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The future of EU financial regulation and supervision

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Written evidence

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Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON THE EUROPEAN UNION (SUB-COMMITTEE A)

TUESDAY 20 JANUARY 2009

Present	Browne of Madingley, L	Renton of Mount Harry, L
	Cohen of Pimlico, B (Chairman)	Steinberg, L
	Haskins, L	Watson of Richmond, L
	Hooper, B	

Examination of Witness

Witness: Mr Lee C Buchheit, Partner, Cleary Gottlieb Steen & Hamilton LLP, examined.

Q1 ***Chairman:*** Welcome to you, Professor Buchheit. Thank you very much for coming. We would hope not to keep you beyond ten-past 11 and we hope to wring a great deal of information out of you in that time. This session is being recorded. You will receive a copy of the transcript and of course asked to make any corrections you would like to make. If I may, as I have discussed, I will launch straight into our first key question. How do credit default swaps operate and what are they for?
Mr Buchheit: Thank you, my Lord Chairman, ladies and gentlemen. It is a pleasure to be with you. Let me launch straight into that. The credit default swap is a bilateral contract between two parties: the seller of the protection and the buyer of the protection. The seller promises essentially this: that if an event—called in the jargon a credit event: bankruptcy, debt restructuring, declaration of a moratorium—occurs in respect of a specific entity (it could be a corporate entity or a sovereign: the jargon is a reference entity) then the seller of the protection promises to buy, at face value typically, specific obligations issued by the entity (the jargon is deliverable obligations) at their face value. The buyer's obligation is to pay periodic payments, very much in the nature of an insurance premium, for this protection, and if the credit event occurs the buyer has the right to come to the seller, tender the deliverable obligations, and receive the full face value for them. It is, therefore, in many respects similar to an insurance policy: if your house burns down, I promise to pay you the value of the house. But there is a critical difference here and the difference is that in a credit default swap context there is no obligation on the part of the buyer of the protection—the insured, if you wish to carry that analogy further—to own the underlying paper, which is to say that the buyer of the insurance can simply take a speculative judgment that they believe that the reference entity will default or will go bankrupt. Under those circumstances, of course, the buyer would enter the market, purchase the deliverable obligations at that point, after the default, and of course the secondary market price of those obligations is presumptively very low, reflecting the fact that the default has occurred. So he can enter the market, buy at, say, 20 cents on the dollar and deliver it the next day for 100 cents on the dollar. That is basically a credit default swap. There are instances in which the parties may agree, in lieu of having the buyer deliver the underlying debt instruments, that they simply cash settle it, as they say—which is to say they make a determination as to what the value of those instruments would be had they been delivered, that value is netted out of what the seller has to pay in order to close out the position.

Q2 ***Chairman:*** Am I clear in my mind, as a buyer, that I can make, fundamentally, an insurance contract on a house that I do not own and claim at any time the insurance on this house that I do not own by going out and buying the house? Or have I darkened counsel?
Mr Buchheit: You have not. You may at any time buy the insurance. You may not call upon the insurance, however, unless and until one of the specified events has occurred. I do not want to carry this insurance analogy too far because the market participants dispute whether these really are insurance contracts and ought to be regulated as insurance contracts, but let us put it this way, my Lord Chairman: you will walk by the house and look at its condition every morning very carefully.

Q3 ***Lord Renton of Mount Harry:*** Before I ask you specifically how the CDS differ from other credit derivatives, could I say that 15 years ago I had been a non-executive director of a big bank for 10 years and in that time I never heard of a credit default swap. Why did they come about and how are they different?
Mr Buchheit: They are a recent innovation in financial markets. They came about because of a desire of market participants initially to hedge themselves against the risk of a default by a debtor whose paper they own. The alternative ways, going

back more than 15 years ago, to have achieved that sort of protection were to have bought a financial guarantee, perhaps a letter of credit, perhaps to have shorted the instruments in the market, but those methods were expensive and time-consuming, required individual negotiation, and so, once the credit default swap template began to evolve, it turned out to be much more liquid and the market embraced it very fast. Again the use of a credit default swap to hedge an existing exposure—as the homeowner insures their house—is one use of the instrument. The other is that it can be used simply to take a speculative bet, if you wish to view it that way, on the likelihood that the issuer of the debt instruments will get into trouble.

Q4 ***Lord Renton of Mount Harry:*** And there are other similar derivatives?
Mr Buchheit: Derivatives is a term that covers, to my mind, three different types of situations. In its earliest form, 1981, the derivatives evolved because people owned things and wished they owned something else. I own a fixed rate bond and what I would really like to have is a floating rate instrument, but rather than sell my bond and buy a floating rate instrument, I find someone else who would like to have a fixed rate stream of payments. He and I agree that if I give him my fixed rate, he will give me his floating rate. We each keep our underlying debt instruments and therefore do not have to sell them. The second type of derivative instrument are situations in which someone wants to own the economic risk of a debt instrument but not take legal title to it. A classic case—and this has been around a long time—is what are called sub-participations—which is the English English version; Americans call them participations sometimes. Essentially they are this: there is a lender who extends a loan to a borrower and someone comes along and says, "I am interested in having the economic risk of that loan but I do not want to lend money to the borrower, nor do I wish to take an assignment of a portion of your interest, so here is what we will do: I will pay you an amount of money now and you promise to give me, if, as, and when received, a certain percentage of whatever is paid by the borrower on that debt instrument." If you view it from the standpoint of the buyer of the sub-participation, he now has the economic risk but he is not in privity of contract with the underlying debtor, has no rights to enforce the debt instrument itself, but he has the economic risk. From the seller's standpoint, the seller has effectively disposed of a portion of the credit risk, and if, for example, the lender has a credit limit, that he can only lend up to a certain amount for this borrower, the disposition of a portion of his existing credit risk means that he can lend more money to that borrower. It is a very efficient technique. Over the years there have been other so-called derivatives that have the same effect, which is to convey economic risk without changing legal risk. There is something called a credit-link note. Think of it is as a kind of mirror image: I promise in a contract with you to make payments to you that are triggered by a borrower making payments on a certain debt instrument. In effect, put the debt instrument under a glass, and if, as, and when payments are made there—not necessarily to me, by the way, just payments made to someone, the borrower is performing—I will promise to make payments to you that correspond to those. There is also something called a total return swap: essentially where the seller says, "I will pay over to you everything that I receive under this debt instrument—interest payments, principal if it is paid—and if it goes into default I will pay you the liquidation value of it. I will sell it in the market and pay it to you, and in return for that you will pay me either something up front or you will pay me periodically over the life of the instrument." A variety of instruments, each designed to hit some appetite in the market for hedging or risk transfer.
Chairman: Lord Browne, I think you probably have the key question at this point.

Q5 ***Lord Browne of Madingley:*** Going back to credit default swaps, did they contribute to the financial crisis that we have today? If so, in what way?
Mr Buchheit: They contributed in this sense. First, they did not cause it, by any means. If you think about the risks of a credit default swap, the first risk is that the underlying borrower goes into default, and that is, of course, the risk that the seller takes. But there is a second risk. Many institutions that operate in this market will run what they call matched books, which is to say that they will not pay protection on a certain debtor without trying to buy corresponding—congruent is the theory—protection from someone else. Therefore, at any given time, the prospect that the underlying borrower may not perform has been hedged, because it is true they will pay out to their buyer but they will collect from their seller. The fly in the buttermilk as it relates to that scenario is one in which the institution for whom they have bought this offsetting protection itself goes bankrupt, and then you have a situation in which a matched book suddenly becomes unmatched. This was, of course, one of the consequences of the failure of Lehman or the failure of any large institution that does business in this. Even though you may have been scrupulous in ensuring that the sale and purchase of credit default swap protection was utterly congruent—congruent in terms of its term, the reference entity, the deliverable obligations, the credit events—that all of that contractual material was absolutely congruent—one morning you wake up to find that the seller to you had disappeared from the scene and therefore

