HOUSE OF COMMONS

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ORAL EVIDENCE

TAKEN BEFORE THE

PARLIAMENTARY COMMISSION ON BANKING STANDARDS

BANKING STANDARDS

WEDNESDAY 6 MARCH 2013

SIR MERVYN KING GBE and ANDREW BAILEY

Evidence heard in Public

Questions 4505 - 4597

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Oral Evidence

Taken before the Parliamentary Commission on Banking Standards

on Wednesday 6 March 2013

Members present:

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

Examination of Witnesses


Q4505 Chair: Thank you very much for coming before us this morning, Governor and Mr Bailey. We have today another hearing of the Banking Commission. First of all, it would be helpful to establish, Governor, whether you are confident that you have got the powers to do the job that you have been given. When you used to come before the Treasury Committee prior to 2010 you told us that that was certainly not the case, but that was prior to the two pieces of legislation, of which one is on the statute book and one is on its way. With that in mind, do you agree with Michael Cohrs that the elephant in the room is that banks are still too big to fail? Have you now got the tools that you need to deal with that?

Sir Mervyn King: I agree with Michael that banks are still too important to fail, or too big to fail. That is the single biggest challenge facing the new Prudential Regulation Authority. If I were to say what the objective is over the next five to 10 years for the PRA, it would be to ensure that, at the end of that period, we have genuinely solved the “too big to fail” problem.

For a long time, we have thought that there are three aspects to this. One is the need to restructure the banking system: to separate what one might call the utility aspects of banking from the investment banking and trading parts, and obviously the Vickers proposals for a ring fence go a long way towards that. The second is resolution: we have a domestic resolution regime but we still have to develop an international regime. The third is to have sufficient capital in banks, by which essentially I mean that the leverage of banks is not too high. On all three we have made significant progress and the Bank has largely the right powers, but not completely, as there are some aspects, particularly on leverage, where the Financial Policy
Committee would like to have greater powers; where we feel that the original Vickers proposals on leverage were the right ones, the concession made on leverage was a mistake and it would be better to go back to the original Vickers proposals.

By and large, I think that we have got adequate powers, subject to those concerns. There is a lot of work to be done; on international resolution we should not believe that we are anywhere near close enough yet to having an international resolution regime. That will depend in practice not on getting legally-aligned regimes, which is not going to happen—certainly not across the Atlantic—but in having sufficiently close co-operation between supervisors that they have a common understanding of how, in practice, they will resolve a bank that is in trouble. There is still quite a long way to go, but we have made a very good start and I am very pleased that we have got significant progress in those three areas.

**Q4506 Chair:** But you have not put any bids in for any powers that you have not got but that you would like?

**Sir Mervyn King:** Not at this stage. Obviously, I have made the point about where we agreed with the original Vickers proposals, both on leverage and where the burden of responsibility lies for arguing that banks have sufficient primary loss absorbing capacity, and there are some things in that area, but, by and large, it is a start.

The unknown question is whether the powers that we have been given will, in fact, be adequate to get rid of the “too important to fail” problem. That is why I said to you before that my view is that it would be sensible to have a proper review, after four or five years, of not just the ring fence but a whole range of issues that I would put under the umbrella heading, “Has the United Kingdom solved the ‘too big to fail’ problem?”. It would be a good idea to ask Sir John and his colleagues to sit again in four or five years’ time—perhaps on the fifth anniversary of the date when the legislation takes effect—to report back on whether what has happened in that five-year period means that he is now content with the measures in place, or whether we need to go further.

**Q4507 Chair:** To be clear about the time scale for this review, you are suggesting that it should be five years after the legislation takes effect, which would probably be in about a year’s time.

**Sir Mervyn King:** Yes.

**Q4508 Chair:** So the review would be in six years’ time.

**Sir Mervyn King:** No, I would have the review to report by the fifth anniversary of the start of legislation—so start the review a year before that. Start the review five years from now, so that it would be in place to come up with its conclusions on the fifth anniversary of the date when the legislation takes effect. Now, that is an arbitrary date. It could be less than that. Obviously, if it is too short a period people will argue we have not had enough time to see how the system works. If it is too long, and there are things that are wrong, we will have built up a banking system with excessive leverage. But that seems to me reasonable; I would be happy with that as a proposal. You may well have thoughts which improve on that.

**Q4509 Chair:** Mr Bailey, perhaps I could ask you to comment on the EU’s proposals to cap senior banker bonuses. It has been alleged that this will raise fixed salaries, that it will complicate the task of arranging deferral and clawback schemes, and that it could reduce the attractiveness of the UK, and London in particular, for inward investment in the financial
industry. Beyond the political attractions of it, do you think it has advantages, or have I correctly listed the down side?

Andrew Bailey: I think there is a longer-term and a shorter-term issue. The longer-term issue goes back to the whole “too big to fail” issue, and the question of why is remuneration so high, as a level, in this industry. To address that, you have got to get to the question of “too big to fail”, and the question of the implicit subsidy, and sometimes explicit subsidy. Of course, as the Governor said, we are not there on that. We are fully committed, and doing everything we can to solve that. My concern is then what happens in the meantime. This is a shorter-term problem.

I do realise that in criticising what the EU is doing you can be accused of saying you really favour promising bankers egregiously large amounts of remuneration so that you can subsequently threaten to take it away from them and in some sense incentivise them to be good. What we have done—and this is a question about how we bridge to a world where there isn’t “too big to fail”—in recent years, and particularly over the last two years, is achieve a world where there is greater adjustment of variable remuneration in a couple of respects. There is less cash going out of the door, which is something that I favour strongly, because banks need to retain more cash to build up their capital base; but secondly there is more deferral, which is a point we have discussed here before—and I know Andy Haldane has discussed it when he has been here before—which we do think, in the world that we live in today, given the regime we have, is a sensible way of incentivising.

My concern, coming back to the EU proposals, is that in setting this hard limit it looks quite tight; it runs the risk, as you said, that it will push up fixed remuneration, because of the tight ratio arrangement; fixed remuneration is essentially cash out of the door—it is much harder to get fixed remuneration back once it is paid, because legally it is much harder to get something back from someone once it has been paid to them rather than when it is deferred and unvested. What we have seen particularly this year is quite substantial progress in two respects. One is requiring banks to reduce the pools of variable remuneration to reflect redress and fining—but, also, what is technically called malus, where there is effectively a cancellation of previous unvested remuneration. Losing those incentive mechanisms before we get to the solution to the “too big to fail” problem is something that concerns me.

Q4510 Lord Turnbull: There is a four-way tussle going on, on this question of leverage. You have the ICB’s position, you have the commission’s emerging position, you have yours and you have the Chancellor’s. The Chancellor’s argument is that if we adopt the ICB’s position it will begin to bite on building societies; and the Nationwide has been quite vocal in setting out its position. Are we allowing the Nationwide tail to wag the dog—that the leverage ratio that would be suitable for the industry generally is not being put in place, because we haven’t found a particular solution for one segment of this market?

Sir Mervyn King: It is the tail wagging the dog. There is a separate issue about mutuals and building societies in general, which has never been resolved. It is how you ensure that there is an adequate loss-absorbing capacity before the depositors are called upon to bear losses, given that in a mutual organisation they are, in effect, the shareholders. This problem has not been properly resolved. We raised it way back in 2007-08, and it has been a problem that has been overhanging us since, without any resolution. There is a need to deal with that problem, but it is quite separate from the question of the appropriate levels of leverage for banks.

Q4511 Lord Turnbull: So you would prefer something that dealt with that directly and allowed the 4% to go ahead.
**Sir Mervyn King:** Absolutely, and I think that, in the long run, even that 4% is rather generous as you move towards the longer term, and that could be very long term. I would be much happier with leverage ratios at 10 to 20 than I would at 25 or 33.

**Q4512 Lord Turnbull:** Do you think that we are also fooling ourselves? The phrase “prime mortgages” is used. One thing that we have learnt is that mortgages are not quite as prime as we thought they were. Some interesting figures were published. How many homes are being sold at a loss around the country? Not many in London, but there are a lot further north. Therefore, lending on residential property is not quite the safe thing we always thought it was.

**Sir Mervyn King:** Yes, and I have some real scepticism about the risk weights that are involved. It is very difficult. They are set under international agreement. These things take a long time to get agreement on, and are very hard to change. Any sensible system of risk weights would have those risk weights changing according to circumstances. It is hard to achieve that, when they are set by an international agreement. It is somewhat absurd, for example, that a zero risk weight is applied to sovereign debt when there are certain types of sovereign debt that no one in their right mind would think was appropriate to have a zero risk weight.

The same applied to mortgages. Indeed, to my mind the most stunning example of that was Northern Rock which, in the summer of 2007, not only said that it wanted to return capital to its shareholders because it had too much, but it was the most highly capitalised bank in the United Kingdom according to the official risk weights. Yet, within literally weeks, it ran out of money. That tells you quite a lot about how inadequate the normal risk weighted measures of capital can be.

**Q4513 Lord Turnbull:** The risk weighting on mortgages is the same in the US as it is here.

**Sir Mervyn King:** Yes, the risk weights on different types of mortgages are set by international agreement because the principle behind the Basel ratio, which is perfectly sensible, was to try to ensure that level playing field banks crossed different countries. Although that sounds fine in theory, in practice the more detailed the Basel regime has become, inevitably the more inflexible it has become. It has become inflexible in areas where actually you need flexibility, such as risk weights on mortgages.

That is why it is the case that, in the crisis, it was not risk-weighted capital ratios, but leverage ratios that proved a better predictor of which banks would get into difficulty. It is why I personally would attach more weight to a leverage ratio as a means of stopping some major problem. Supervisors would normally say that they want to use leverage ratios as a backstop. I understand that. It is a sensible thing to do, but I would rather have a tighter backstop than 33:1.

**Andrew Bailey:** What we have to be very careful about also in the current environment, where banks are using models in the mortgage area, is that we are going through a period obviously of unusually low and sustained low interest rates. That is, of course, enabling in a sense the sustaining of debt servicing in ways that was not necessarily the case in the early '80s and the early '90s. We have to be very careful that banks do not in a sense overweight that experience in the modelling they do to prove that the model-predicted losses are lower, because when you project that into very long-term contracts, which mortgages are, we could end up with unsustainably low risk weights.
It is interesting in that respect—my second point—because a number of countries in recent months, such as Sweden, Switzerland and Hong Kong, have all moved to introduce a form of macro-prudential tool, which is putting a floor on mortgage risk weights.

**Q4514 Lord Turnbull:** The Treasury is committed to giving the FPC the power to adjust it, but from 2018. Why is it delayed so long? Should it be delayed so long?

*Sir Mervyn King:* Only the Chancellor can answer that. I think that he feels that in this area he does not want the UK to be seen to deviate too much from the international agreements reached, particularly in Europe, so he would rather the UK not go ahead with those agreements. But he has agreed. I asked for this and he agreed he would say that this would go to the FPC in 2018.

**Q4515 Lord Turnbull:** It is accepted in another field, ie the risk-weighted assets, that we treat Basel as a minimum and that we go further.

*Sir Mervyn King:* Indeed.

**Q4516 Lord Turnbull:** But when it comes to leverage, you are saying that we shouldn’t go further than Basel. I don’t understand that.

*Sir Mervyn King:* That is a question you will have to put to him, I fear.

*Lord Turnbull:* Except we have just seen him.

**Q4517 Chair:** Before we leave the leverage issue, do you think the banks are just too successful at getting at politicians on this?

*Sir Mervyn King:* They have lobbied very successfully in this area and I suppose that one reason is that they are extraordinarily focused on rate of return on equity, which is a very bad measure for judging the success of an institution. You simply increase your leverage and you can improve the rate of return on equity without any change in the underlying performance of the organisation. To the extent that remuneration agreements are linked to rate of return on equity, they have an incentive to do that as well. That is why Andrew in the PRA has very much been trying to ensure that organisations move away from rate of return on equity, both in terms of judging their own performance and in determining their remuneration. I suspect that this is the driving force behind the lobbying on leverage.

