticipation of the previous crisis. That should be implemented through European legislation, and CRD IV provides an ability to do that.

The hon. Member for Nottingham East thought that that should be introduced more quickly, and that has been mentioned by others, but he will be aware that the ICB recommends only that the leverage ratio that it recommends—the high one—should be introduced from 2019; it does not make a recommendation that that should come in earlier. That leads me to note two concerns about the provisions of the new clause. The first is the question of timing.

The new clause seems to propose a provision—the hon. Gentleman confirmed this in his remarks—to introduce the higher leverage ratio now, or at least sooner than would otherwise be the case. Basel III called for mandatory leverage ratios to be introduced, but from 2018. To run ahead of that timetable would certainly create costs, and potentially uncertainty at a time when many of us are trying to encourage banks in the UK to lend more to home buyers and small businesses. Were we to introduce it precipitately, the measure could have material consequences for the real economy at a time when most people in the House would want to see an increase in the lending activity of those banks that we would expect to be ring-fenced.

3.30 pm

Secondly, the new clause would imply a higher ratio than is proposed in Basel III. The hon. Gentleman alluded to the expectation, certainly in the building society movement, that the proposal would disproportionately hit institutions that focus on activities that in any reasonable assessment are relatively low risk at the moment, such as the activities practised by building societies. Their concern is that far from being the back-stop that the Government and the Independent Commission prefer, for some institutions it could be a front-stop; it could be the primary constraint. As I mentioned earlier, if those institutions were prevented from practising their current business model, it could drive them into more risky lending.

I am conscious that there is no counsel of perfection in these matters. To refer to what I said on Second Reading, we are seeking to find the best solution to this British dilemma of how we can have a prosperous, functioning, disproportionately important financial services sector, lending to businesses and home owners in this country and trading successfully around the world, while protecting the British economy and particularly the British taxpayer from the consequences and ramifications for the taxpayer and the system that failures would entail. The combination of measures we are taking, in terms of capital requirements and the ring-fencing provisions, leads us to conclude, knowing the particular institutions that we have—I am thinking in particular of building societies—that we are striking the appropriate balance by having exacting domestically specific standards, which are provided for in the European legislation, while taking a broadly international approach. It is worth pointing out that at the moment provision is not envisaged for national differences in the arrangements on leverage, so anything we introduce may have to be rescinded if it were not allowed at European level.

I would like to comment on a few features of the new clause before the debate is opened up. It is not entirely clear from subsection (2) whether the power to be given to the Financial Policy Committee would be a macro-prudential or a micro-prudential one. If it is a macro-prudential use, the Government have made a commitment to give the FPC powers to have a time-varying leverage ratio; that would be introduced in 2018 subject to the review planned at European level in 2017, and we are pressing for the legislation to allow that at European level. In the meantime, of course, the Financial Policy Committee has other tools available, such as imposing sectional capital requirements on areas that it thinks contribute to excessive leverage. If the proposed power is more a question of micro-prudential regulation, the Financial Policy Committee is not the right body with regard to the prudence of particular institutions on their own terms.

The new clause talks about "risk profile;" it would be helpful to understand whether the risk profile of the balance sheet envisaged is a macro-prudential or micro-prudential concern. As I said, if it is macro-prudential, the proposed time-varying power would address that; if it is micro-prudential, it seems to be outwith the remit of the FPC.

Secondly, subsection (2) refers to requiring any

"relevant body to maintain a minimum tier 1 leverage ratio."

On the face of it, it is not clear to what the "relevant body" refers. Is it intended to be limited to all banks, or is it, as the Independent Commission on Banking recommended, to be applied to a subset of banks, particularly ring-fenced bodies of systemic importance?

We understand that the matter is important. It has exercised both the Commission and the Parliamentary Commission, and I am sure that we will continue to debate it throughout the House. I hope that I have given a reasonable account of the Government's view as to why the new clause is not necessary and could have consequences, however unintentional, that damage the prosperity of the country.