you are now exposed on one side of the aspect. In a sovereign situation—and I should say that is mostly how I see this product—there is one further complicating factor. The seller of CDS protection on a corporate borrower knows that if the entity goes into bankruptcy the seller will now be a creditor of that entity but it knows in advance what the rules of the bankruptcy procedure are and it can predict its outcome. Not so for a sovereign entity. Sovereigns are not subject to anyone's bankruptcy code—not their own, not anyone else's—hence, if you sell protection on a sovereign borrower and the sovereign defaults, you do not really know what the restructuring or workout process will look like at this stage, and that adds a further complicating factor. One other thing I should say—and I see it in the sovereign field, but I think I see it because that is where I practise—if you think about what this has done in the financial markets, in the old days a creditor was a creditor and a creditor's only interest was to see that the borrower continues to service the loan. We now have a group of institutions who have directly opposite interests: the buyers of CDS protection where they do not own the underlying debt instrument. As a matter of fact, if anything their interests are in seeing that the debtor defaults. In the years of an unsophisticated sovereign debtor, this can create great confusion, because the minister of finance will hear from market participants, who are often viewed in a somewhat homogeneous way when you are a minister of finance, half of them saying, "Minister, it would be a very good thing if you did not make the payment next Tuesday". Why? "Because hundreds of millions of dollars will turn on the credit default swaps having been triggered and therefore the delivery taking place." That I regard as a perverse and unintended consequence of the product.

Q6 ***Lord Browne of Madingley:*** To come back to the present financial crisis, where I think the issue is much more at a corporate level.
Mr Buchheit: It is.

Q7 ***Lord Browne of Madingley:*** One can make the unmatching of books look terribly linear: it is just like cards that will go down one at a time. Was that the case? Could you describe more dynamically what happened in the present financial crisis?
Mr Buchheit: The CDS market operated well when the CDS were written on institutions. For example, Lehman failed. People would have written CDS protection on Lehman Brothers and the good news is that those trades settled with relative ease. Things were less happy when the CDS were written on special purpose vehicles that had issued the securitised interests in sub-prime mortgage, because you see that was the real cause of the problem. There had been—and I think mostly we acknowledge this now—a failure by the market to appreciate the risks of the sub-prime mortgage industry, the reason being that to predict the cash flow of a pooled group of debt instruments like mortgages, of course you have to do it retrospectively. You look at the history. All of mortgages below $200,000 originated in Phoenix, Arizona, and have over the last 20 years had a default rate of two per cent. It is that statistical prediction, almost an actuarial prediction, that then allows sponsors of these special purpose vehicles and the rating agencies to say—with some degree of confidence, they thought—"Well, all of this cash flow is coming in to a central point, the upper tranche, the senior instruments, will almost certainly be paid because there is an historic default rate of only two per cent." Based upon that, they could reach a prediction and price how the various interests in that pool of mortgages and the cash flow generated from it would come down. A couple of things happened. First, more or less in the middle of this, the standards for originating those loans degraded. Whereas it had been the practice in the past to ask borrowers to make a down payment, 20/25 per cent, in addition a borrower would be vetted based on their income and their ability to incur a mortgage would be conditional. As the market expanded and, frankly, as the real estate market was continually going up, bankers became more liberal in giving mortgages to people who would not have passed the test 10 or 20 years before. You may ask why, and the answer is, first: when the market is always going up I can lend 100 per cent of the value of the house today and next year it will be worth 110 per cent—if you believe in the linear movement of values. Second, unlike the old days, the very existence of widespread securitisation meant that the banker in the village or town no longer would be there 30 years later when the final payment came due. He would in fact sell the mortgage that he had originated yesterday, sell it to one of these intermediaries, who would repackage it, so that banker no longer had the credit risk. As long as people were prepared to buy those mortgages, he was prepared to originate them and sell them. The result was, therefore, that those misperceptions, if you wish to see it that way, of the underlying credit risk of the mortgages meant that the mortgage instruments themselves went into default at a higher rate than people had expected, but, also, people who had written credit default swap protection on those pools found themselves being presented, at a much higher rate than they thought, with the underlying debt instruments and having to pay out 100 cents on the dollar. This was particularly acute for institutions like Bernstein and AIG which had been very active in that market. It did contribute significantly to their troubles.

Q8 ***Lord Watson of Richmond:*** I suspect we are coming to the nub of it now really. You used a vivid phrase: "the fly in the buttermilk". Are we not

looking at quite a small swarm of flies, in effect, and two of them, perhaps, are Greed and Dishonesty? The nub of the thing is the desire to repackage and sell on risk. In the repackaging and selling on of risk you can say there is an assumption of an inevitability of growth or you can describe it as greed, but the fact is that these products were sold on without proper explanation and we now know that the people who were the recipients, some of the large institutions, had not the faintest idea what they were buying. They were talking about having to debundle and unwrap these things to find out the degree of their exposure. I would be very interested, and I am sure the Committee would be, to hear how people in institutions of such supposed expertise could get into this mess.
Mr Buchheit: That is a very good question.

Q9 ***Chairman:*** Against that background, it is an excellent question and one for which we barely have time, so if we could have a shortish answer that would be great.
Mr Buchheit: Yes, my Lord Chairman. I believe that the markets have reached a point when the complexity in the innovation of financial products, complexity often accompanied by a rapacity in the description of those instruments to prospective investors, has reached a point where the boards of directors of the institutions that are issuing or sponsoring these may have only a dim view of precisely what it is they do and what the risks are. I sometimes believe that the authors may only have a dim view, and I am morally certain that many of the buyers rely on either a rating agency to analyse the risks and they simply look at the rating and say, "Well, those folks know what they are doing," or sometimes they will rely on the fact that the house that has originated the product is of such good reputation and calibre that of course they would not put something into the market that had any sort of structural flaw, or sometimes they will say, "Gosh, why are all these others supposedly sophisticated people buying it if it is not a good bet?" In this I think both the financial community and I must say the legal community have not behaved in a wholly creditable way. It seems to me that the basic proposition always should be for every investor that you should understand and be able to understand what risk you are taking. The lawyers need to draft the underlying contract so that those risks can be perceived by sophisticated observers, such as rating agencies, and they need to prepare the disclosure in such a way that the average investor can, with a perusal of the offering circular, determine what the risks are and so forth. I have some sympathy for the sentiments that you have expressed.
Chairman: I think this takes me to Lady Hooper and regulation.

Q10 ***Baroness Hooper:*** You have already, in replying to Lord Browne, identified some of the risks. Perhaps you would elaborate. Presumably the risks you have identified are the major risks but are there others? Are they being regulated anywhere in the world? Perhaps I might add: who is responsible for identifying the risk? You have referred to regular risks being the responsibility of a board of directors in a company, and presumably that is still the case here, or is there any agency other than the rating agency who bears responsibility in this?
Mr Buchheit: Let me first focus on the CDS component. CDS, to the extent that they are products written or purchased by regulated institutions, will have a degree of regulation in the normal supervisory sense. One of the most useful aspects of that is the posting of collateral as a counterparty's credit. Remember the buyer of the product is taking the credit risk of the seller, so if the seller begins to get into trouble and it looks as though they may not be there to be able to honour their contract, then margin or collateral can be called for, and that tends to mitigate the risk that if the CDS is triggered the seller will not be able to make good on it. In addition, the CDS market has become so popular so fast that there is a perceived need to have a central clearing system in which these trades can be lodged, so that, in the event that a market participant disappears, you do not have a shrinking void with what I have described as the uncovered or broken match to the chains. Work on developing a clearing agency is going on quite extensively and I think it will help the market operate in a much more fluid way. The rest of your questions really went to this question of financial instruments generally and who bears the responsibility. Certainly the board of directors of the institution does, but also their regulators. But the same problem afflicts many of them, which is to say that it is possible to design an instrument in a way that is so complicated that determining what its risks are and in what circumstances it could pose a material threat to the institution that has issued it becomes very difficult. Innovation happens so fast. You have to understand the very nature of regulation: as soon as a regulation is written, a lot of clever people out there will find a way to . . . . I do not say get around it, but find a way to deal with it. My perception often is that those who write regulations, in the same way as those who write tax codes, are very much trying to shut the barn door after the horse has won the Kentucky Derby.