*Andrew Bailey:* When you meet them, I advise you to ask them if they know what their leverage ratio is.

**Q4518 Lord Lawson:** Have you asked them that?

*Andrew Bailey:* If you are lobbied by institutions on this, I would advise you to ask them what their leverage ratio is.

**Q4519 Lord Turnbull:** Are you saying that they don’t know?

*Andrew Bailey:* I would be interested. I am not sure they always know.

**Q4520 Lord Turnbull:** I thought it was a thing which you carried round in your head every day, almost.
Q4521 Lord McFall of Alcluith: Have you asked them?

Andrew Bailey: I ask them.

Q4522 Chair: And what answer to do get?

Andrew Bailey: I will tell you. You usually get a long diatribe that there are many ways to calculate the leverage ratio. It is like Heinz with 50-odd varieties of the leverage ratio. It is all a bit preposterous and you cannot possibly predict one. The only point behind that is that the Basel committee has to finish off deciding how to calculate the leverage ratio.

Q4523 Chair: But you don’t think that is an argument for keeping the status quo for very long—or do you?

Andrew Bailey: No, I do not. I think it’s an argument for telling the Basel committee to get on with it, but nothing beyond that.

Q4524 Chair: And over what time frame do you think that would be reasonable?

Andrew Bailey: The Basel committee should get on with it this year, frankly.

Q4525 Chair: Just back on this lobbying issue, on the one hand we want our most senior politicians—the Chancellor, for example—and the Treasury to be closely informed about what is going on in a very important sector of our economy. There are legitimate and important exchanges that should take place. On the other hand, you are suggesting that they are a bit too successful on self-interested demands, for example in this area. Do you have any suggestions on how that can be better handled?

Sir Mervyn King: Other than self-discipline in resisting the demands for something that is not in the UK’s long-run interest. That is a question of what policy is all about. There will always be lobbying from self-interested groups on any aspect of policy. The role of the politician making the judgment is to do what you do, which is to make a judgment in the interests of the UK as a whole.

Q4526 Chair: So we have to encourage Chancellors to be robust?

Sir Mervyn King: If you can find a way of doing that, it would be admirable.

Q4527 Chair: You have seen more Chancellors than I have.

Sir Mervyn King: I was surprised at the degree of access of bank executives to people at the very top. Certainly they have easier access to the people at the very top than the regulators have. I remember before 2007 that the only time there was a speech about regulation from the Prime Minister was when there was an attack on the FSA for over-bureaucratic regulation. That was the climate in which the regulators operated then. It was extraordinarily difficult. They knew that if they were tough on a bank, the chief executive would go straight to No. 10 or No. 11 and say this was an attack on the UK’s most successful industry—even when it was a perfectly reasonable application of the regulations. The climate has clearly changed since then, but the access probably has not.

Chair: That is very helpful, although you haven’t got the solution.

Sir Mervyn King: I cannot control the response of politicians to lobbying. All I can do is say what we think is the right framework for regulation for the UK.
**Chair:** That is helpful and frank advice.

**Andrew Bailey:** The broader point here for me is what I call the long-run procyclicality of regulation. That is exactly what the Governor said: the pressures are procyclical. One of the clear objectives we must have in the new system is to create accountability and transparency in regulation, which will help to counter some of this. It will not solve it on its own but it will help.

**Mark Garnier:** Just to get back to the question of the European cap on bonuses. I am particularly interested in Andrew Bailey’s thoughts on that. The UK regulators—and what we have been doing here over a long period of time—have been working quite hard to address this thorny issue of financial incentives and how it affects behaviour and all the rest of it. How does it make your job more difficult for the future, if every time you come up with a subtle, nuanced and intelligent response to this, Europe merely comes in with a sledgehammer to crack a nut?

**Sir Mervyn King:** It is a bit of a distraction. My own feeling about this is that there is a great deal of sound and fury about the proposals. I guess this is one of those measures that will have neither the intended effects that its proponents believe nor be as damaging as its detractors fear. The risk is that it will simply deflect attention away from the real issues.

There is perfectly justifiable concern about the scale and form of remuneration in the banking industry. It is perfectly justifiable concern. But those are symptoms, not causes. I think there is a question we should deal with. If we could manage to resolve the “too big to fail” problem, I don’t believe you would find the scale and form of remuneration of the type that it is. It is very much an example of what economists call rent-seeking behaviour.

We need to create structures that take away the incentives for people to seek economic rents. I don’t think you can do that by imposing caps on actual payments. I don’t think that in practice, given the imagination that will inevitably be directed to finding ways around this and the various details associated with it, it will be anywhere near as effective as its proponents believe it will be. Neither, for that reason, is it likely to be as damaging.

What it will be is a distraction to everyone. I do not think that Andrew and his team ought to be spending vast amounts of time monitoring a detailed plan for remuneration to each individual when they ought to be trying to reform the system of regulation to remove the “too big to fail” problem in the first place. If we could resolve the question about separation of utility banking from investment banking and proprietary trading to ensure that the people who earn the profits of that area are also the people who bear the losses when it goes wrong, then I think incentives will take care of themselves.

**Mark Garnier:** In terms of the culture of banks, do you not think that the leaders of the banks, the people who are trying to drive the culture in the banks, are now going to find themselves distracted about how to game this, rather than trying to get on with the possibilities of effective action?

**Andrew Bailey:** Yes, and that’s unhealthy. I have been struck over the past two years that there has been a greater consensus and understanding of what we are trying to do with incentives. It is quite interesting. Two years ago, and even a bit last year, we got resistance from institutions when we said, “I’m afraid you have got to apply these malus provisions.” This year it has not happened.

My concern is yours, that we will move into a much more rules-driven world, where the incentive, as you say, will be to spend time trying to game the rules, with an undercurrent of
“This is what you need to do to preserve London as a financial centre.” It is all going to be tacitly understood, as it were, and that is not a good place to be frankly.

**Q4531 Mr Love:** Governor, can I come to one of those banks in particular, RBS? Is its ability to make an adequate contribution to economic recovery compromised by its state-ownership and, in particular, the legacy problems that it had to face on its balance sheet?

**Sir Mervyn King:** Yes, the legacy problems of the balance sheet of RBS have had macro-economic effects. It has clearly been a drag on the supply of lending to the UK real economy. If you go back to the measures that were taken in 2008-09, the idea was that we needed to recapitalise the banking system and if necessary to restructure it and to take it into public ownership, not because it was a good idea to put banks in public ownership, but because the medium of public ownership was the vehicle by which they could be recapitalised and restructured and then sold back to the private sector.

It is four and a half years on and there is no immediate sign of it going back to the private sector. That means that we have not been sufficiently decisive in either recapitalising the bank or restructuring it. I sense, from comments of the Prime Minister and the Chancellor, that they feel too that they are rather frustrated in their attempts to get this bank back into playing a role as a healthy UK bank, lending to retail and commercial clients. I think that will need a more decisive approach to the restructuring and recapitalisation of the bank.

**Q4532 Mr Love:** That is echoing the sentiments of the Chancellor. But he has not come forward with what should be done. What should we do about that more radical plan?

**Sir Mervyn King:** I do not think it is beyond the wit of man to devise a plan which would enable you to restructure RBS, to divide it into a bank that could be a new RBS that would be a healthy, well capitalised bank, capable of lending to the UK real economy and attracting funding to finance that lending, and therefore could be sold back to the private sector relatively soon. It does mean, however, being decisive in dealing with those activities that would go into the other part of the bank, which would be separated from the new RBS, which would then have to be run down over a period of time. It inevitably means accepting that there are losses. Those losses are there anyway. The fact that if we just let this muddle through the losses are not realised, does not mean that the economic losses are not there. It is just that they do not show up as losses to the taxpayer given the normal conventions of public accounts.

The fact is that at present RBS has a portfolio of different activities which do not sit well enough together to make the market willing to bid for it. That portfolio will need to be restructured in order to come up with an entity for which the market will be prepared to bid. That is what the objective of recapitalisation and restructuring should be. The lessons both of the failure of Japan to do this and for their banking system to be hobbled for a long time because they were not decisive enough in dealing with it, in contrast to the Scandinavian experience in the early 1990s when they took banks into public ownership for a short time to restructure and recapitalise and put them back into the private sector, show very clearly that it is not a good idea to have banks in the public sector for very long. The purpose of taking them into public ownership is not to run them as public sector banks but to have a window during which you restructure and recapitalise the bank and then put it back.

**Q4533 Mr Love:** When this was put to the Chancellor last week he raised all sorts of objections to taking the whole of the bank into public ownership—that part that is currently still in private hands. Do you see that as an obstacle in any way?
Sir Mervyn King: No, there may be alternative ways around that. The key thing is to accept that whatever we do now will mean recognising losses relative to where the public accounts currently show them, but that is the economic reality. We simply have to accept that. The way to minimise the losses in the long run is indeed decisively to restructure the bank and get a healthy RBS back into the private sector.

Q4534 Mr Love: So what sort of restructuring are we talking about? Are we talking about separating the investment bank activities and selling that off or are you talking about a traditional good bank, bad bank split?

Sir Mervyn King: I don’t think I want to go into a detailed plan in public. I certainly can discuss this with the Chancellor and others. It would clearly mean having a plan to create a healthy unit that is capable of attracting funding to lend to the UK real economy. It does mean accepting that there are a number of activities and a number of assets on the balance sheet which are likely to generate continuing losses and which need to be separated from the healthy bank. In that sense it is a good bank, bad bank split. Accepting that and facing up to the reality would be the right way forward. It would enable, in my judgment, the Government to get the bank back into the private sector sooner rather than later. The whole idea of having a bank that is 82% owned by the taxpayer, run at arm’s length from the Government, is nonsense. It cannot make any sense. I know it was put there for good reason; people felt they did not want politicians running banks. But I think it would be much better to accept that this should have been a temporary period of ownership only, to restructure the bank and put it back. The longer this has gone on, the more difficult it has become.

Q4535 Mr Love: So what sort of time scale are we talking about? Under some pressure, Stephen Hester suggested that he will get rid of the non-core assets much more quickly. There is talk of getting rid of the American end of RBS. Are we talking about a year, two years?

Sir Mervyn King: Stephen Hester has struggled manfully to reduce the size of the balance sheet. That was the remit he was given, and he has done a great deal to achieve that. But I am talking about something rather different; a much more decisive restructuring of the whole outfit in order to sell it back to the private sector. It should not take more than a year to do this. There are plenty of people around the world who do this for a living. They need to be given the authority to take decisions and to get it done. That is the whole purpose of taking banks into the public sector, in order to recapitalise them. The sad thing is, the UK led the world in recapitalising the banking system; the US took the idea from us, but they were in effect more decisive that we were. This has dragged on for an unnecessarily long time. I do not want to blame anyone for this, but I think the lesson of history is that we should face up to it.

Q4536 Mr Love: There’s a lot of talk about having paid too much for our banks.

Sir Mervyn King: Bygones are bygones. I am not here to allocate blame or anything else. What we should do is simply accept the reality today, and the reality is that it is probably worth less than we thought. We should accept that, and now get back to finding a way in which we can create a new RBS that ought to be a major lender to the UK real economy, as opposed to a lender that is contracting its lending because it has little choice under the current overall strategy.
Mr Love: Let me come on to another, associated issue. The Financial Policy Committee has asked the PRA to look into the capital shortfall of the UK banks. There are all sorts of figures out there, but they all suggest there will be a substantial shortfall. How are we to take the action necessary to strengthen financial stability, without having a very negative effect on lending to the economy?