Jacob Rees-Mogg: Capital is at the heart of all the financial crises that we have had, and the solution to them. It is relatively simple, and there is a great tendency to over-complicate banking. If bank capital ratios were put right, most of the other problems would fall away. There would be less need to worry about ring-fencing and protecting depositors. Bank capital really is at the absolute heart of what we are trying to do now to put things right. It is worth bearing in mind that the Royal Bank of Scotland had only just over 1% capital; it was more than 90% geared at the point at which the crisis hit.

The question is, what is bank capital all about? It has a number of functions. It is there to absorb losses when banks run into difficulties. If we consider that a reasonably run bank will probably have to write off between 0.5% and 1.5% of its outstanding loans and assets every year, that gives us some idea of the minimum level of capital that is needed. In a bad year, in which the bank loses slightly more than that, it knows the order of magnitude with which it is dealing.

The other reason why bank capital is important is that when depositors turn up at the bank and say they want their money, the bank must be able to provide it; that is the classic run on a bank. The issue that banks have when there is a run is not that they are short of assets but that they are short of liquidity, which is where the definition of assets that are going to be counted towards capital is so crucial. The assets have not only to be of low risk, but to be liquid. When we consider what

[Jacob Rees-Mogg]

happened to Northern Rock, there was no shortage of assets, but there was a shortage of liquid assets with which to meet the demands of depositors.

Interestingly, the Bank of England decided not to follow the suggestion of Bagehot that the central bank should be willing to lend when there is a liquidity issue but not when there is a fundamental solvency issue. The Bank of England decided that there was a moral hazard over Northern Rock and that if it came to its rescue, it would leave the wrong impression for all of the banking community. Therefore, the Bank of England decided not to help with the liquidity issue, underlying the point that the capital assets of a bank, the capitalisation ratios, need to be liquid as well as solid assets.

What is it that can be liquid and is a solid asset? They are extraordinarily limited assets. They are the notes and short-dated bonds issued by the currency in which the bank has the majority of its liabilities, or indeed any of its liabilities. If it is a multinational bank, it is conceivable that it will have a run on its deposits in dollars and therefore it will need to have assets in dollars against that. If it is a UK bank, it is simpler just to deal with sterling. It needs to have notes and coins issued by the Bank of England and short-dated Government debt.

Anything that is long-dated immediately loses liquidity. In this context, it is worth bearing in mind what happened to Long-Term Capital Management. LTCM had a simple financial model. It dealt in enormous amounts of money to make a tiny margin on the difference between the benchmark bond and the bond that had just ceased to be the benchmark bond. The bond that has just ceased to be the benchmark bond yields a little more than the benchmark bond, because the benchmark bond has a number of buyers who need it for regulatory or index purposes. It will be in index funds, and so on. Therefore, against the normal trend of the yield curve, the slightly shorter-dated ex-benchmark bond had a slightly higher yield. LTCM piled into those bonds with billions and billons of dollars, and was able to earn a consistent return year in, year out. It was a very successful model, but it catastrophically exploded when liquidity in the ex-benchmark bonds suddenly disappeared. LTCM found that its model no longer worked, and it was left with many billions of dollars exposed in an unwinding market.

Even longer-dated Government bonds, because of the variability and unpredictability of liquidity, are not zero-risk assets. This comes back to the core of the argument: how are assets defined? The hon. Member for Nottingham East said that the Europeans have included some extraordinarily insecure sovereign bonds. Sovereign bonds are not automatically good risk. Anyone who does not believe that just needs to think of the Argentinean bonds that they might have held over the years, or the Chinese bonds that were issued in the 1920s that are used as elegant wallpaper, or imperial Russian bonds, and so on.