Q11 ***Baroness Hooper:*** We cannot say that in any country in the world this particular nettle has been grasped in a way that might provide an example for us.

Mr Buchheit: Not yet that I am aware of. I can tell you it is being actively worked on in the United States. The institutions that I think were most effective were the monoline insurers and institutions like AIG, where there was no collateral posted for their obligations and they wrote a very large number of protections on these instruments and when the instruments failed they had to make good on them.
Chairman: I guess really to the question of whether greater regulation is needed the answer is yes. Lord Watson, on that basis perhaps I could skip to you asking about the European Union.

Q12 ***Lord Watson of Richmond:*** You have said that there is evidence of real work being done on this now in the States. You presumably have seen some of the proposals that are around in the sense of the European Union taking action. I think the question really is whether you think that sort of level of authority is the appropriate one for trying to deal with this or is there a better level. Also implicit in it, I think, is the question of whether it makes sense to try to approach this on a regional basis (that is, so that the EU has one set of regulations, the US another set of regulations, Asia Pacific another set of regulations) or should we seek to deal with it globally somehow?
Mr Buchheit: With your permission, I would offer two answers. First, I would distinguish between these proposals to put together clearing arrangements which I think are probably best done on as broad a basis as you can.

Q13 ***Lord Watson of Richmond:*** In that, you would favour an EU—
Mr Buchheit: Indeed, if possible I would favour a central clearing agency that would cover both the United States and the EU. In terms of the regulation, I think this might be sensible for regional regulation, in part for this reason: when these products are triggered and when people have to adjust their positions, they need to deal with the insolvency laws in many different countries and we have seen situations where those insolvency laws can be very different, producing very different outcomes. That would make obviously a centralised clearing arrangement much more difficult to administer, because you would have to be constantly thinking about what are the insolvency arrangements in each of the countries where issuers of this paper might be located.

Q14 ***Lord Watson of Richmond:*** Are you implying, therefore, that you have to get that right before meaningfully you could have a clearing agency agreement?
Mr Buchheit: I think it would facilitate a meaningful clearing agency. If you did not get it right, you would probably find some reluctance on the part of the United States participants to be joining that global arrangement.
Chairman: I am going to ask Lord Steinberg to ask his question. This is one to which we are all dying to know the answer.

Q15 ***Lord Steinberg:*** You have mentioned a number of times about Lehman Brothers. One of the things that has rather puzzled me is how governments decide who is going to be helped and who is going to be cast aside. There is no doubt, whether it was right or wrong, that Lehman Brothers seemed to be a catalyst for the onset of the problems with which we are now faced. Undoubtedly, we all agree that better and further regulation is required, but had Lehman Brothers been saved—and I would like to know whether you think it should have been saved—might we then be faced with a different kind of approach from governments around the world who appear—and I only say appear—to choose who they are going to let fall and who they are going to support?
Mr Buchheit: It seems to me that the fundamental principle of a capitalist system is that within the constraints of the law, and regulation if it is a regulated entity, every enterprise is free to pursue its affairs as it sees fit. No one guarantees that you will not fail, but by the same token no one places any artificial constraints on your ability to succeed. The sanction that capitalism imposes on imprudence, incompetence, sometimes just bad luck, is failure. It is the brooding presence of that sanction that keeps managers on their toes, that keeps them acting in a prudent way, and, moreover, keeps the counterparties with whom they do business from constantly assessing just how they are doing in the management of their institutions. The moment that one says that there are systemically important institutions in critically important industries—and finance certainly is that—for which this remorseless sanction of capitalism may not be applied because public funds will come in, in effect to keep them afloat—and I am not saying it is necessarily a bad thing, it is just that one has to realise that it is a warping of the normal regime: no corner grocery store is going to receive that sort of assistance—you must confront the fact that any decision to assist such an institution will inevitably have consequences. Managers of similar institutions who believe that they are too big or too interconnected to fail may approach the abyss a little closer than they would without a safety net. I have never stood on a tightwire, but I imagine I would be more nervous if there were not a safety net underneath it. Similarly, counterparties would look at that institution and say, "Well, I am prepared to take more risk with them than I might otherwise have

done, because I perceive a safety net underneath them when the time comes." The use of public funds to rescue—which I think is the more polite term—these institutions is a serious decision. In my experience, and it is limited to the United States, the regulators do not take it lightly and they never wish to be put in that position. This is an odious position for a regulator to be put in. Their preferred solution is to encourage the institution to retrench its activities, to sell its assets, to merge, and this was done in Lehman. For whatever reasons, the management of Lehman did not pursue those more limited solutions that might have kept the thing from coming to the final abyss. Certainly the regulators did not wish to be confronted with the "either rescue us or we go into bankruptcy" type of decision, but they were put in that position, and they had to make a decision. I will not speak for the motivations of the decision makers, but they concluded in the case of Lehman that the appropriate course—and there was some justification for this by other market participants—the best course—not a good course but the best of what remained—was to allow certain components of the Lehman empire to go into Chapter 11. But, interestingly, the broker-dealer did not, and over the course of the next three or four days many of the broker-dealer assets and many of its liabilities were assumed by Barclays Capital, and so the kind of markets merger that they had hoped might occur before they reached that point occurred for a portion of the Lehman empire not too soon after.

Lord Steinberg: I have a very quick supplementary, if I may. The comparison between Lehman Brothers in the United States, where its management was very heavily criticised, and the Royal Bank of Scotland here in Britain which has also been very heavily criticised by making a number of bad decisions, what do you think prompted the British Government to save the Royal Bank of Scotland and Lehman Brothers to be allowed to go?

Chairman: Could I edit that question a little.

Lord Steinberg: Of course you can.

Q16 ***Chairman:*** Because I absolutely need to ask Professor Buchheit about what any of this shows about the need for further regulation in the financial markets.

Mr Buchheit: My Lord Chairman, I could not answer that question, merely because I do not know what was in the minds of the British Government.

Lord Steinberg: That is a quick answer. Thank you very much.

Q17 ***Chairman:*** Can we ask, to wind up, what could have been done differently if the regulators had got on to it? What regulation would have helped that situation?

Mr Buchheit: The fundamental problem was a failure to understand and appreciate the risks of this particular type of financial instrument: securitised sub-prime mortgages. That failure was widespread. I tried to give my view of why it occurred. It occurred because the retrospective nature of an analysis of that kind of product when the predicates, the loan origination standards, change, is no longer applicable, and people failed to understand that. They also failed, I believe, fundamentally to understand that there is a degree of interrelatedness in these products so that, to take a pedestrian example, if the mortgage on the house in the middle of the street is foreclosed and no one cuts the grass and no one paints the house, it will have a depressing effect on real estate values for the whole block, and therefore you can find yourself almost in a spiral. It cannot be attributed to securitisation as a financial technique or to credit default swaps as a financial technique: it is a failure to appreciate the underlying risks. It was aggravated, if you wish, by credit default swaps because they are a relatively cheap way of buying risk: you do not have to buy the instrument, you just have to make your equivalent of a premium payment and you have got the risk. If you have misanalysed, mispriced the risk, credit default swaps are a very tempting way in which you can take that risk and compound the consequences of your ignorance.

Q18 ***Lord Haskins:*** Is it not clear that, because of the failure, of the system even if regulators are going to come in and solve the problem, after the horse has bolted, people will not do this again for the next 10 or 15 years.

Mr Buchheit: One expects so.

Q19 ***Lord Renton of Mount Harry:*** That is the key question: what do you expect to happen in the States now?