Sir Mervyn King: The FPC has asked the FSA and Andrew to come back to us later this month with a view about how far current estimates of banks’ capital are overstated. They may underestimate their expected losses on some of their existing portfolios of assets, or have underestimated the provisions needed to meet future regulatory fines and redresses; or the use of risk weights may have meant they were over-optimistic in calculating their capital requirements. The FSA will report back to us later this month. We cannot put a figure on it until then, and I do not want to do so. At that point, and only at that point, will it be possible to decide on the appropriate actions. However, I don’t believe these numbers are likely to be of an order of magnitude that would make it impossible for UK banks to raise the appropriate capital. Some of them are already looking at ways of doing this, either by equity or contingent capital, or in the case of state-owned banks by an appropriate degree of restructuring.

We clearly understand that it is not the role of the FPC to recommend that the Government put in more money on behalf of the taxpayer; that has to be a decision for the Chancellor. None of this, we believe, is beyond the wit of man to come up with a plan to deal with. After all, continental banks, which are in worse shape than UK banks, have raised capital over the past year. UK banks could do so as well.

Mr Love: You indicated earlier that the Chancellor might be somewhat reluctant to put more capital into banks, for very obvious reasons.

Sir Mervyn King: I understand that, and I would not wish to persuade him otherwise, but that doesn’t mean you can’t deal with the problems we have talked about. The state has a very large share in one of the banks, and there are other ways of dealing with that problem.

Mr Love: If the banks come to the FPC and say that it is really too difficult to raise capital and they want to do it in other ways, what other ways are there apart from restricting lending?

Sir Mervyn King: A bank can sell off assets which are not germane and associated with lending to the UK real economy. Through Andrew’s normal supervisory engagement he is always talking to the banks about their plans. So it is not unreasonable for the FPC to say that it wants banks either to raise more capital or to restructure the balance sheet in a way that does not undermine lending to the UK real economy. To link this to the recent lending figures, we knew when we created the Funding for Lending Scheme that there were at least three major UK banks that were going to contract their balance sheet on their lending to the UK real economy. There was nothing we could do about it. What we could do was design a scheme that would give them an incentive to contract their lending to the UK real economy by less than they would otherwise have done, and I think we have achieved that.

The legacy problems on the balance sheets of some of our banks have been largely responsible for their wish to contract lending to the UK real economy. The banks with the largest amounts of capital have actually increased their lending; Barclays, HSBC and Nationwide have lent more to the UK real economy. RBS and Lloyds, unsurprisingly given their balance sheet legacy problems, have been contracting lending. All of that is completely natural and understandable. Only dealing with those legacy balance sheet problems as soon as possible will get you into a different position.
Q4540 Mr Love: What role will the PRA have in doing that and getting them into the position to take the tough decisions necessary both to sustain the UK economy and to replenish their capital base?

Andrew Bailey: We have two roles, as the Governor has outlined. The first role in this process is to provide the FPC with our assessment of the likely capital need, based on the factors the Governor has mentioned and which were in the FPC statement back in November. That assessment of needs has to take into account the capital buffers the banks already have; it is an assessment based on what the banks have, against those needs. I would tend to cite one statistic here. In 2008, the major UK banks had some £15 billion of capital above what we call Pillar 1, which is the minimum amount—the core capital requirement. These are the sort of add-on buffers. Today it is about £150 billion. That does not mean that I am telling you there is no shortage; I am merely saying that you have to look at those buffers. Then you have to decide why those buffers are there; what do we have them for? Is it right to say part of them is for the things the FPC has identified, or not? That is the debate we will have, and out of that comes the answer.

The second leg is that it is, of course, our responsibility. The FPC will, in a sense, hand it back to us and say, “Well, this is what we think the need is”. Essentially, we then have to get the banks to adopt the plans and measures which fulfil those needs. Again as the Governor said—the FPC flagged this—that can be restructuring measures and it can be capital raising. My own view is that it differs between institutions, because institutions that don’t currently have what I might call a fully sustainable business model really have to look at restructuring before they can sensibly do the full range of capital raising. I think it must be in that order, because it is much harder to raise capital on the basis of something about which outside investors would say, “We don’t really understand how this is sustainable”. Essentially, our job is to get that delivered.

Q4541 Chair: May I ask you Governor, do you agree with Stephen Hester’s view that RBS could be privatised on the plans he is putting through within a couple of years?

Sir Mervyn King: I cannot easily judge that. I certainly have no reason to doubt it and if he believes that, then I am willing to accept it. The question is whether that is soon enough to get RBS back into a position where it can be a healthy lender to the UK real economy.

Q4542 Chair: And if he were here, Stephen Hester would say there is demand problem on this lending, not a supply problem.

Sir Mervyn King: There is both a demand and a supply problem. I certainly accept that in the current circumstances there is a demand problem which you can see most clearly with big companies. Big companies have large cash mountains, they are not investing a great deal and the massive amount of uncertainty out there is very hard for any policy measure to overcome; and certainly it is not the fault of the banks that there is a demand problem. That is in large part associated with the continuing uncertainty about the euro area and the resolution of the problems there.

There is a deeper problem for the banks themselves, and certainly for SMEs, and if you look at the banks, there is a clear distinction. The banks with the largest amounts of capital are expanding their lending. The banks which have bigger legacy balance sheet problems are contracting their lending. The reason why there is a difference between those two types of bank has nothing to do with the demand situation; it has everything to do with the position of the bank.
Chair: Perhaps the PRA could send us a table that sets that out clearly and unambiguously? That is an important clarificatory point.

Q4543 Lord Lawson of Blaby: Governor, what you were saying earlier to Andy Love about RBS was very important indeed. You were saying, in effect, that going ahead quickly with a radical restructuring and cleaning up of RBS would be the biggest single thing that could be done to assist SME lending in this country, which, in turn, I would suggest is probably the single biggest thing needed to get the economy in better order. When some of us, such as Andy Love and I, put that to the Chancellor, he objected to it because he said—I don’t think I’m falsely characterising this—he couldn’t see how he could possibly present more public money, with the subsequent borrowing requirement, going into banks or bank shareholders. He said that you would have to buy out the £18 billion—or whatever it is—minority holding in RBS, and that that consequent increase in public indebtedness could not be presented either to the public or to the financial markets. I think I told him at the time that that was nonsense, but I would be grateful for your more considered, statesmanlike reply.

Sir Mervyn King: The Chancellor has inherited a very difficult position. I know he has been concerned about this from the beginning of his term as Chancellor, and he has found it difficult to make progress on this problem. He inherited a situation where there was a very clear view that the banks should take time; there was a strategy in place and to turn that on its head in 2010 would have been a very bold move.

Over time, we have all come to realise that, actually, time has passed and nothing really has been achieved. The balance sheet has been reduced, but we have not actually managed to get the bank back into the private sector. And the problems of RBS—the FPC has been very clear on this—have actually had macro-economic consequences, so it is a problem. I believe that the financial markets have seen through the question of the impact on Government debt of the holdings of Government: the assets and loans to the banking system. This is not the same as the pattern between Government spending and Government revenue; this is a different question where, in the national accounts, if the Government uses money to buy shares in a bank, because those shares are not deemed by the national statisticians to be as liquid as the Government securities that are issued to finance the purchase, the debt appears but there is no corresponding asset to allow the debt to be offset.

I think, therefore, that the Chancellor faces a presentational problem. I do not face it, but he does, and I can understand that it is difficult to explain that problem because many commentators will say, “Well, you would say that, wouldn’t you?” But the financial markets do see through that; they realise that the losses out there at present don’t go away just because we haven’t recognised them in the accounts today. They are real losses, and it is better to face up to that. Simply putting the problem off and postponing it will, I think, delay the time when we could have a healthy RBS back, lending to the real economy again. The arguments for restructuring sooner rather than later are powerful, and I would certainly be prepared to lend my support to those who would argue that it is better to recognise it and we should not worry about the consequential impact on the apparent scale of public debt.

Q4544 Lord Lawson of Blaby: So will you tell him that?

Sir Mervyn King: We have regular conversations on a wide variety of issues, and you can safely assume that this is likely to be one of them, or that it already has been.

Q4545 Baroness Kramer: I would like to go back briefly to funding for lending. I suspect that nobody would use any word other than “disappointing” to describe the numbers
for the first quarter of 2012. If there are public figures that show which groups of borrowers have been the least able to benefit, I am afraid I have not seen them. I apologise if those figures are public, but I am not sure they are. However, if we had RBS and Lloyds in front of us, they would swear blind that they were lending to every SME that came in with a bankable deal and that they are cutting in other sectors to rebuild their capital. That does not seem to chime what you just said, Governor. One of the rationales put before us is that banks face very high capital requirements when they do SME lending, which is typically backed by some form of commercial real estate, and that this is a disadvantaged sector. This is exactly the sector that falls under the PRA. Could we have your comments on that?

**Sir Mervyn King:** I will comment first, and then Andrew can tell you what he is doing. I don’t think your characterisation of the capital requirements is entirely fair. The FSA, which will become the PRA, has been clear in saying that new lending under the FLS will not trigger a higher capital requirement. Indeed, it is precisely because any extension of lending under the FLS will not incur a marginal capital requirement that the scheme actually favours SMEs, rather than mortgage lending, contrary to many of the comments you may have read in the press. Whereas, normally, it is true that SME lending—understandably, given the experience of the greater riskiness of such lending—would attract a higher capital requirement, at present extra lending under the FLS does not trigger any additional capital requirement, either for mortgage lending or for SMEs. Relative to the normal position, that is a beneficial position for SME lending.

I go back to what I said before: the figures are disappointing, but they are not surprising. We knew, when we set up this scheme, that some of the major lenders to the UK, accounting for over 50% of lending to the UK, had the strategy, which you could not blame them for at all, that they had to contract their lending to the UK real economy because of balance sheet legacy problems. Indeed, in the case of Lloyds, it was a requirement of the European Union that they sell off some of their branches. So they were in a position where they had to contract their balance sheets, and we knew that. When we set up the FLS, we carefully defined the parameters of the scheme. It is quite an ingenious paramaterisation, which gives an incentive to those banks that we knew were likely to contract their balance sheets to contract them by less than they would otherwise have chosen to, and which gives incentives to the Barclays and HSBCs of this world, which wanted to expand their lending, to expand by more than they would otherwise have done. I think we have gone some way towards achieving that. We cannot prove that to you until, certainly, towards the end of this year, when we will see data for the whole of 2013.

So the figures are disappointing but I don’t think they are particularly surprising. The one area where we can see the FLS has clearly worked is in reducing funding costs for banks; they have fallen very significantly since the scheme was announced last summer. That is really all the scheme can do. To the extent that the scheme was likely to work, it would do so by lowering the funding costs for banks, making it cheaper for them to expand their lending and giving them a strong incentive to do so, because that would lower the funding costs yet further. But the backdrop to all this is a UK banking system where some of the biggest lenders to the UK real economy were in deep difficulty with balance sheet legacy problems, and unless we tackle those, lenders are not likely to be in a position to expand lending.

**Q4546 Baroness Kramer:** I do want to hear from Mr Bailey, but that sounded slightly perverse. If you are telling RBS and Lloyds, “Look here, the capital problems you are suffering under generally don’t apply in the funding for lending context,” you would think they would have the highest increases in that area—even higher than at the banks that do not suffer from capital constraints.
**Sir Mervyn King:** No, they are entitled to apply. We designed the scheme exactly in such a way that the RBSs and Lloyds of this world would have an incentive to take money from us, if funding costs stayed at the level that they were at. For that reason, they would have an incentive to cut back their balance sheet by less than they would otherwise have done. That is certainly true of Lloyds. The fact that, overall, lending has not gone up is not a result of the FLS; the FLS has meant that the lending figures have been somewhat stronger than they would have been had we not introduced the FLS. Certainly, funding costs would have been a lot higher had we not introduced the FLS, so I think the scheme has achieved its basic objectives. What will happen to lending will depend on how quickly we can resolve the underlying legacy balance sheet problems of some of the biggest lenders to the UK real economy.