It cannot be Government bonds. It cannot be mortgages. Even packaged and resold mortgages ought not to count as the base capital of a bank because of their inherent risk. Again, if there is any doubt about that, look at the ratings given by Standard & Poor's to packaged mortgages of sub-prime debt. When that debt was packaged together, it gave the highest tiers triple A ratings. What happened to those triple A ratings? They disappeared in a puff of smoke when the underlying mortgages turned out not to be sound. So the ratings agencies cannot be a guide. I have very strong views about the general ability of ratings agencies to predict anything other than what has already happened. It comes back to the simple base capital of short-dated domestic Government bonds, cash and—dare I say it—gold, which always counts as a bank's capital.

Then the Government need to decide what the right ratio is. My hon. Friend the Member for Wycombe (Steve Baker) thinks it should be 100%. I do not go as far as my hon. Friend, but I think it should be at about the 4% level—higher than is currently suggested by the Bank for International Settlements. We have to be careful about the BIS and Basel, because Basel is deeply political. There was a point when we were arguing at Basel that mortgages should count towards bank capital—this was prior to the Government being in office—because politically that was helpful in this country; it allowed banks to approve more mortgages. As I understand it, the Germans were arguing that loans to small business should count as bank capital because of the structure of German banking. So the BIS and the Basel accords are not independent, Olympian figures that calculate risk outside any political context. They are subject to all the normal political horse trading that international bodies suffer from.

I do not think it will be easy for the Government to get this right, and I certainly want them to take their time. We are emerging from the depths of a crisis, and banks still have many billions of pounds of bad debts on their balance sheets. To tighten bank capital now would be a mistake. It needs to be eased in so that banks can recover and restore their balance sheets first. When it is done, if we want to have a long-term, sustainable banking system, it has to be based on real, solid capital that is liquid and is not dependent on complex financial models, which should be treated with suspicion bordering on contempt.

Greg Clark: The Committee is grateful to my hon. Friend for his perceptive and elegant summation of the issues that we face. All of us would accept his advice that the science of risk weighting does not merit the name. Even bodies that aspire to augustness, such as the Basel Committee, tend not to be populated by Olympians but by ordinary mortals who are subject to the same frailties as others.

3.45 pm

My hon. Friend is absolutely right in reflecting that there should be a separate means of assessing the resilience of the institutions that do not rely on risk rating alone. Whether the appropriate ratio is 3% or higher is a separate question. As he rightly said, the question of when that should apply from is also a separate matter. Our view is that we should have the backstop ratio that is there. We have been persuaded by the Basel agreement. It reflects a study of the consequences of the past few years and the response to the crisis. But the provision that we have in mind is for a variable ratio that is scrutinised and enacted by the FPC and able to respond to the changing conditions. The circumstances in which this leverage ratio would apply will vary. Most people would accept that there are times, such as the time that my hon. Friend alluded to, when people are intoxicated by the availability of credit and the opportunity to make returns from that. That was just the point when a more precautionary approach and a higher leverage ratio should have been instituted.

It is important to have regard not just to a single ratio but to the possibility of a variable one. So the Government's view that we should introduce in 2018 a power for the FPC to be able to set a variable leverage ratio goes precisely to the point that my hon. Friend was making: that it is in the hands of another group of people—a group of expert people, no doubt subject to the same frailties as the supervisors in the Basel Committee, but nevertheless people charged with having a clear-sighted view on the consequences for financial stability of the way that the system is going from time to time—to look in particular at the leverage ratio and what can be done about it.

My hon. Friend is absolutely right; it is the liquidity, not simply the maintenance of levels of capital, that is important. The Vickers Commission is clear about the importance of that. Paragraph 3.20 of its interim report states:

> "In light of the advances made by the FSA and the Bank of England, the Commission will not make recommendations directly on liquidity regulations, but will take due account of them in its work. The reforms contemplated…aim to support the liquidity of banks by ensuring that they remain solvent during times of stress."

In other words, the provisions for enhanced liquidity—through Basel and other means—are regarded as being complementary to the recommendations.

It is a matter of judgment. It is important that the Committee understands that the Government have no objection whatsoever to a leverage ratio being in place. More than that, we think that the leverage ratio should be an important tool for macro-prudential regulation and that it should be possible to increase it above the 3% level that Basel implies. That should be vested in the way that is proposed in the Financial Policy Committee, so that it strengthens the armoury that that institution has for regulating the sector.