Mr Buchheit: I expect there will be regulation. We have no shortage of regulators—we have an almost viral ability to expand them—but their jurisdictions are sometimes overlapping, sometimes there are portions that are not covered at all. You can find a situation in which an institution is not wholly regulated by any one regulator and that causes blind spots for all of them. I expect that they will try to address that, that there will be, how shall I say it, a concentration of regulatory authority or certain types of institutions.

Chairman: Thank you very much, Professor Buchheit. I am going to have to stop the Committee. We could easily ask you to stay for the morning but it has been very kind of you to come at all.

Examination of Witness

Witness: Mr Marke Raines, Partner and Head of Securitisation, Taylor Wessing LLP, examined.

Q20 ***Chairman:*** Welcome Mr Raines. We are broadcasting and we will provide you with a transcript of your answers so that you can have a look at them and decide whether they came out right. How has the practice of securitisation contributed to the recent financial crisis? Was the problem securitisation itself or its misuse? Did the crisis indicate that we did not have enough regulation?

Mr Raines: The short answer—and let me preface this by saying that I express my own views and not those of my firm or my clients—is that securitisation as a technique is a very old one: it goes back hundreds of years in Europe and it has been promoted by the legislation of Member States since the late 1980s. In itself it is an excellent technique. It helps to provide capital markets funding where it might not otherwise be available or funding at rates and maturities not otherwise available. Its role in the current financial crisis, I think, arises largely out of the immense volume of securitisation. The US structured finance market, I read recently, is estimated at $6 trillion, and these are several hundred billion euro outstanding of bonds backed by European assets. Many of these instruments, as the previous speaker will have noted, are the subject of credit default swaps, which serve not only to transfer credit risk but to multiply credit risk; in other words, several participants can purchase risk in the same underlying credit instrument. The unbelievable volume—to me unbelievable—of securitisation paper was encouraged and accelerated by Basel II. Its ratings-driven requirements effectively allowed a bank that under Basel I would have put €8 of capital against a particular bond worth €100 to now put €8 of capital against bonds worth €500. Yes, very much the practice of securitisation was a contributing factor, but that does not go to the technique itself. These are macro problems and, as I am sure we will come on to, problems of behaviour within the market. The third element of your question, I think, was regulation.

Q21 ***Chairman:*** Yes, was regulation inadequate?

Mr Raines: I think that the principal way in which regulation was inadequate was in the incorporation of ratings directly into the legal obligations of banks to determine capital requirements. Under Basel II, any bond rated AA- or better issued by a corporate attracts only a 20 per cent risk weighting. That presents a tremendous incentive to construct—and I use that word advisedly—triple-A credit. Out of almost anything you could imagine, it is astonishing what was repackaged into bonds that achieved a triple-A rating.

Q22 ***Chairman:*** So there was a failure in regulation.

Mr Raines: There was a failure in the quality of the regulation, I think. There were failures, I hasten to add, in many constituencies. There was what I would loosely call a moral failure that certainly you can impute to lawyers, to banks, to regulators, and possibly to accountants.

Q23 ***Lord Browne of Madingley:*** Can you go back—because you have said it once but I would like to do it one more time—to the changes between Basel I and Basel II and whether or not this opened up a weakness; for example, if we were at Basel I would we have been better off or worse off?

Mr Raines: Better off, in my view.

Q24 ***Lord Browne of Madingley:*** Perhaps you could take us through this one more time.

Mr Raines: Under Basel I the minimum requirement of capital that a bank needed to set against its assets would be eight per cent. The important factor is not the eight per cent; the important factor is what we call the risk weighting of the assets against which the eight per cent has to be set. Under Basel I an ordinary corporate debt of €100 would have a risk weighting of 100 per cent. Therefore €8 of capital would be set against the €100 asset and if the bank wanted to advance more funds, it had to set eight per cent capital against the new advance. There were other risk weightings. A loan to another OECD bank would attract a risk weighting of 20 per cent. A loan secured ultimately by mortgages on residential property attracted a 50 per cent risk weighting. There is more, but that was Basel I in a nutshell. Under Basel II, with a view to implementing a more risk-sensitive and, I think, efficient method of determining how much capital needed to be set against these risk-weighted assets, two alternatives were offered to banks. One, taken up by a sophisticated minority of large banks, is the internal ratings based (IRB) approach, which I will not deal with here. The standard ratings-based approach is much more common and I think that has helped to fuel the current crisis. That ratings-based approach is what it sounds like. There are tables which will show different categories of assets, referenced by the nature of the obligor and the rating of the obligation. To take an ordinary corporate—and here I am talking about a corporate issuer of a bond in the context of this crisis and in the context of securitisation—if the bond is rated AA- or better, it will attract a 20 per cent risk weighting; if it is single A, it will attract 50 per cent; and if it is BBB or down to BB, it is 100 per cent risk-weighted—which is interesting—150 per cent if it is BB; and 150 per cent if it is CCC+ or below. You can see that, if you are a bank that is going to purchase assets such as bonds or take other exposure to corporate credit, the rating suddenly assumes a tremendous significance. There is no question that that accelerated the growth of the more complex financial instruments. At the height of the market frenzy, just before the crash (if I might call it that) banks looked to the spread over cost of funds and to the rating of a new bond. They frequently did not have time to look at anything else because if they did not make the purchase then another bank would. The transaction was dealt with on one phone call.

Q25 ***Lord Browne of Madingley:*** Without wishing to lead you, is this a case of regulations being too sophisticated and maybe simpler would be better?
Mr Raines: I think it depends on the quality of the regulation but I believe the short answer is yes. Yes, I think simpler tends to be better and I do not believe that principals-based regulation for the FSA is a conceptual failure. I think it is the quality of the regulation that is important. There is little question that the participants in Basel II undertook this exercise to the best of their abilities, but when you want to undertake a wholesale amendment of the regulatory infrastructure of credit institutions, a lot of thought needs to be given. At the risk of being too topical, I would note formally and with approval the words of the President of the Czech Republic Mr Klaus, currently the President of the EU, who in the context of this crisis wrote in the *Financial Times* on 7 January that it is important to differentiate between fighting the fire and drafting fire protection legislation, and it is best to do the second later, without haste and panic. It is easy for me to criticise the proposed EU regulation on the rating agencies and it is easy for me to criticise the proposed new paragraph 122a the Capital Requirements Directive in relation to securitisation, but my private fear is that we will not have an opportunity to think this through. Unfortunately, we will have to let some of these terrible events unfold in order that we can better determine what needs to be done not least, because some of the key players may not be with us a year from now.

Q26 ***Chairman:*** There is a supplementary on this question. Basel II only came into operation in January 2008, did it not?
Mr Raines: The deadline set by the Commission was 1 January 2007 for most of it, with 1 January 2008 for some of the more complex elements. The FSA implemented it in October 2006.

Q27 ***Lord Haskins:*** Did that make a change in that short period? Did it change the situation?
Mr Raines: It was long anticipated and I think that it would have had some effect for more than the 18 months period ending in the summer of 2007. That is a guess from a market participant, and not a considered study.

Q28 ***Lord Renton of Mount Harry:*** It rather spread in a moment of optimism, did it not?
Mr Raines: Yes.

Q29 ***Lord Renton of Mount Harry:*** I mean, at the moment when the opposite might have been more appropriate.
Mr Raines: Yes, there was astonishing liquidity in the markets. Money was freely available. A little over a fortnight ago BNP Paribas launched what is called a covered bond. That essentially is a residential mortgage securitisation where the originator bank guarantees the bond. I believe that the spread over mid-swaps was 110 basis points, which is 1.1 percentage point. When that sort of a bond was issued by BNP Paribas two years ago, the spread was two basis points. That is a 5,500 per cent increase in the credit margin, if you like.

Q30 ***Lord Steinberg:*** Do you regard that as being circumspect?
Mr Raines: No. I suppose the narrow point is that risk premium for borrowed money using these techniques was exceedingly thin. There was too much money available. There were a number of problems that were apparent well before the market turning point in mid 2007. The Bank of England Financial Stability report in the summer of 2006 warned, as I recall, about the mismatch between bank lending and bank deposits. I am not sure who noticed at the time.