**Andrew Bailey:** I am not sure that I have a lot more to add. As the Governor has said, what we sought to do with the capital treatment that we announced last summer within this overall package of measures that came out at around the same time as the funding for lending scheme—which also, by the way, included some measures that we took on liquidity buffers—and what we tried to do on the capital buffers was, in essence, mimic what we think will be the macro-prudential counter-cyclical regime of the future. We did not have that regime then, but we thought we could mimic it with our existing powers and tools by, in effect, giving a risk weighting concession for the new lending attached to the funding for lending measures. As the Governor said, for every given unit of lending, the concession was greater for a small firm loan than for a mortgage.

I reinforce the point that the Governor made: when we looked at the projections that we were given for lending over a year ago, going forward to this point now, they looked substantially negative. We understood that. In many ways, you have to see the measures that were taken as intended to attempt to lean against that, and the judgment of what has been achieved so far has to be in that context.

In your initial comments, you mentioned the debate and argument about whether loans are made to bankable propositions—you used the term “bankable propositions”. That is a term that can be argued about endlessly. I have a tremendous sense of déjà vu back to 20 years ago in the wake of the early 1990s recession, when we were in a similar position, in terms of this debate around the bankability of small firm lending. As well as what we are doing at the macro and micro level, you have to find ways to dig into this question of bankability.

The Governor mentioned the question of loans to small firms secured on commercial property. There is no question that commercial property in this country is one of the assets that people are most concerned about. It is not a homogeneous market, but there are sections of the commercial property market in this country that are notably weak. Another perennial issue with small firm lending is to what extent it is really equity and to what extent it is debt, and how the banks see it versus how the people who apply for loans see it. You have to dig into those questions, otherwise the tools that we are using, though they will help, may not get you all of the way.

**Q4547 Baroness Kramer:** Could I come at the issue of capital from a slightly different perspective? Is its impact creating a more competitive environment? As you know, the FCA leads, if you like, on competition, but there is still an important role for the PRA, particularly since it sets capital requirements and the differential between the new and small and the large. Tell me if I read this wrongly, but I was looking at the Bank of England Prudential Regulation Authority publication of October 2012 on the PRA’s approach to banking supervision, and I understand that competition is merely a “have regard”. We have often been assured that that
still means it plays an important role. I could not find the word “competition” anywhere in the entire document. Did I misread it?

Andrew Bailey: Well, you do have to bear in mind that “have regard” was added to the legislation after that document was produced. We are going to produce a new version of that document, because it is—to use a terribly hackneyed phrase—a living document. We are going to publish a new version of that document at the point when the PRA is launched. The new version will take into account the fact that Parliament added the “have regard” for competition into legislation in the intervening period. That is a point well taken.

Q4548 Baroness Kramer: Okay, so we are in a process of change. That helps me.

Andrew Bailey: I am very aware that the new version of the document has to explain what we intend to do about the “have regard” for competition.

Q4549 Chair: You also suggested to the Treasury Committee, in separate evidence, that you might be able to go further, and that we might want to consider moving beyond the “have regard” to some kind of secondary objective.

Andrew Bailey: What I would say is that the FCA, very clearly, has the primary objective for competition. Only one body should have a primary objective, because otherwise there will just be confusion. I am well aware that the history of “have regards” is not a particularly glorious one, in terms of what people are interpreted as having done about them. We will start with the “have regard to”, because the legislation is done. There would be sense in reviewing how we go about that after some period of time—frankly, I would welcome a review—to decide whether that is the right way to do it or whether there is an alternative. There clearly is another way that is used in legislation. We know that.

Q4550 Baroness Kramer: That is encouraging. I have one final question within the same scope. When we had Lord Turner in front of us, we discussed the issue of the differential that is created between the new entrants—the small players—and the large ones, such as the large four. That is an area that we are obviously concerned about, across a whole range of forms of financial services. He suggested that your approach would not be to reduce the barriers for the new and small, but to take a very sceptical approach towards risk-weighted models and the levels of capital required for the large. Can you give us some sense of the extent to which this will end up reasonably levelling the playing field? Or are we still talking about more caution with the large, but still very large discrepancies?

Andrew Bailey: I think, to be fair, we are going to do both, actually. That document emphasises what we regard as right in the context of the objective that Parliament has given us on safety and soundness, which is cast in terms of financial system. The word we use there is proportionality. That takes two forms, in my view. There is proportionality in terms of the amount of supervisory time we devote to each institution, bearing in mind the risks that it poses to our objective. The second category of proportionality is the one you are referring to, which is the scale of the capital buffers and the liquidity buffers. As Adair Turner said to you, we are taking a very important step in that direction when we publish the proposal on so-called barriers to entry, which is to reduce the capital barriers at the point of entry. The underlying principle here, which allows us to take that view, is about resolution: the easiest point at which to make a bank resolvable is the point when it enters. You can do all the systems; you can have the so-called single customer view, which allows you to pay out the depositors easily—you can wire all that stuff in at the beginning much more easily. We would
expect new banks to be resolvable. Of course, they will also be small, which makes them more resolvable.

The logical consequence of that is that the initial capital buffers should be lower. This goes back to before my time, in a way, but my impression is that the FSA used to look for, say, a capital buffer that equated to something like five years of survival for a new entrant. A lot of that was driven by the fact that if you do not know how to resolve a bank, you want to put more protection in front of you. We are going to reduce that quite substantially, because it is quite clear that orderly failure is consistent with our objectives. In other areas of the economy, firms enter, and some succeed while some do not—that is competition. We are moving in that direction.

My final point is that I also recognise that we then, quite rightly, have to consider how we apply that principle of proportionality not just to new entrants who are small, but to those who are small for a long time. We will do that.

Sir Mervyn King: Can I just emphasise something? We are committed to ensuring that the world is an easier one for new entrants to banking. The measures that Andrew has described, and the ones that Lord Turner mentioned to you before, have this property: we are moving from a world in which the capital requirements were bigger for the small than the big to a world in which the capital requirements will be bigger for the large than the small. That is a big change, and that is going to happen.

Chair: That is very helpful.

Q4551 Mark Garnier: Andrew Bailey, in an interview with The Mail on Sunday recently, you said that it is only the boards and the senior management of banks that can drive cultural change from the top. Do you think that, in any practical terms, it is a feasible proposition to try to drive culture from the top, given that an organisation such as HSBC employs 270,000 members of staff, and there is only one guy in charge?

Andrew Bailey: First of all, I strongly believe that the culture of an institution has to be set and determined by its board and senior management. It cannot be done by us as regulators. What we can do, obviously, is incentivise that process. Don’t get me wrong, it is not that we are powerless, but we cannot be the determinants of culture; that has to be done from the top of the institution.

We have seen changes over the past year or so, but for me, there is one very big challenge ahead. The last 12 months have been very interesting. I call it, in some ways, the second phase of the crisis. The first phase, which was much longer, was a prudential phase, but what we have seen in the last 12 months is the coming together of a whole series of conduct issues. These issues did not suddenly blow up in the last 12 months, but they have come to a head: the scale of domestic conduct redress in areas such as payment protection insurance—

Q4552 Mark Garnier: You are referring to the recent scandals that have been emerging.

Andrew Bailey—LIBOR, and the quite big issues around anti-money laundering and sanctions, particularly in the context of those banks operating in the US. If you put all three things together, you have a very powerful leg of the crisis that has a conduct driver behind it. I say that because I think it poses a very big question, in terms of both culture and controls, for people who run very large banks, which is, in essence, this: “Society expects you to control and operate this institution to higher standards than those we now know you were applying five or 10 years ago. That is a fact, and you have got to prove that you can do it.” That is, as I
say, both a controls issue and a culture issue. “If you cannot do it”—let us face it, the jury is out—“we have to think very seriously about the implications of that.”

Q4553 Mark Garnier: The one thing that struck me in taking evidence, particularly on the LIBOR thing and when the UBS guys came along, was that the very first indication for the senior management that they were running a shop that had gone badly wrong was when they read about it in The Financial Times, which was also when the rest of us read about it. It seemed an extraordinary proposition that the regulators, in any form, would not even have cast a bit of a glance at the people in charge, or even just given them a bit of a roughing up, if you like, in an interview room, just in order to demonstrate to them that the regulator expects them to take some sort of control. Tracey McDermott told us that if a trail goes cool, they will not follow it all the way up to the top, so there is almost an incentive, whether implicit or explicit, for wilful ignorance at the top. Is it not the case that in trying to drive culture, the people at the top must not only say, with a great deal of sincerity, “This is what we want to be”, but understand what is going on at the bottom? They have to have some sort of sense and some sort of feelers out there, but there seems to be no incentive whatever for those managers to know what is happening on the trading floors or in the bank branches.

Andrew Bailey: I agree with you on the regulators. My only point of difference is this point about how it cannot only come from the regulator. We cannot have a culture in which it is all right to do something and to ignore something until the regulator comes along and tells you that it is not all right, because that way you get a culture embedded in an institution that is not acceptable.

I think you are absolutely right about this point about senior management. One of the disturbing things about the history of the crisis is—I have been following some of the transcripts of your hearings on HBOS, and I think you come to this point—why is it that we have gone through this crisis with a record of formal action being taken against a number of individuals at the level below the very top of these institutions?

On Tracey McDermott’s point about following the evidence, however, using that line of approach does not take you to the people at the top, and the problem—I start from this principle—is, “Hang on a minute. These people are setting the standards, the tone and the controls for a whole institution.” To say that they are, but they did not literally have their fingers on that transaction or literally make that loan, does not seem to answer the question. The answer is, yes, but they are responsible for the standards, conduct and behaviour of the whole institution. I think it is a major issue that action has not been taken against the individuals at the top of failed institutions.

Q4554 Mark Garnier: My final question is this: at the end of the day—the Archbishop, in particular, has discussed this—you can have a small, complex institution that is easy to manage, and you can have a big, simple institution that is easy to manage, but is impossible to manage effectively a large, complex institution. Specifically on the subject of culture, do you think is it simply impossible at the end of the day to drive culture all the way through to every part that needs to have that culture?

Andrew Bailey: I think that comes back to the point I made a few minutes ago. The big challenge that major international banks face in the light of the events that have come to a head in the last year is, can they answer that question? Is it possible? These institutions are a lot bigger, as you said, than they were 10 or 20 years ago. I sometimes hear people say, “I want to take my institution back to how it was 15 or 20 years ago.” That, by the way, begs the question about whether we once lived in a golden age. We will not go there; let us assume for a moment that we did. You then have to make the point that the institution today, whether it is
measured by staff numbers or the balance sheet, is many multiples bigger than it was 15 years ago. So it is clear that they have to answer the question you are posing.

Sir Mervyn King: There is a very telling way of seeing this. Long before the crisis, I remember going to Wall Street and talking to all the banks on Wall Street. Every single one of them was trying to follow, or was worried that it could not follow, the model of Citibank. Citibank was the biggest bank in the world. It was expanding, shaving a few basis points off its funding costs by getting bigger and using the “too big to fail” implicit subsidy to lower its funding costs.

If we had had a discussion around this table before the crisis, and you had said, “We are getting a bit worried that it is too complex and too big. Let’s choose four people whom we really trust to put into Citibank, and they will surely know what is going on.” Well, we might have said, “Let’s start with Bob Rubin, Treasury Secretary in the US, who used to run Goldman Sachs; Sandy Weill, streetwise trader who built up Citibank; Stan Fischer, one of the world’s most respected economists, former No. 2 at the IMF, now central bank governor at the Bank of Israel; and Bill Rhodes who has seen every emerging market debt crisis there has been.”