Chris Leslie: I think I heard the Minister say that he supported a leverage ratio that had the potential to go above the Basel minimum recommendation and that may be a slight departure from my understanding of the Treasury's recommendations hitherto. Setting that to one side, however, I still think that the importance of getting some progress on this issue requires us to address it now in the Bill in some shape or form. I accept the point of phasing in the arrangements and allowing time, particularly in the economic circumstances, to ensure there are no adverse consequences. Nevertheless, over the medium to longer term, putting our banks on a safer and sturdier footing is incredibly important, as all the weight of the evidence of the Vickers Commission and the Parliamentary Commission suggests.

I commend the helpful comments of the hon. Member for North East Somerset. He is insightful about the nature of bank capital and, in particular, issues of liquidity—in general confirming my view that this is not a left versus right wing question. It is not an issue where some on the left think that we need to constrain the banks and others do not. There are some, such as Lord Lawson and others on the Parliamentary Commission, who have taken a very firm view about the need for reform of the structures and the balance sheet arrangements of the banking sector.

The hon. Member for North East Somerset talked about a 4% leverage ratio. That was a really important comment. I understand that in the United States in some circumstances that could be nearly 5%, ironically, although they have the Fannie Mae and Freddie Mac arrangements that tend to distort international comparators of leverage ratio arrangements for some of the banks. Nevertheless, the hon. Gentleman was correct to talk about the need to be wary of going for the lowest common denominator through some of those international institutions, particularly given the importance of the banking sector in the UK economic make-up. It is systemically important for banks in particular, not just worldwide but for our economy, that we apply that extra degree of care and attention to these leverage questions.

Greg Clark: It is important to put it on the record that the comparison with the US, as the hon. Gentleman implied, is not strictly fairly made, in the sense that there are different elements included and different ratios from place to place. The Governor designate of the Bank of England, when giving evidence to the Parliamentary Commission, said that apples and pears were being compared in those matters. I do not think it right for the Committee to think there is a higher comparable ratio in the US.

Chris Leslie: My point still stands. I certainly agree that, as I was saying, in some ways the level of state intervention in the capitalist entity that is the United States of America is quite high, which ironically makes direct comparisons quite difficult. Nevertheless, I think it is important to recognise that, as the hon. Member for North East Somerset set out, some of the circumstances at RBS and others were quite shocking. We should take the opportunity to learn lessons and ensure that we have put ourselves on the right course.

We have not specified the leverage ratio in new clause 1, because we want it to be variable across different classes of ring-fenced bodies. Systemically important banks are very different from building societies, and that is something on which we ought to take the regulator's lead. Including new clause 1 would, however, put down an important marker that we consider the leverage ratio to be a crucial component of the safety and security of the banking system. We cannot simply rely on ring-fencing, because this is a bigger story than structural constraints.

For those reasons, rather than simply treating the Committee stage as something that we have to get through and saying that the matter will be dealt with at a later date, we must ask ourselves: if not now, when will we do this? We have to take a stand and sort it out, which is why I would like to put new clause 1 to the vote.

Question put, That the clause be read a Second time.

The Committee divided: Ayes 8, Noes 10.

Division No. 7]

AYES

Ashworth, Jonathan
Doughty, Stephen
Durkan, Mark
Jamieson, Cathy
Leslie, Chris
Qureshi, Yasmin
Smith, Nick
Wright, David

NOES

Clark, rh Greg
Evans, Graham
Hands, Greg
Mills, Nigel
Morris, James
Mowat, David
Rees-Mogg, Jacob
Sharma, Alok
Stevenson, John
Thornton, Mike

Question accordingly negatived.

Ordered, That further consideration be now adjourned.—(*Greg Hands*.)

3.58 pm

Adjourned till Tuesday 16 April at ten minutes past Nine o'clock.