Q31 ***Chairman:*** The thing that you have said that rings the most bells with me is that everybody got wildly excited.
Mr Raines: Yes.

Q32 ***Chairman:*** And maybe Basel I and Basel II did not have that much necessarily to do with it.
Mr Raines: I would not want to be taken as suggesting that Basel II was the main force behind this, but Basel II was talked about constantly, is talked about constantly, and helped to drive the expansion of credit and the structuring process for many of the problematic bonds. There were many factors in the development of this crisis. Fair-value accounting must have been a significant exacerbating factor.

Q33 ***Lord Renton of Mount Harry:*** Can I switch to the Capital Requirements Directive. As you will know, an amendment is requiring the originators to retain a material share of risk that is not less than five per cent of the total. In your judgment, is that going to work? Is it going to be really helpful? What will it do for the future?

Mr Raines: Having looked at the draft new regulation, the five per cent rule is only one part of it. There are other clauses which go to disclosure, conditions to investing and reporting. Those are remarkable in their detail and, on a first read, struck me as being quite onerous. The five per cent seems to apply to the originator bank or even a bank selling to another bank. It is not at all clear to me that this does not apply outside the context of securitisation; where, say, banks are selling books of mortgage loans to other banks, as they have done in the "whole loan sales" market. This whole loan trading market has been very active until recently. It seems that any bank, has to retain five per cent of the portfolio with the same risk profile of what it has sold on. The risk profile that a bank sells to a securitisation structure is going to be reconstituted on reconstructed, so I assume the rule must relate to the gross risk profile; the raw risk profile. I suppose that might be accomplished by applying the usual eligibility criteria to design a particular pool of securitisable assets and then retain five per cent—something like that. I am not sure that the five per cent requirement by itself would stop securitisation. However, I do not like to see property rights intruded on to the extent that a bank is told that it cannot sell; that has to keep an asset—and not only does the bank have to keep it but it also has to keep it for as long as the bonds are outstanding. I do not like that at all.

Q34 ***Lord Renton of Mount Harry:*** I do not want to put words into your mouth but is it that the Capital Requirements Directive is either too detailed or not detailed enough? Is it really going to help in the future? Do you think it is more likely than not to stop a further crisis of the same sort as we have at the moment?

Mr Raines: It might to some extent stop a crisis like this one, possibly by dampening, or discouraging the use of a popular financing technique, but the financing need, will be satisfied elsewhere.

Q35 ***Lord Renton of Mount Harry:*** You are very hesitant.

Mr Raines: I would rather ask if we could not rephrase the question to whether we need more detailed regulation or less. I reiterate that I think it is the quality of the regulation that matters more than the level of detail. There is no shortage of antifraud legislation in the United States of America, but look at what happened with the sub-prime mortgage market. Beyond belief.

Q36 ***Lord Renton of Mount Harry:*** Could this sort of regulation be implemented on an EU basis rather than a national basis?

Mr Raines: Can this be implemented on an EU basis?

Q37 ***Lord Renton of Mount Harry:*** Yes, can it work for 27 countries?

Mr Raines: I think it will be difficult. You can make most things work if you have to: the question is how well it will work. In my view, it is less a question of stopping a future catastrophe of this nature than it is avoiding systemic collapse. If we can avoid systemic collapse, we can then worry about what we might do with what we have left.

Q38 ***Lord Renton of Mount Harry:*** Which it might do: avoid the systemic collapse.

Mr Raines: I do not think this regulation will avoid systemic collapse. I do not see how it could.

Chairman: Against that wonderfully cheery background, Lord Watson, would you like to ask your question.

Q39 ***Lord Watson of Richmond:*** Filled with optimism, this. Could I preface the question I want to put to you by observing that you quoted the Czech head of government, which I thought was rather telling, that we have to distinguish between fighting the fire and writing future fire regulations. The pressure on politicians and governments, given the nature of this appalling crisis is that they really have to do both those things at the same time. They have to come forward with regulations because that is what governments do. In that context, how careful do we have to be at an EU level? For example, if we go ahead with that Directive, could that encourage financial institutions to try to avoid the regulations by relocating elsewhere? Do you trigger a whole process of avoidance simply because you put forward the regulation? To put the question around another way: If you were advising the European Commission on this matter and you said to them, "Of course you have to do something, because that is the nature of political reality, and given the fact that you have to do something, this is what I think you should do."

Mr Raines: You are asking me to be constructive.

Lord Watson of Richmond: I am tempting you, yes.

Q40 ***Chairman:*** We are also asking you whether one of the great expressed worries about this regulation, that all our financial institutions will relocate elsewhere, is a real worry or are we fussing?

Mr Raines: I think there is a real risk that certain financial institutions would try to relocate their activities elsewhere. In my experience, they are sensitive to regulatory constraints and they are mobile. Today they are quite mobile.

Q41 ***Lord Watson of Richmond:*** But they may be faced with rather similar regulations or equivalent regulations in the States.
Mr Raines: That is absolutely true.

Q42 ***Lord Watson of Richmond:*** Where do they run off to?
Mr Raines: You are asking me, I think, what would I advise the European Commission to do, and you are also warning that it is not helpful politically to say it would be best for the Commission to wait and see what develops before it acts. I suppose my advice would be—in the case of the rating agencies most certainly—to reduce what appears to me to be a fairly comprehensive suite of regulatory provisions down to two or three essentials: avoidance of conflict of interest and one or two others. The draft regulation does not make for easy reading and it is prefaced by something like 38 recitals. It plainly was drafted at speed. It could be substantially reduced. The Commission could decide which provisions really matter. You cannot legislate the quality of ratings. The Commission want to improve the quality of, and public confidence in, credit ratings. I would drop that.

Q43 ***Lord Watson of Richmond:*** We were asking the previous witness, Mr Buccheit—and this is in the context obviously of CDS—where he thought the priority should lie and he answered rather clearly that he thought the priority was the establishment of the clearing agency, and that that ought, if possible, to embrace both the European Union and the United States, and that that should precede regulation, because regulation would not be feasible, or co-operation certainly across the Atlantic would not be feasible, unless you evened out the clearing agency side of it.
Mr Raines: Comments went primarily to credit default swaps.

Q44 ***Lord Watson of Richmond:*** Yes, it was all about the CDS. This is different, I know, but I am just wondering whether, in terms of where you start this process.
Mr Raines: Most of the initiating in the swaps market are industry-driven. The regulators obviously are involved but the International Swaps and Derivates Association are driving the CDS clearing initiatives. I mentioned the multiplying effect of these credit default swaps: there have been tremendous efforts, and achievements, over the past few months at collectively netting out these various obligations and reducing this bubble. I see that as a parallel path led by the industry and not as a supervisor/regulatory led path. The narrow point, however, is that, even if the President of the Czech Republic is correct, it may be that regulators cannot do that. They have to do something now and be seen to do something now. The Commission have proposed the regulation in relation to the rating agencies and the Americans are licensing and regulating the rating agencies. The Commission have to do that.to use a light touch and decide what is really important and achievable. Do not try to regulate the entire process. I suggest that conflict of interest probably is the point to address.

Q45 ***Lord Haskins:*** I think what has come out of this inquiry already is the point you have made several times, a point with which I have a lot of sympathy as an ex supervisor regulator: Do not knee-jerk react. If something must be done, it could end up with awful consequences. The second assumption I think which is coming through is that mainly this is a failure of corporate governance, mainly this is a failure of boards. Then, if you talk to the directors of those banks they would say, "Well of course we were not very sure but we looked at the rating agencies and they reassured us, and therefore it was okay." What they omitted to say, of course, was that the organisation in question were paying those rating agencies to do this job—the conflict of interest issue. It seems that there is a case for regulation of rating agencies. As you have said the EU and the US are both at this. Is it possible to create an independent rating agency which would satisfy the concerns of directors of banking boards?
Mr Raines: I think politically something probably needs to be done, realistically at the European Union level, in relation to the rating agencies, if only because it has happened and it is happening in the US. I can only suggest that you address at the European level what I would call the moral risk rather than the technical risk. The rating agencies will get it wrong in the future, as one does, but the Commission could try to ensure that the rating agencies appear to have very, very clean hands in terms of conflicts of interest.