I think we would all genuinely have thought that you couldn’t get four better people to sit there and say, “Well, let’s see what’s going on.” But they didn’t see what was going on. I think that is evidence that these institutions were simply too big and complex for anyone to genuinely know exactly what was going on. That is why I think I understand why the FSA and the regulators find it difficult to take a trail to the top, but it is not something that we should therefore just sit back and accept. These institutions have become absolutely enormous.

A year ago, some people were saying, “Yeah, there are some good banks and some bad banks, but there are still a few very big banks in the world that haven’t got into control problems.” Well, in the last year, we have seen JP Morgan, HSBC and Standard Chartered, which people would have picked out as banks that did not have problems or would not get into serious difficulties with control problems. I just think it shows that when these institutions become so large and so complex, no matter how talented the people are, it is very difficult to ensure that you prevent things going wrong.

Q4555 Mark Garnier: You are presenting a very convincing and strong argument for breaking the banks up.

Sir Mervyn King: Well, on the “too big to fail” problem, you can put in place the measures that we want to put in place in the UK, which is effectively to separate the balance sheets of those parts providing major banking services to the real economy from the investment banking and propriety trading activities, and to have higher capital requirements and not to allow leverage to build up. After all, the reason that the banks became so big is because of the rapid expansion of leverage to levels that 40 years ago no bank would have dreamt of entertaining. So it is a relatively recent phenomenon. If banks are too complex and the regulators feel that they cannot resolve them, they will have to change the structure of the organisation in such a way that they can be resolved. I think that, over time, these measures will lead to the banks becoming smaller and certainly not to go on growing in the way they have been.

Some may feel that we should be more proactive in doing that, but let’s get these three measures to work. Let’s give the PRA here a chance. We cannot do much about the rest of the world, but we can get the UK right. I think the three aspects of restructuring with the Vickers reforms, resolution mechanisms, including more progress on agreements internationally on resolution, and not allowing leverage to become anywhere near as high as it was—and, in my
judgement, lowering it still further in the longer term—would go a very long way to creating institutions that would voluntarily choose to structure themselves in ways that could be managed.

Chair: Very helpful evidence.

Q4556 The Archbishop of Canterbury: Mr Bailey, you commented a few moments ago that regulators cannot make culture. Does that mean they cannot do it at all, because something we have heard evidence about is that dysfunctional corporate governance, inadequate competition, ill-conceived remuneration and misaligned incentives across banking have all contributed significantly? Those all seem to be areas in which regulators can have some say. What do you see as the role of the regulator in identifying cultural issues? How do they do it, and what should they do about it when they do?

Andrew Bailey: To be clear, what I meant was that an institution cannot outsource its cultural management to the regulator. Clearly, we can do two broad things. In what we do all the time continuously, we can design and in a sense structure our approach to regulating institutions to incentivise good standards and good culture, and we do. I like to think we are doing more of that through the system of judgmental regulation that we wish to develop in the PRA, and that is why I am a great advocate of judgments against a framework of rules rather than just rules. It comes back to our earlier discussion about remuneration. We do that all the time.

The second thing we can do, do do and will do is that if, despite all that, we get to a point very much to your description where things are clearly wrong, we must step in. There was a famous account of that just under a year ago when that did happen. Interestingly, we now see it fully developed, and certainly you now have an institution taking a very different approach and saying very different things in public. We can step in at that point, but my very clear view is that we cannot have institutions thinking they can outsource culture to us. That is just an abandonment of responsibility.

Q4557 The Archbishop of Canterbury: We have also heard evidence that the Basel Committee on Banking Supervision has revealed that internal modelling by banks has enabled some banks to hold just one eighth of the capital held by other banks on the same assets. It is clear that supervisors did not undertake detailed reviews of asset quality pre-crisis because they were concentrating on the technicalities in internal models to some degree. How then can the PRA assess assets in banks? Will we go on relying on internal modelling, or what will happen to risk weighting?

Andrew Bailey: There are two things you can point to in the past that illustrate what went wrong. I have been interested to follow your hearings on HBOS, as we also work on the history of HBOS, and one thing that comes out of there is the obsession with getting the model right, as if there is such a concept, to the exclusion of proper supervision. That is the first thing.

The second thing was my experience just over two years ago—at the first year end in my role at the FSA—we came up to the banks’ year ends, and the model change requests started coming through the door. What do you get for Christmas, as a regulator? You get a request to change somebody’s model before the year end. What is all this about? What it is all about, essentially, is fitting your model to deliver an overall capital ratio that you think is the one you want to tell the world you have got. I do not fall for the fact that they all come in at the same time of year. There is a distinct seasonality to this. That was very striking.
What are we doing? First, to go back to the work that we were talking about earlier in the context of the FPC, it is very much an asset quality approach. We have done the work that we will be discussing with the FPC shortly very much in terms of going back to asset quality and saying, “Across the piece for the major asset portfolios that these institutions hold, what do we think about the quality of the assets, irrespective of what the model is delivering?” It is clear that that has to be done.

The second thing—this will also come out in the FPC—is that the FPC has already done quite a bit of work to essentially tell institutions, “You cannot actually run models that deliver these results.” That has been done in a number of ways, partly by putting on capital add-ons to say, “I’m sorry, I don’t accept that”. Secondly—probably the best-known example is, again, in commercial property—we have essentially thrown out a lot of models and said, “I’m sorry. In essence, the problem is that these assets are too lumpy. The modelling is frankly ropey.” I have to be careful what I say now, because I keep getting letters from companies that produce commercial property models telling me that I am destroying their business. But the models are ropey.

Chair: Maybe they need to be destroyed.

Andrew Bailey: Well, you said it, not me.

We have introduced a simple approach that says, “Here is a certain set of characteristics of your assets. Score those characteristics and put it into a bucket, basically.” All of that work is going on. Finally, we come back to the point that we were also discussing earlier, which is that in some areas, there is a very good case for moving, as we are, towards putting floors on models. To come back to the Christmas thing, “Sorry, you’re not going below that floor, because the evidence doesn’t support it.”

Q4558 The Archbishop of Canterbury: This rings a number of interesting bells for most of us who have been listening to the evidence for seven months, particularly the issue of gaming the rules. Their Christmas present is essentially, “Please let us through on this.” That seems to bring us back to the issue of leverage. Leverage is something that to some degree, if you believe accountants—Saki described naivety as believing company annual reports—but to the extent that to you can believe them, it is a measurable number.

Andrew Bailey: It is, but you need both. The problem with only using a leverage ratio is that, again, it is easy to game it. You just put on more risky assets for any given unit of growth.

The Archbishop of Canterbury: Absolutely.

Andrew Bailey: You need both.

Q4559 The Archbishop of Canterbury: But tighter control of models and stronger emphasis on lower leverage will result in cutbacks in bank lending, surely.

Sir Mervyn King: Not in the long run. To the extent that the FPC is now requiring firms to raise more capital—

Q4560 The Archbishop of Canterbury: They can do it that way.

Sir Mervyn King: We are asking them to raise an absolute amount of capital. They cannot get around that by lending less. They still have to raise the capital. There is no incentive to cut back lending, when they are told to raise more capital now. That is the way we get around it in the short run. In the long run, to move to a very different level of leverage, you should certainly be prepared to take your time to adjust to it, absolutely.
But I think you are absolutely on the right track. The difficulty with models and risk weights is that there is no easy, objective reality. People come along, produce very complicated models and expect the regulators to understand them, approve them or pass judgment on them, but they cannot do that. The success of any policy—certainly regulation—is simplicity, and the virtue of a leverage ratio is its simplicity. I would put more weight on that than we have done in the past.

I think that Andrew is right that we certainly cannot give up risk weights, but we do not need to. But we certainly need to put more weight on leverage, because it is a very good check. If someone says your leverage appears to be 42:1, despite the fact that you have met all the capital requirements and how can this possibly be the case, it is a pretty good indication that some funny models are being used to calculate the risk weights. That is when we should be extremely worried.

Q4561 The Archbishop of Canterbury: I will ask you a more general question, which you may choose not to answer, quite possibly. One of the things that has been coming across, certainly for me—you have talked about it today—is the political power of the banking industry and its capacity to have access at the highest level. Continually, and in almost every area, the banks are gaming and pushing at the limits, seeing what they can do. It seems unlikely that that will suddenly change overnight, from the next few months.

We keep hearing that the banking industry is such an essential contributor—the only successful contributor to the British economy, apart, possibly, from the North Sea. If you were to look back over the period from the re-opening of the Euro-markets in the ’60s to the development of London as one of the greatest financial centres, would you say that, taking into account the direct and indirect impact of the banking industry, including the crash and what followed, its overall contribution to the British economy has been positive or negative?

Sir Mervyn King: Well, I think if you take banking in its widest sense, which includes the provision of normal banking services to households and small businesses, it has to have been positive, because the absence of those services would have made life extremely difficult for the businesses. The economy cannot really function without a basic banking system.

I think if you restrict it to a narrow range of trading activity, it is much more debatable. Much of the activity in that area has been of a zero-sum kind and it has encouraged people who are seeking economic rents. If you end up being able to create a world in which, if you make large profits, you pay yourself a large bonus, but if you make large losses, you get nothing, the asymmetry there encourages you to do more and more trading so that, even on the basis of no superior performance—just random outcomes—the people in the industry doing buying and selling take a larger and larger of the returns on the activity.

Indeed, it is striking that, looking back at the returns that investment banking has generated, almost all of them have gone to the employees in the industry and not to the shareholders. I think that tells you something: not that investment banking is wrong, but that it is an activity whose natural form of activity is a partnership, rather than a limited liability company.

One of the things that went wrong in the ’80s was that—moving away from a very uncompetitive banking system which had many flaws—the Bank of England played its role in ensuring an oligopoly that provided inefficient banking services. It was important to move away from that, but what happened was that we had a wave of takeovers and investment banks started to run retail banks. That was a very unfortunate development and many of the problems have flowed from that.
I do not think these problems are insoluble. I think we can produce a system. The Vickers reforms, plus resolution, plus taking a leverage ratio much more seriously, will get us back to a much better position, with a competitive banking system. There are other aspects of competition that we have not discussed today, which will encourage new entry. Portability of bank accounts strikes me as an important issue, to create competition in retail banking. It is a small part. It does not deal with all the banking activities, but it is something that we could make progress on.

I do not think we should give up on this. The existing form of banking is not something—we never say about other forms of industrial structure, whether electricity generation, mobile phones, or telephony in general, that the current structure today is obviously the right one and we have to protect it. We have had immense reform—radical restructuring—of these industries, with privatisation in the ’80s and much more competition. We have learned about the need for regulation in those areas and, with trial and error, got the right kind of regulation. We are much better off than we were in respect of those industries. We can do the same in banking as well.

**Q4562 Chair:** Are you saying that Vickers and the other reforms can act as a rough-and-ready substitute for the switch from the partnership to the limited liability model?

**Sir Mervyn King:** Well, that remains to be seen. It is a good first step, and we should take it. Whether we need to go further, time will tell. I have an open mind on whether we need to go further, whether for complete separation or to have a Volcker rule on top of—

**Q4563 Chair:** I am just trying to clarify whether we are trying to replicate by other means some of the features of partnership—

**Sir Mervyn King:** In proprietary trading, the natural form ought to be a partnership. I think the example of hedge funds is very revealing. When the crisis first hit, many of my colleagues in the euro area felt that hedge funds were the villains of the crisis, the institutions which caused all the problems. They did not like them; they were paid too much, etc. As it has turned out, the answer has not been hedge funds at all; it has been the basic banking framework that has been the problem. The reason why hedge funds have not been a problem is that no one really believed that they would be bailed out. That is perhaps partly the result of the experience with LTCM in the late ’90s. The banking system around the world learned the lesson that they had to be careful how much they lent to hedge funds, because if they lent too much they would not get bailed out. As a result, they were more cautious about it.

During the crisis, many thousands of hedge funds failed. Other hedge funds prospered and some people got paid enormous amounts of money. Other hedge funds failed and no one cared an iota about that, and that is absolutely what should happen in a competitive industry where you have got entry and exit and the state never gets involved in using taxpayer’s money to bail it out. That is how proprietary trading activities should be organised. It is how in many ways they were organised.

Goldman Sachs was a partnership for over 100 years. If you ask them why they are so good at managing risk, one of the answers they give is that for over a century they were a partnership and learned how to manage risk, and they say they have not forgotten it. In many ways, that is the natural form in which those proprietary trading operations should be set up.

We do not have to enforce that by law, but we should not underestimate that the economics of investment banking are changing. Irrespective of what the regulators do, the incentives to the people who supply capital and funds to these institutions have changed. They now realise that the rewards have gone to employers and not to the shareholders who put up
the capital. They need to monitor the returns that the hedge funds are making. The idea that
someone should automatically hand over 2% a year of the capital value, plus 20% of the
profits, is a pretty dumb way to manage your money. More and more people are starting to
understand that.

There will be quite big changes in the economic structure of investment banking, even
without any change in regulation. The regulatory developments are supportive of those
changes. I would put them in place now, let the PRA have four or five years to get on with it,
and then come back and ask the question again.

The big questions are the ones you raised right at the outset: the “too important to fail”
problem and the “too big to fail” problem. I cannot be certain that the changes that have been
put in place will get us to a point where that problem will have disappeared. Let’s get on with
making these changes work and give the PRA a chance to make a success of it and set up
another inquiry five years from now.

Chair: You can chair it, Governor.

Sir Mervyn King: Sir John Vickers will be able to do that admirably.

Q4564 Chair: Do you want to come in and add anything, Mr Bailey?

Andrew Bailey: No.

Q4565 John Thurso: I want to ask a quick follow-up to that response, which I pretty
well entirely agree with. Is there a role for us to recommend, while the existing institutions are
subject to what you just described, the creation of a parallel situation where new entrants, if
they wished, could have a regime that favoured the partnership approach? Through that,
whether by capital requirement or whatever, there would be an attractive route in to encourage
people to go down if they wished to create a new partnership. Without doing anything about
splitting up the existing institutions, we are saying, “Hey, if anyone wants to, here is a rather
attractive model.” Would that be a good thing for us to look at?

Sir Mervyn King: Yes; I think it would require an assessment of how the partnership
form would make the resolution of the institutions easier, and I think it naturally would do so.
One would have to carefully appraise the benefits of having easier resolution against the
trade-offs one gave on the capital benefits. That is certainly something that is worth pursuing,
yes.

Andrew Bailey: An interesting thing is, going back to remuneration again, that one of
the aims in imposing the longer deferral of remuneration is to mimic the sort of partnership
structure that would leave, to put it crudely, more skin in the game for longer. That has been a
clear objective in creating the economic incentives without having the legal structure.

Sir Mervyn King: That is why the current European proposals do not hit the nail on the
head. The right approach is, as I believe and as Andrew just said, to try to mimic the partnership
arrangements that would follow. To give banks an incentive to raise the fixed
remuneration at present, which is what the proposed rules would do, is to go in the wrong
direction.

Q4566 John Thurso: The Chairman has encouraged me to ask the question that I
would have asked later, which was the follow-up on the question of bonuses. Your analysis
was that it is not going to be the doom and gloom that everybody thinks it is, neither is it
going to be the panacea that the proposers think it is. Is not one of the problems that we talk
about bankers as a catch-all, now covering anybody who is an employee of a universal bank?
We need to get back to a definition where banking is what we think it ought to be, which is largely around the utility.

The other functions of investment and merchant banking and trading are not actually banking, as we would like to understand it, and are not professional, as we think of professionals. Remuneration for professionals working in a bank is appropriate to cap, but remuneration for those acting as traders, commission agents or advisers is perhaps less necessary to cap and more appropriate to the partnership model. Therefore, where this is all going to go, if we wish to see the great strengths of the City of London maintained, is an emerging architecture that reflects all those elements of professionalism, remuneration and structure. Therefore, enabling that to happen in parallel to what we are doing with the existing structure is of equal importance.

**Sir Mervyn King:** Yes, I will make two comments on that. One is that if you are going to remove caps—let us say that there aren’t any caps in this trading area—it is very important that it is a quite separate, stand-alone organisation that will be allowed to fail. That is absolutely fundamental.

The second point I would make is that the strength of the City of London has always been its adaptability and its ability to respond to changes. I think that the economics of investment banking is changing and with it the City of London. The vast majority of services, activity and income generated by the City of London comes from a wide variety of sources that have nothing to do with the limited trading activity that has attracted so much attention recently. There are many things that go on in the City that generate overseas earnings and are good for the UK but have absolutely nothing to do with the problems that we have been discussing in banking today. It is quite important to separate those two things.

**Q4567 Lord McFall of Alcluith:** Governor, you mentioned the Citi experience with Stanley Fischer, Bob Rubin and Sandy Weill—the latter, by the way, has recanted, and last year called for the reinstatement of Glass-Steagall. Isn’t the reason that we have this situation and that these individuals find the system impenetrable that the complexity of regulation provides an illusion of control? There is an element of comfort there. As a Commission, we should start with the proposition that the regulatory complexity is unprecedented, the supervisory enforcement is almost non-existent and the private risk at public expense is almost unlimited. If we are going to sort this out, it is going to take a long time.

**Sir Mervyn King:** This is a powerful point. Clearly, the firms themselves and those who work in them may draw false comfort, and may defend themselves by drawing false comfort from saying, “Well, the regulators didn’t spot it.” What is very clear from the experience of the crisis is that in many of the American banks there were literally many dozens of regulators living and working in the building, and they did not spot what was going on. Sometimes, big shocks and changes in sentiment occur that no one can anticipate. The aim really is to ensure a sufficiently robust structure of the banking system so that these shocks can be withstood without the underlying basic banking services being disrupted. That goes to the heart of the separation of basic banking from the trading activity, and it goes to the need for much greater levels of capital. That gives a buffer that allows the shocks to occur and makes it very much less likely that a bank will fail. If it does fail, you need a resolution mechanism to handle it.

It is very important that we do not say, “Okay, we have reformed the regulatory system, therefore there can be no problems in future.” That simply isn’t true; there will always be big shocks. We have to say to ourselves, “Despite the best intentions of Andrew and his colleagues, some things will happen and mistakes will be made.” As Andrew said, the purpose of regulation is not to pretend that no bank will fail. Some banks will be badly managed and make big mistakes, and they should be allowed to fail, but we should have a
resolution framework that allows banks to fail safely without destroying basic banking services offered to the rest of the economy.

It is that resilience of the system that the structure of regulation should be designed to achieve, not to pretend that regulators will always spot every aspect of what is going on. The recent LIBOR events are a very good example of that. They were discovered by accident as a result of a massive e-mail trawl that went on for reasons other than concern that there might be manipulation. Sometimes these things will happen. If the system is too complex, we need to think about a framework for regulation that adds resilience to the system and to do what we can to reduce the complexity of those organisations.

Q4568 Lord McFall of Alcluith: Andrew, you mentioned the issue of the past 12 months: conduct issues. What we have seen after LIBOR is that those immediately responsible, almost at a junior level, have been punished, but it is doing nothing to solve the root causes of the scandal. What we have not seen is senior people taking any personal responsibility or culpability for what is going on. What comfort can we get from the arrangements in place that the responsibility will lie right at the top, and that it won’t be collective, and, as Tracey McDermott said, that the trail will not go cold when you look at it?

Andrew Bailey: As I said earlier, the history of the crisis should not give you much comfort on that financially—any comfort actually, in the sense that there has been no direct action taken against senior people. Of course, to be clear, many if not most of them are no longer in those jobs or, indeed, in some cases, in any job. No direct action has been taken.

I will give you one interesting fact here. I have been around dealing with failed banks for too long. In the wake of the failure of Barings, the senior directors were disqualified as Companies Act directors by whatever manifestation of the Department for Business, Innovation and Skills it was then. They were disqualified; they did not like it. Nobody has been disqualified as a Companies Act director, I believe, during the course of this financial crisis. Why is that? I don’t know the answer, so it is a rhetorical question. I do not know the answer to the question; it is not within the FSA’s powers to do that.

Q4569 Mr Love: Can you give us the answer?

Andrew Bailey: I don’t know. The point is that it is not a power that the FSA holds. I can’t answer the question for you. It is not very helpful of me to put rhetorical questions, I know. It is an illustration of the point that there has not been that follow-through.

Q4570 Lord McFall of Alcluith: You mentioned PPI earlier. Lloyds told us that they have got 5,000 people working on PPI, trying to sort it out. Barclays told us that they have got 1,200 staff on it. By the way, their complying staff is 1,300, but they have got 1,200 on PPI. Eric Daniels told us that Lloyds was on the side of the angels in terms of PPI, even though £6.5 billion has been put aside. I asked a simple question a while back. Why has there never been in banking a product recall? Governor, you are smiling. Come on.

Sir Mervyn King: That is a good question. I don’t have an answer to it. What I would say is that the impact of the products that are launched in the savings industry is very often seen many years down the road. I think at that point it is too late to decide whether there was mis-selling. Very often it is a question of good luck or bad luck; do you get high returns or low returns? Ex ante there was a distribution of possible outcomes.

Where I do think the banks have a good point is that if the conduct regulators are going to launch an accusation of mis-selling, they need to do it much closer to the date when the product has been “mis-sold”. If it is possible to conceive of mis-selling a product, it ought to
be possible to do it pretty close to the time when the product was sold. You can’t just wait and say, “Did my shares go up or down in value? If they went down I was mis-sold the product.” That can’t be right.

In terms of mis-selling, there needs to be a much greater degree of certainty about the regime that will apply to this. One concern that the FPC has had is that the scale of the regulatory redress is such that it is affecting capital levels in banks. Where there are genuine cases of misconduct then banks should pay the penalty. To have this open for so long on such a scale is damaging and creating uncertainty, which is affecting the capital position of the UK banking system. We need to move towards a regime so that in the case of mis-selling products, there has to be a regime that either allows banks to sell products that have been approved or under which the banks know that the regulator will say, “After three years, if you have sold the product, we will not come back and say that it has been mis-sold because that would be too late.” I do not know the simple answer to this, but the banks have a point in being exposed to uncertainty for an indefinite period on an unknowable scale, when the regulators can simply deem something to be mis-selling.

Q4571 Lord McFall: If you look at the history, you will see with PPI that the banks consistently challenged the FSA. The FSA’s heart is in the right place, but it seems to lack the guts or the courage to challenge. That is an issue for yourselves in the future.

Andrew Bailey: To be clear, it is actually an issue for Martin Wheatley.

Q4572 Lord McFall: If there were a prudential implication, there is an issue for you.

Andrew Bailey: The prudential problem is that, in effect, the capital of the banking system has been overstated. The particular challenge facing Martin Wheatley is that he has to steer a course between what might be called product regulation and a process by which action is taken early. If you do not have that, there would be a fairly long build-up of evidence on people before anything happens. Yes, the banks did fight the FSA. There is no question about that. Some of the things that have been said to you are very interesting. People are now saying that they regretted it. As I remember, some of those who are now saying that they regretted it were those who were fighting for it.

Q4573 Lord McFall: Lord Lawson’s sub-committee has been looking at structured capital markets and Barclays. We are trying to find out what useful activity that was performing. We know that it was rewarded well with Roger Jenkins getting £40 million per year in cash and, over a 10-year period, I think that Bob Diamond got £105 million. We are still on the quest of trying to understand that and, if you can help us, it would be great. It begs the question whether there is something for us still to look at regarding the cultural of universal banks.