Q46 ***Lord Watson of Richmond:*** You said that "at the peak of the frenzy"—a vivid phrase—a banker had minutes, in effect, to buy what he or she was being offered because they knew that if they did not buy, the next banker would.
Mr Raines: So I am told.

Q47 ***Lord Watson of Richmond:*** In that environment, is there anything that regulation could have achieved which would have meant that the banker, instead of saying yes, might have picked up another telephone and ascertained the nature of the risk more reliably?
Mr Raines: I suppose when you look at the proposed section 122a—which may have been on your mind when you put the question to me—would that have given the gentleman or the lady—

Q48 ***Lord Watson of Richmond:*** Cause for pause.
Mr Raines: The answer to that must be yes. Of course it would have done. I suppose if I phrase the rhetorical question: "Do they have to be told to do that by a regulator?" your answer will be: "Well, they were not told and they did not do it." I think the worry that I have with this, is that it strikes me at first impression as a very detailed and onerous regulation. I wonder whether problems of corporate governance will not just find another place to surface. We do tend to try to work round regulations. We call that compliance! And the more detailed the regulation, the easier it is, as a rule, to find a way through it.
Lord Haskins: The non executive directors of the Royal Bank of Scotland when faced by ABN-AMRO—and they had several months to think about it, this was not a snap decision—had plenty of time to ask questions of the executives and to turn to the regulators as to the quality of the business which was being bought.
Chairman: That is what a feeding frenzy does, presumably.

Q49 ***Lord Browne of Madingley:*** I think I understand your viewpoint but I just want to ask you if you can reconcile the question of regulatory capital and its use against ratings which are conducted in a commercial way—as you say, a light touch—only to avoid conflicts of interest—the moral issue. Would you suggest that therefore ratings are not used in consideration of regulatory capital?
Mr Raines: If we have to accept Basel II's ratings-based approach for most banks, I think there probably needs to be some kind of get-out, a refinement that would allow banks to depart from that. There may already be in the regulation—that I simply have not studied in detail because I am not a financial services regulatory lawyer—an overriding duty on banking to satisfy themselves as to the risks and ascertain whether they have set enough capital against them. More generally, the Commission might consider a temporary suspension of certain reduced risk weightings for certain classes of assets. But I am afraid that once the Commission have embarked on the path of making a rating agency part of the law, on capital adequacy probably it is a matter of time until the Commission license these institutions and, whatever I say or you recommend, until the Commission regulate them in a fairly detailed way. I would like to be of more help but for now, I suppose all I can say is that you should recommend a light touch. The risk of getting it wrong is significant.
Chairman: Thank you. Lady Hooper you have a sweep up question.

Q50 ***Baroness Hooper:*** It is really crystal ball time. Would you like to suggest any further areas where European initiatives might help to prevent another financial crisis?
Mr Raines: The word "initiatives" is emotive. I have to reiterate what I said earlier: I do not think it is the time to worry about another future financial crisis. I worry very much about this financial crisis. If you were right now to look into a crystal ball, you would be looking at a different world.
Chairman: Thank you. I am sure that is a very sensible and perceptive answer. Thank you very much.

TUESDAY 27 JANUARY 2009

Present		
	Cohen of Pimlico, B (Chairman)	Renton of Mount Harry, L
	Haskins, L	Steinberg, L
	Hooper, B	Trimble, L
	Jordan, L	Woolmer of Leeds, L
	Northover, B	

Examination of Witnesses

Witnesses: Lord Myners, a Member of the House, Financial Services Secretary and Government Spokesman, and Mr Clive Maxwell, Director for Financial Stability, HM Treasury, examined.

Q51 ***Chairman:*** Minister, welcome to this meeting of Sub-Committee A of the European Union Committee. We thank you very much for coming, particularly on what I know to be a very difficult day, since I know perfectly well that you were up finishing the Banking Bill at 2.30 this morning. Can I just make a few preliminary points? You have in front of you a list of the interests of this Committee, which I would like to record, as it were, so that we can read it into the record. You can see what we all do as well as being in the House of Lords. The session is on the record, it is being recorded for a web-cast, so please speak into the microphones. You will get a transcript of what is said during the session. I would also like to welcome your colleague. Could I ask you to introduce yourself so that we can read you into the record as well?
Mr Maxwell: Yes, my name is Clive Maxwell; I am the director responsible for financial stability in the Treasury.

Q52 ***Chairman:*** Thank you very much, Mr Maxwell. I hope, Lord Myners, that we can keep you with us until somewhere near half past eleven, but please let me know if you have to go before then. If I may, I will lead off with the first question. Does the financial crisis show the need for reform of financial supervision and, specifically, since we are an EU committee, is there a need for an EU wide supervisory body?
Lord Myners: Lord Chairman, good morning. Thank you very much for inviting Mr Maxwell and myself to join you this morning. My time is at your disposal. I would like to ensure that you are able to complete your work, and I am not, therefore, working to any deadline, but it was very kind of you to offer me that facility should I want it. There are many lessons to be learned from the financial crisis, in particular it has heightened the need to ensure that we have the right regime for capital adequacy for our banks and to look again at issues around accounting, liquidity, the role of the rating agency. It has also shown the importance of getting the rules right at the international level. The Government is, therefore, working with the Financial Stability Forum and the G20 to ensure progress towards better rules. There is also a need to establish a global early warning system to analyse risks, vulnerabilities, cross-border distress and spill-overs across markets. It has become very clear during this global crisis that the interdependencies and interactions between different types of financial institutions and different geographies are significantly more complex than had been appreciated by many people in the past.

Q53 ***Chairman:*** Your colleague, Lord Turner, was here as Chairman of the FSA and, when being asked about European Union supervision, he said that he thought a European wide financial supervisor was impossible because, as it were, he had no teeth or, rather, he had no pockets. While it was only Member States who retained the ability to bail out banks, he said you could not realistically expect an EU wide financial supervisor because we had no EU wide mechanism for bailing out banks? Do you share this view or do you think something different can be done?
Lord Myners: I think it is a legitimate area of inquiry, quite frankly, given what has happened, and I think we should be open-minded about all options in terms of trying to find an architecture in which the risks of the type of situation we are currently confronting can never be experienced again. Lord Saatchi, in the Banking Bill committee stage last night, set that as a goal. Whether that is a reasonable goal, I do not know. I think a zero failure objective would come at quite considerable cost in terms of economic efficiency, but I think the opportunity to examine new forms of co-operation is one that we should respond to positively. The financial crisis has demonstrated the need to improve cross-border co-operation, and that is one of the reasons why this Government has proposed supervisory colleges. Colleges will bring together supervisors of a firm to discuss and exchange information and, therefore, improve their understanding of the risks that individual firms face. Crucially, they allow for third countries to be present, but they preserve national accountability. We have also actively taken part in the discussions to reform

the Lamfalussy Level Three Committees. In particular, committees now have incorporated qualified majority voting into their charters coupled with comply or explain procedures. The UK is strongly supportive of improvements to enhance their efficiency. There has been talk of creating a single EU supervisor to better supervise cross-border EU financial institutions. Those who take that position argue that such a body could improve supervision by allowing for better understanding of a firm's EU operations and by applying a single set of rules and a single approach to the firm's EU entities. However, it is not at all clear at this stage that a single EU supervisory body would have made a difference in this crisis, in particular the mis-selling and mis-pricing of loans in the United States and their conversion into securities and their onward sale. Further, the UK has always been concerned that any proposal for a single EU supervisor would need to overcome a number of issues. Firstly concerning accountability, where the crisis has demonstrated the importance of national finance ministries and national central banks. In the absence of such accountability, it could make a crisis much harder to manage or resolve. Secondly, there is the issue of third countries, as the largest banks are global, not simply European. Therefore, solutions to improve supervision of cross-border firms need to encourage supervisory co-operation with, for instance, US and Swiss regulators, and a single EU supervisor would not in itself address that issue. The third and final reservation concerns the loss of regulatory diversity, where a single European supervisory body eliminates the opportunity for national supervisors to learn from each other, including, I would say, from each other's mistakes.