As an aside, should this Committee be looking at inequality in society as a result of the vacuum that almost exists between the financial services industry and the rest of society? I am talking as someone who represented an area in Scotland for 25 years, which had problems with engineering and shipbuilding—and 40 years later, is still dealing with those problems.

Sir Mervyn King: There are some deep problems surrounding the creation of new financial products that can be created literally on an infinite scale. There is no limit on the size of it, unlike producing manufacturing products or even services. The questions are who should be allowed to trade in them, and when we need to be concerned about the potential exploitation of consumers, retail customers and pension funds.
Let me give one simple example. Michael Lewis’s book “Liar’s Poker” clearly well predates the crisis. It portrays that, in some of the trading areas of investment banks, the culture was—I am not criticising it, but just observing it—that they thought themselves smarter than many of the customers and that they would sell the dud stuff to them and make a lot of money. If consenting adults want to engage in trading activity when the smart guys will win and the dumb guys will lose money, that is up to them. They should be allowed to do that in forms that do not endanger the banking system and should not be in organisations that are connected with basic banking systems. We should try quite seriously to protect retail customers from being involved in that.

Broadly, that is the direction down which the UK has gone in terms of making it more difficult for retail customers to go to hedge funds, where they can be sold products that may be hard to understand. My concern would be that a number of pension funds that have taken the opportunity of saying, “These hedge funds seem to offer very high rates of return. Let us put a bit of our money in them and see what happens.” I am not sure that the investment strategy of pension funds has necessarily served pensioners well. That is an area that I would have some concern about. But where it’s consenting adults, then we should just let them get on with it. People want to play those games. However, it is important not to let that kind of activity contaminate the returns and the ability to provide basic banking services, which is clearly what has happened over the last ten years or so.

**Chair:** We have three colleagues who want to get in and we want to finish before midday.

**Q4574 Lord Turnbull:** I have one question for Andrew Bailey. If we look back at how regulators have investigated the three great banking failures—Northern Rock, RBS and HBOS—you can discern two features. One is that initially those investigations are quite narrow in scope, concentrating largely on enforcement. Secondly, investigating the whole story of why it failed and what role the regulator played or did not play comes later, often only at the prompting of Parliament. I just want your reassurance that it will be the standard practice of the new regulator—that is, you and your colleagues—that future investigations of this kind will be both more comprehensive and earlier. In other words, we should not have to wait for five years before you are ready to get round to HBOS.

**Andrew Bailey:** I think the key point is that the model that was adopted, which, as you say, started with the Northern Rock investigation, was for the FSA to investigate itself. To me, that is a difficult model which is always likely to end up where it did, which is people then calling into question the validity of it and it being, in a sense, reset, as it was particularly with RBS. So the key thing that I expect the PRA board to commit to is that although the board will have to commission reviews, they will not be done by the PRA. Essentially the board will say that they will commission the review, but they will be done outside the executive of the PRA. That seems an obvious point, but it lies at the heart of it.

**Q4575 Lord Turnbull:** But in fact you have adopted a slightly different model. The regulator has looked at itself, but an invigilator—David Walker in the case of RBS—has been inserted. There has not actually been a fully external investigation.

**Andrew Bailey:** The chairman is better placed to talk about this than I am, because he was a part of that. My understanding is that the initial review of RBS by the FSA was regarded as not adequate, so out of that the process was reset and out of that the insertion of the external reviewers was made. I would judge that this was a halfway house to the external review process. By the way, the HBOS review in essence has replicated that arrangement, without having that furore around it. I regard it as a halfway house; it is not the model I would
want to see because you have to beg the question: why don’t you just get the external reviewers to do the review?

Sir Mervyn King: This is an absolutely fundamental point and I can give you an assurance about what the Bank of England will do in the future. The Bank’s oversight committee will have the power to commission external reviews and it will do so. One small point on that: I don’t think we want to have reviews only when there are failures of banks because we don’t regard the failure of a bank as in and of itself evidence of a regulatory failure. We are not going to operate a no-failure regime. So we need some reviews of where there aren’t failures: “Has supervision been adequate?” and so on. So it is very important that we do not equate failure of a bank with a regulatory failure from the outset. That would be a serious mistake.

Going back to the reviews, there will be external reviews. The reason is the following: during the creation of the PRA we spent a lot of time talking to supervisors, both former supervisors in the UK and elsewhere, about the right model for supervision. One thing that struck me very forcefully talking to these people is that only one review of a bank failure episode commanded confidence among those involved. That was the Bingham inquiry after the BCCI failure. Why was that? Because Lord Justice Bingham was regarded as a person of unimpeachable integrity and was completely objective. He had no agenda of his own, no side, no particular issues to pursue, and he gave everyone a fair hearing. In my view, that is vital if you are going to have confidence in the process of holding an inquiry.

You cannot have an institution like the PRA investigating itself, because one person in that institution will be asked to sign a document that is a report on the behaviour of other people in the same organisation. No one is going to believe that is a fair process, and in large part, it will not be. It is very important to have these external inquiries, and that is exactly what the Bank will do.

Q4576 Lord Turnbull: The oversight committee has oversight over the PRA. Is that right?

Sir Mervyn King: Yes.

Q4577 Lord Turnbull: I am not clear who plays that role when it comes to the FCA. Is it the board of the FCA, because it does not really have an oversight committee?

Sir Mervyn King: It doesn’t—I don’t know. You will have to ask the FCA—presumably it is the board of the FCA. The difference between the boards of the PRA and the FCA is that the board of the FCA, as far as I understand it, will be much less involved in making the detailed regulatory judgments into which the board might want to see an inquiry. The board of the PRA will be taking the major regulatory decisions itself. It will delegate many to the executive, but it will take the big ones itself, and therefore, it is not the appropriate body to carry out the inquiry. It may decide that it wants to see one, but it is the oversight committee of the Bank of England that will ultimately authorise and create that inquiry, and it will look to an outside person to carry it out.

Q4578 Lord Turnbull: I am very glad to have your endorsement of the oversight committee, because I am not sure that it is exactly where you started.

Sir Mervyn King: No—it is exactly where we started, to be honest. I have always been in favour of an oversight committee, but the key point of difference I suspect with the TSC is that, in my judgment, the oversight committee of the Bank should be responsible for commissioning reports and reviews, but it should not take a stance itself on whether the policy
judgments made by the three policy-making committees of the Bank of England—the MPC, the FPC and the PRA board—were right or wrong. It is the body that commissions the reviews and holds those three committees to account. It says, “You must explain yourself to us and in public,” but it does so from a dispassionate point of view.

If it starts to take judgments itself about what the actions should or should not have been, all you will get is a simple to and fro in which the people on the PRA board or the members of the MPC will say, “Well, I don’t know who you are. The Chancellor appointed us to take the decisions here—not you, but us, and if you disagree with our judgments, too bad.” What the oversight committee is responsible for is a process for ensuring that there are proper public reviews and examinations of the behaviour of those three bodies, and that those bodies have publicly to account for themselves, but it is not that the oversight committee sets itself up to second-guess the decisions of those bodies.

**Lord Turnbull:** I will leave it there, otherwise we will redo the whole debate about the Financial Services Bill.

**Q4579 Chair:** The fact that you yourself are not quite sure what the arrangements are for the FCA, being very close to the whole regulatory framework, tells us how we already have a system that is relatively opaque. You have just been having a debate with Andrew Turnbull about your own internal arrangements, which I doubt very few people outside the Bank could possibly understand. We do have a problem here, don’t we?

**Sir Mervyn King:** No, we don’t. The oversight committee doesn’t exist at present, because the legislation only comes into effect on 1 April. That is why I would not expect the outside world to know much about it, but from 1 April, I can assure you that the oversight committee will be very clear, in public. It will publish its report every year on its work and it will ensure that it publishes the reviews that come out of the process that it has commissioned.

**Q4580 Chair:** I do feel that it has to be put on the record that you were not, to put it mildly, an enthusiastic supporter of any kind of reviews, whether internal or external, when this was first put to you, were you, Governor?

**Sir Mervyn King:** I was all in favour of reviews of things for which we are accountable, yes, but to ask us to carry out a review of things for which we were not responsible does not seem very sensible. That is what I was opposed to.

**Q4581 Lord Lawson of Blaby:** The tax system discriminates—not just in this country, but we are particularly concerned about this country—against equity capital and in favour of loan capital. There have been suggestions that that might be changed—for example, for an allowance on corporate equity along the lines suggested by the Mirrlees report, and there are various other possibilities. Do you attach any importance to movement on this front?

**Sir Mervyn King:** I do, for two separate reasons. For many years, as you know, I have been in favour of a neutral tax treatment of different types of investment income and income from capital. It is rather unfortunate that we appear to have gone backwards from some of the very sensible reforms that you introduced in the 1980s. This is an area where we might well learn from you. You should, I hope, actively promote a debate on this. A neutral tax system would be very important. I say that for two separate reasons. The first is the one we have just been discussing. It would help to reduce the incentive which banks have for high leverage. One of the arguments that banks can put forward for saying that it is good for the shareholders to have more leverage is that there is a tax advantage to use debt finance rather than equity. It
would be important to try to get rid of that and to show banks that they should be willing to use more equity capital. The argument for using higher leverage has very little foundation.

That is one argument I would use. The second goes right back to the debates in the 1980s. It is precisely because you can produce financial products without limit that if you have a non-neutral tax system, not merely can you avoid tax on your genuine economic income, but you can generate instruments which reduce the tax burden to an almost infinite extent. You can create losses in one area, profits in another, with differential tax rates on them. You offset one against the other. You make a pure profit. It is a money-making machine to have a tax system that is non-neutral in respect of investment income and income from capital. That basic proposition still holds. You can see that many of the activities which Andrew and his colleagues had to deal with in respect of some of the banks were promoted because of the complexity of the tax system and the wish of the banks to try to create products which would avoid tax. Moving towards as neutral a system as possible is the way to take away those incentives.

So for those two separate reasons I would very much like to see a move back towards a much more neutral tax system in respect of different types of income from capital. It is more complicated than just talking about the tax deductibility of debt finance because you need to take into account the personal as well as the corporate tax treatment and the tax treatment of institutional investors. It is a much more complicated issue but we wrote about that at great length in the late 1970s and 1980s and I think it is time for a bit more work in that area. I would certainly support initiatives in this area.

Q4582 Lord Lawson of Blaby: Right. Although this lack of neutrality, which you accurately described, applies to the tax system across the economy as a whole, it is particularly malign, would you not agree, as applied to banks?

Sir Mervyn King: Absolutely.

Q4583 Lord Lawson of Blaby: So even if the Chancellor is not prepared to do it, possibly because of the upheaval or whatever, for the economy as a whole, would you think it is worth considering doing that just for banks? After all, we have a separate regime for banks anyway in the form of the bank levy.

Sir Mervyn King: We do. One of the opportunities here would be to reduce the bank levy and instead have a much more neutral system on banks as a whole. I would be sad if there weren’t to be greater enthusiasm for the cause of tax reform more generally, clearly. That would be a sensible framework within which to put changes for the banks. But it does not necessarily mean that you have to have that in order to have changes for the banks.

Q4584 Lord Lawson of Blaby: As you know, that has always been close to my heart. Moving on to another area, there is plenty of evidence of the inadequacies of the IFRS accountancy regime. That is not to say that the previous regime of UK GAAP was perfect, but that is no excuse for the flaws in the IFRS. There is a problem about addressing this. We don’t have sovereignty. We are committed to the European agreement on this. Like most agreements, it is the lowest common denominator, and sensible changes are therefore unlikely. They say that they are going to change it a bit, but the prospect, I think, is that the changes will be too little. Do you feel that there is any way—because this is quite a significant area—in which we can go it alone? I would like to know what Andrew Bailey thinks, as well as what you think.
Sir Mervyn King: Let me briefly comment on two aspects of that. One is that measures are being pursued through the Financial Stability Board to try to redefine the profits of banks to include a forward-looking provision for expected losses. I think that most people now understand and agree—that is fairly widespread agreement—that it is important for banks to recognise that they are likely to make losses on a portfolio of assets, even though they cannot identify a specific loss on any one specific loan.

Q4585 Lord Lawson of Blaby: They have history. They know history.

Sir Mervyn King: Yes. It is not in the interest of banks to have to report profits higher than they themselves believe to be their true position, because they are not allowed by the accounting rules to recognise losses. I hope that there will be progress on that front, which would be an important step forward. It is one of the areas where the Financial Policy Committee has asked the FSA to say, “Well, whatever the accountants say, tell us what the true picture is.”

One area where the UK could make real progress is to insist that, in annual reports, there is a much deeper reconciliation of the standardised accounting profits with what the regulators and others feel shareholders should be told. To the extent that banks, as banks very often do, themselves make some estimate of expected losses, shareholders should be given much more information about the scale of those expected losses, the assumptions used to make those guesses or estimates, and whether or not the regulators think that they are adequate, and there should be a genuine reconciliation in the annual report. Some banks have started down this road of giving more information. That is something that we could do ourselves, without the need for international agreement. That is the area where I suggest we could try to do something on our own.

Q4586 Chair: A brief word from Mr Bailey, and a brief rejoinder from Nigel Lawson.

Andrew Bailey: There are two fairly frustrating things that you observe. You have seen some of this; I have read the records of your hearings. First you get this sort of circle going on, where the standards setters say to you, “It’s not a problem with the standards; it’s a problem with the implementation of them,” and the implementers come in and say, “It’s not a problem with the implementation; it’s a problem with the standards.” That is the sort of circle that we seem to go around.

The second one is when it is said that the reason why you had to go down this route of being seemingly overly strict about the interpretation of expected losses is to prevent hidden reserves and profits smoothing. That is not a logical conclusion of the first argument. No doubt, there was an issue with that, but you do not have to do what has been done to solve that issue.

As I mentioned earlier, we have put in place more Pillar 2 capital, part of which is, in essence, a substitute for old-fashioned general reserves. Like the Government, we have to have much more effective transparency on this. That will drive change—along with the pressure that we are putting on institutions, with the support of the MPC.

There was an important initiative last year, which was something called the Enhanced Disclosure Task Force, which the FSB—Mark Carney, in some sense—sponsored. It involved both the banks and the investment community. It was really driving at saying, “Look, you have done disclosure, but what you have actually done is dumped data. What we have to have
is disclosure that, in the Government’s view, is more useful and meaningful.” We have to push this.

I was quite encouraged earlier this week, when HSBC effectively implemented the Enhanced Disclosure Task Force in what it released. Frankly, my message to all the major banks, not just in this country but globally, is: “Get on and do it.” That will help to get at this question about what their view of expected losses is.

Q4587 Lord Lawson of Blaby: Last question, if I may: do either of you feel that there is any merit in cutting the Gordian knot in this way? Okay, the IFRS is there—that is, the statutory requirement to produce accounts in accordance with the IFRS—for all its manifest defects, many of which have come to light in hearings we have had, as you pointed out. In addition, you must draw up accounts in the way the PRA will lay down. This makes sense, which in many cases the IFRS does not. So for regulatory purposes, and also for exercising a discipline on the banks, you will have this set of accounts to assist you.

Chair: That was a quick rejoinder, and we would be very grateful for an even quicker reply.

Andrew Bailey: I regard that as a bit of a counsel of despair. We may get there, for the simple reason that if we produce even more accounting information it is needle-in-the-haystack time. I talk a lot to investors in banks, and they say that so much data are dumped out there that they cannot find what they are looking for. You can rejoin to that by saying, “Ah, but this would be the truth”, but I hope we do not have to end up there, and can knock the current system into shape so that we only have one set.

Q4588 Lord Lawson of Blaby: But if we cannot knock the current system into shape?

Andrew Bailey: If we cannot, you may be right. I think that would be unfortunate, but we may end up there.

Q4589 Baroness Kramer: Just a short while ago, Governor, you were somewhat concerned about pension funds investing in hedge funds. We have not had time to discuss bail-in, but given its characteristics would you be concerned about pension funds holding bail-in bonds?

Sir Mervyn King: That depends on whether the trustees fully understand the consequences. If they do, they are taking a risk. I think there is also the question of the kind of pension fund, whether it is a defined benefit or defined contribution fund. A defined benefit pension fund really ought to hold assets that match its liabilities. That would reveal the true cost of the pension, but it would make sure that the pension fund had assets which then went up and down in value in line with the liabilities. That is what the Bank of England pension fund does. I think that is the right strategy for a defined benefit pension fund. A defined contribution pension fund is something rather different, where individuals entrust their money to be invested in a wide range of risky assets, some of which will earn higher returns than others in return for taking more risk.

I think that there is quite a difficult judgment to be made about how much we do to protect investors, or how much you leave people exposed to the consequences of their decisions to be in a particular pension fund. I do not think bail-in bonds themselves are

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1 Witness Correction: I should have said ‘authorities’ view’ and not ‘Government’s view’.
sufficiently different from other risky assets to justify separate legal treatment. It is very important that people understand the consequences of the assets that they hold. I have some concerns, not so much about the overall strategies of pension funds, but about the extent to which very clever, smart people come up with instruments that the trustees may or may not understand. They are told that over the last five years these instruments have earned returns that are three times as high as any other instrument, and then they buy them just before the crash comes.

**Q4590 Mr McFadden:** Governor, in our first report, published just before Christmas, we argued for two reserve powers with regard to separation. One was a reserve power in relation to individual banks, and the second was a reserve power in relation to the sector as a whole. The Government have agreed with the first, but rejected the second. Their reason for rejecting the second is because they say the Bank of England is against it. Is that the case?

**Sir Mervyn King:** Yes. When we were asked about this before we said that we would not object to the reserve power in respect of an individual bank, because that is part of the normal supervisory process. In my judgment, the trouble with doing this for the sector as a whole is that this reserve power is pretty much equivalent to primary legislation, which ought to be the responsibility of Parliament. I would worry that enormous pressure would be brought to bear on the regulator, and there would be a lot of lobbying. Even if the regulator felt that it had the reserve power, my guess is that the Government would say, “Look, if you go ahead and use it, we may well pass legislation reversing it.” I think in effect a provision so important that it affects the entire sector is one that both de facto and de jure will and should be taken by Parliament, and it is better to recognise that. I welcome the first reserve power, but I would be nervous about the second.

**Q4591 Mr McFadden:** But the decision would be taken by Government, by Parliament. Our proposal is not that the regulator or the Bank of England take this decision; it is that the Government of the day would have to take it.

**Sir Mervyn King:** Fine, but if it is a question of the regulator making a recommendation to Government, and the Government deciding, that could always happen. I would say that this is something that would be highly suitable for the review that I mentioned at the outset. You could have a proper review of the regime after four or five years; that would be a good time to have a review about whether we needed to go further.

**Q4592 Mr McFadden:** That is what we say.

**Sir Mervyn King:** If that is what is meant by the reserve power, that is fine. What we were nervous about was being given the right—the obligation, really—to say to Government, “You should make a policy change in this area,” when nothing had generated that question.

**Q4593 Mr McFadden:** There has never been a suggestion from us that this decision, affecting the sector as a whole, could be taken purely by the regulator.

**Sir Mervyn King:** Fine. That was our concern initially.

**Q4594 Mr McFadden:** We always saw the Government of the day taking the decision, although, obviously, we would be interested in the regulator’s views of how the ring fence was operating.
**Sir Mervyn King:** Indeed, and the regulator would give its views. As long as the decision is taken by Government, we would have no objection to that.

**Q4595 Mr McFadden:** We are coming to the end, and this is your final appearance before this Commission—believe it or not, the Commission’s hearings will themselves come to an end.

**Sir Mervyn King:** I think it has been a very productive exercise.

**Mr McFadden:** Like the cardinals, we are about to enter conclave, before we produce our final report. Is there anything we have not covered in our questions, particularly in relation to standards and culture, that you think is important for us to have in our mind? Is there a particular recommendation that you think would be useful to make in our final report, but which you have perhaps not been asked about today?

**Sir Mervyn King:** Let me just elaborate on two points we have touched on. The first one is on culture. I would emphasise what Andrew said earlier: in my view, there is no substitute for leadership. You can have codes of conduct, and you can have regulations, but when it comes to culture, there is no substitute for leadership. That means that the regulator will need to have the power and the self-confidence to say to a chief executive or a chairman of a bank, “Sorry, we’ve listened to your representations. You’ve brought your lawyers along. We’ve listened to all that lot. The lawyers can now go away, please. We will have a frank conversation with you.” Whether that is about the individuals running the institution or the overall level of capital, in the end the regulator has to make a judgment that it is in the interests of the UK for there to be a change, either in the personnel or in the levels of capital at the bank.

For the success of the regulatory regime, it is important that the rest of society—Parliament and others—is prepared to give that degree of support to the regulator. If not, I fear that when it comes down to a legal argument, with people bandying rules and regulations around, there will be only one winner, and that will be the banks, which will have far greater teams of lawyers, PR experts and others to pursue that. It has to be a question of integrity: the regulators have to be individuals in whom people have complete confidence. I am delighted that Andrew has been made chief executive of the PRA. I have worked with him very closely for a number of years, and he is exactly the right person to lead it. We have to have trust in the regulator to make that kind of judgment; it cannot just be that the regulator has to defend themselves in a court of law against people’s attempts to game the rules and regulations.

The second thing I would say goes back to what I said at the beginning. In my view, many of the failures of the system—things that people do not like—stem from the very simple point of having a system that relied, in many ways quite explicitly in the minds of those working in it, on an implicit taxpayer subsidy: “If things really go wrong, you’ll have to bail us out.” That explains the sound of anger I heard from those in the banking sector in 2007-08; they felt our job at the Bank of England was just to bail them out, irrespective of anything else. That cannot be right.

We need a regulatory regime that gets rid of this “too big to fail” problem. We have made real strides towards it. The new legislation will take us a long way. I hope it will be enough, but we cannot be entirely certain. That is why I put great weight on having a review after four or five years to see whether the UK really has resolved that problem. If we have not, we cannot hope to be an international financial centre. On a global level, if we fail to solve the “too big to fail” problem, there are only two countries in the world that will have big banking centres—the United States and China—because their economies are so big that their taxpayers can afford to bail out the system.
Q4596 Mr McFadden: So “too big to fail” is a greater problem for the UK because of the size of the banking sector?

Sir Mervyn King: Yes. We have real advantages in being an international banking and financial centre, and we should exploit those advantages. It is precisely because we have those advantages that it is crucial that we overcome the one area where we have a comparative disadvantage—we do not have big enough taxpayers to bail the system out. We have to resolve this problem. I think we can, but it is vital that that is seen as the main role of the PRA. Let Andrew and his colleagues focus absolutely on solving that problem first; do not burden them with too much else yet. Come back after four or five years and then see whether we need to make further changes.

Q4597 Mr McFadden: Thank you very much. Finally, Andrew, we might not have time to go into this much today because we are overrunning, but there is one area we wanted to ask you about. You may need to take it away and write to us, but you might be able to give us a quick response. Part of the anger that the public feel is around this issue of personal responsibility, skin in the game and so on. In our report, we will want to consider how to inject more personal responsibility for actions into the system, both at the level of the individual LIBOR trader and at the level of stewardship of the institution. I would be grateful for any help, advice or thoughts that you have on that.

Andrew Bailey: I will certainly do that.

Chair: Thank you very much for coming this morning, which has now just become this afternoon. We have learned a great deal, and we are extremely grateful. No doubt there will be further exchanges. It is the last appearance before the Commission for both of you, and I think your penultimate appearance before Parliament. We look forward to seeing you in June before the Treasury Committee.