Q54 ***Chairman:*** Can I ask what you feel about the recent proposal from the ECB that the ECB should have a role?
Lord Myners: I am not at all convinced that the ECB has the necessary skills in place to become a regulatory body.

Q55 ***Baroness Hooper:*** Is it not true that the FSA itself has had difficulties bringing together the different strands of its responsibility and the different organisations which are now under its roof over the last 10 years? Is this not, therefore, a really practical difficulty to getting a rapid reaction from a much wider body as well as the lack of pockets that Lady Cohen referred to?
Lord Myners: I would agree with the noble Baroness. The issue of managing scale and complexity has been at the heart of some of the challenges that individual banks and financial institutions have faced. Citibank, for instance, has acknowledged that the breadth of its operations, bi-functionality and geography and the sheer size of the numbers involved has represented very serious challenges and, accordingly, the board of that company has now moved to recognise that it needs to be split into more manageable entities. Other institutions, in America the Bank of America, have moved in another direction, but I think the issue of managing complexity is very large and one which we should be very mindful of when proposing something which is even larger.

Q56 ***Chairman:*** In that context (at the tail end of my question) is it implied in what you are saying, Minister, that you perceive a need for a global supervisory body, or would that make it even worse?
Lord Myners: I think that would be the logical conclusion from my observation about the United States and Switzerland and, indeed, the Far East, because the Far East is becoming an increasingly important centre for banking, and yet, on the other hand, that drives you towards some concept of a global regulator. I think one needs to acknowledge that there are global issues but they may not necessarily take one to the conclusion that a global regulator would be the right response. It is clear that we must adopt a new approach to the supervision of global financial firms with a global early warning system and a clearer and more enduring approach to the resolution of the crisis. This is why the UK has looked to the G20 to secure global agreement on a charter of principles for financial regulation. In particular, we need to ensure that the principles and rules by which firms are regulated are the same regardless of their respective business models or countries of origin. There is always a risk of regulatory arbitrage and that risk is at its greatest when there are inconsistencies in basic principles and rules. Alongside that observation, there is a need to expand monitoring and surveillance of individual financial flows. This is why the Prime Minister and the Chancellor of the Exchequer have proposed an early warning system, which will provide a global framework to analyse risks, vulnerabilities, cross-border distress dependencies and spill-overs across markets. The UK has also proposed colleges to encourage cross-border supervisory co-operation. There are many arguments both for and against a single global regulator, and I think we have touched on some of those. The arguments in favour would include the fact that it would acknowledge the fact that the world's banks are now global institutions, and some approach which was based upon country of origin would be disregarding the fact that these banks now have very substantial operations outside their home country. A global regulator might complement the activity of national regulators by providing oversight of global risks, and a global regulator might also foster collaboration along the lines of firms' specific crisis management groups and supervisory

colleges. However, I would suggest, Lord Chairman, that there are a number of significant issues that would have to be overcome before such a proposal could be viable. A global regulator would lead to centralised supervision insufficiently close, I fear, to the activities of the firms being supervised and less able to allow for the differences in sovereign legal systems and the risks in different local markets. Moreover, in times of turbulence, responsibilities for financial stability go much wider than those of financial supervisors to involve national central banks' finance ministers and, ultimately, possibly access to the public purse, and I think that those are issues which one would expect to see rooted in domestic institutions as opposed to exposed to levying by a global institution.

Q57 ***Chairman:*** You spoke of an early warning system. May I, in my last question, pick that up? Do you think the IMF or the Financial Stability Forum might act as an early warning system. Might they assume that role?
Lord Myners: I think that they both have the potential to do that. I cannot speak with as much experience of the IMF as a number of the members of this committee. The Government has expressed the view in the past that the Financial Stability Forum needs more resource and probably needs more teeth, but it has the basis for being a more effective agency than it has been expected to be in the past. I think it has done the job that most people look to it to perform, but there is a bigger role that it could perform and which it might be invited to step into, and the UK Government would approach such a prospect positively. Might I invite Mr Maxwell to add anything else he would like to?
Mr Maxwell: Yes. I think the IMF can bring an awful lot on the macro-economic side. We are talking here about very often looking at macro-economic developments and financial market developments together. The IMF can bring a lot in that respect. I think the FSF brings an awful lot from the financial markets perspective. There are some issues here about making sure that these different bodies have the ability to work together to provide a bit of a challenge function between themselves and also to make sure that they are involving the right countries. Indeed, we have supported the expansion of the FSF to make sure that it is including the largest financial markets in the world. So there are those roles they can play, working together, and I think, finally, there is a question about the bottom-up surveillance of individual countries or regions, where the IMF has also developed some experience through its FSAP programme, as it is called, where it goes and looks at the financial markets and state of financial regulation in different countries, and its Article Four assessments of countries. I think those sort of routes give it the possibility of looking in greater depth at individual countries and using that as a building block for their assessments. So both agencies work together, I think.

Q58 ***Lord Renton of Mount Harry:*** Minister, I realise that you are being very careful in what you say to us today. This is a public meeting, but we are, above all, of course, an EU committee. Could I, therefore, before getting back to the role of supervisors, go back to what you said; that you did not see any role in this for the European Central Bank. That does, as you will know, of course, go quite contrary to what Jean-Claude Trichet thinks and, of course he made that clear talking to the European Parliament a week ago. I see that he actually said, "As far as I am concerned personally, I stand ready with good staff", but, of course, one has to bear in mind that some 45 of the large cross-border finance groups in the EU do account for 70 per cent of bank assets. So, on that basis, there is surely very considerable reason why the ECB should be saying that they should have a role in what happens now?
Lord Myners: Lord Renton, I think the key word that Mr Trichet used was that he stood ready, and I think my qualification to that was, in order to stand ready and then move to implementation, one needs to have the effective capabilities and competences, and I am not underestimating the challenge of ensuring that those are in place. Perhaps a better response to give here would be that the ECB could, as one of a number of agencies, perform a role here, but it would need to ensure that it was appropriately resourced to do so. I do not believe, on the basis of my understanding, that the ECB is ready to go and could do this tomorrow. I think there is a very important role for the ECB to play in macro-prudential supervision (this is the term which is now used to distinguish from the micro-regulation of individual entities) but to look at the broader systemic risks, and the ECB could clearly play an important role there, as we envisage the Bank of England will do under the new Banking Bill in which it is given a statutory responsibility for financial stability.

Q59 ***Lord Renton of Mount Harry:*** Thank you. We have in the past had Mr Trichet as a witness before this committee when I was on it before, and from that one sees where he is coming from on this. Could I go back for a moment to colleges and supervisors? Do you think these should be formalised in legislation, perhaps in order that they should be taken rather more seriously by banks? I would have thought there was a danger here that actually those who worked for banks, advisers of the banks, chief executives, at this stage are not necessarily going to be very impressed or influenced by the supervisors. Would legislation

help to solve some of the differences in approaches which certainly exist, or would it make it worse?
Lord Myners: I think that good progress has been made, and I have heard reports of positive outcomes from the college-based approach, for instance in respect of the supervision of Deutsche Bank, and I would like to see that work continue. I mentioned earlier that one of the benefits of the college approach is the opportunity to improve regularity of communication between individual regulators and to learn from the processes of others in order to inform and, hopefully, strengthen one's own procedures. I do not, therefore, at this stage envisage a legislative need but, rather, that we need more commitment to the process of making the colleges work well, recognising, as you have so correctly observed, that the concentration of banking, which is a significant phenomenon over the last 30 or 40 years, both domestically and across continents and globally, the top of the market has come to dominate an even larger share of banking activities and that, therefore, requires more resource and more co-operation across geographies. I think, in conclusion, I would say that this is one of these areas where the answer does not necessarily lie in architecture; it does not lie in the design of buildings as much as in the way people behave within the buildings; and I think that that is, generally speaking (that is to say the behaviour aspect) not one which is best addressed by legislation. I wonder if Mr Maxwell, who has been very much involved in the area of colleges, might have something to add.
Mr Maxwell: Colleges, I think, bring together both the advantages of retaining clear responsibility for decision taking with the home supervisor, in the case you are talking about, with the ability to work closely with other supervisors who have an interest in how that financial institution is supervised: so it ought to bring some of those benefits of co-ordination and co-operation and information sharing. It also brings the benefit that it can be expanded outside the European Union with the new structures which allow supervisors from third countries to take part in those arrangements and work together. I think that the process of setting up colleges, we have seen some successes, but that probably needs to accelerate to make sure that enough banks, insurance companies and other financial institutions have colleges in place, and that is something we have been pressing for. It may help that process for some of the rules of engagement for colleges to be set a little more clearly within the so-called Lamfalussy Committees, for example, or within other bits of legislation about how those colleges should perform the different roles for the different members of those. It struck me during the recent year or two, a very important factor has been the flexibility to be able to respond to different sorts of crisis situations and different sorts of problems emerging in firms, so for that reason we would not want to hard-wire too much exactly how colleges should operate and prevent them from having that flexibility to deal with different situations.

Q60 ***Lord Haskins:*** The nub of this issue surely is that we are talking about globalisation, we are talking about being members of the single market, including trade, including finance. The difference is that when it comes to trade, there are regulatory arrangements about trade. The single market requires people like me who trade in it to operate within certain rules. When it comes to global trade, the WTO is there to make sure that people behave themselves. When it comes to financial activities, there is no set structure; you have to fall back to national regulation. That, in turn, could lead to some rather dangerous economic nationalism in the next few months, and there are clear examples of this with the home/host country in the last four months: the question as to whether Lehman Brothers transferred money out of the UK back to New York very quickly and without regulatory control, the question about the Iceland deposits, as to where responsibility was there and, more recently, the question about Irish banks which have had deposits on both sides. How are we going to deal with this home/host country issue?
Lord Myners: I think there is a danger of a mercantilist approach to this crisis in which economies and institutions will withdraw back into their national boundaries. One of the challenges we are facing at the moment in terms of insuring an adequate supply of credit to support business and personal borrowers in this country is the withdrawal of foreign banks, most obviously the banks from Iceland and from Ireland but, also, the world's larger banks, who are simply not participating in syndicated loan renewals but instead are transferring their resource back to their domestic economy. Major UK banks have actually increased their lending to the UK economy over the last 12 months, but not to such an extent to make up for the departure from the lending market of foreign banks and non-bank lenders. If I may now move on to the issue that the noble Lord Haskins raises about home/host, it is clear from the financial crisis that we need to look again at the home/host model and, in particular, the EA and EU branching across borders. The Chancellor wrote to Commissioner McCreevy in late November 2008 to outline our concerns. It is clear that a number of changes are necessary. Confidence needs to be restored to the EU model for cross-border banking. Therefore, work is needed in three areas: risk assessment and monitoring, crisis prevention and mitigation and crisis resolution. There is a need for better information sharing. Beyond that, there is a

need to improve the quality of EU supervision. Here, we believe, supervisory peer review is necessary and important, where supervisors jointly assess the quality and effectiveness of each other's supervisory practices. Alongside information there is a need to further analyse the arrangements for hosts of significant branches and other cross-border entities. The Commission's current work on early intervention will be useful in this regard. It may be necessary, as part of this, to examine tools and powers available to host supervisors of significant branches. It may be that additional roles and decisions normally reserved for the home supervisor are necessary. It is also necessary to look at inter-group exposures of subsidiaries to other entities within the group and, in particular, what limits might need to be placed on these in the future. There is a need to ensure that deposit guarantee arrangements are sufficient. We welcome the recent changes to the Deposit Guarantee Scheme Directive to raise minimum levels of cover. We need to ensure that schemes can work across borders and that there is sufficient funding and pay-out procedures. We must also ensure that co-operation arrangements are in place to manage crises. We, therefore, propose that cross-border stability groups, bringing together the supervisors, finance ministries and central banks of a firm, are established swiftly. Finally, Member States also need to ensure that they have effective crisis management tools and have removed any barriers that hinder their use. Indeed, it is quite clear that over the last six months we have observed deficiencies in a number of those important areas.

Q61 ***Lord Haskins:*** Assuming all of those aspirations of goodwill are signed up to by the 27 members—I am sure they will be—what happens if one of them suddenly says, "No, I am not going to do it. I am going to act in a unilateral way"? There are no powers within the EU, and there will not be. You, I think, are saying that regulation is going to remain a national issue, as Lord Turner told us a few weeks ago, and is not that the dilemma?

Lord Myners: I think you have absolutely put your finger on an important issue, and that is why the Chancellor of the Exchequer has been so forceful in his representations to Commissioner McCreevy about the need to take action to address this issue: because we have certainly found in the experience of the Icelandic banks, very serious short-comings in how the protection arrangements for depositors work. I would add in parenthesis here that, when I first came into banking and finance thirty, or so, years ago, one of the supposed assets of major banks was their branch network and their ability to collect retail deposits. In my home town of Truro, in Cornwall, there is a crossroads right in the middle of the town and the four major banks had the dominant positions on the crossroads—one of the things which led me to believe that this might not be a bad business to contemplate becoming involved in at some time as opposed to farming or fishing, but the Internet has transformed this. The Internet has allowed the gathering of very substantial retail deposits without a branch network, and it has been facilitated further by best-buy tables, which we know, not only individuals, but local authority treasurers and charities found seductive in directing them towards Icelandic banks and others. So the exposure of British depositors to banks elsewhere in the EU as a result of this can be facilitated by the use of the Internet as a form of deposit gathering. I think what might have appeared to people 20 or 30 years ago to be relatively insignificant—that is to say the prospect of non-UK banks gathering significant retail deposits was very low—has changed quite dramatically as a result of the Internet.

Chairman: I think we would now like to ask you a couple of things that the EU are specifically proposing.

Q62 ***Lord Woolmer of Leeds:*** Good morning, Minister. You mentioned fairly early on the subprime problems in the States and that these are global issues, and that was all part of the securitisation, of course, that then made it even more difficult to know what was going on. Was it the practice or the misuse of securitisation that led to the financial crisis? Then, if I can turn to the Capital Requirements Directive: do you think that will help prevent a future financial crisis or do you think that in introducing it, it may actually prevent the use of an innovative and useful financial instrument?

Lord Myners: I find it very difficult to put my finger on the cause of the financial crisis because, whatever point I start at, I then ask myself what were the conditions which led to that? One would certainly see the development of securitisation and, in particular, the move to package poor quality assets in the belief that, assembled as a portfolio, they could somehow by alchemy be converted to something stronger than they were, was undoubtedly a response to technology, to more aggressive use of leverage by banks and non-bank institutions and to a pursuit for yield, but I am then obliged to say, "So what led to those situations? Why did that occur when it did?" Then one comes back to issues such as global imbalances and the accumulation of substantial liquidity in developing markets, and then I would say: "Why did that happen?", and I fall back on arguments such as the inability of the developed world to defer gratification, as reflected in a consumer driven economy where people said, "I want it and I want it now", and credit, as a result of these global imbalances—because very large savings from the developing work were flowing into the developed world—facilitated that. So I am afraid, my noble lord, Lord Woolmer, I have yet to find the starting point at which I can say everything can be explained from here, but I have no doubt that subprime lending, securitisation, increased use of leverage, was critical to the evolution of the global economic situation about trade imbalances into the financial sector. You then asked about the capital requirement directive. The CRD amendments have a number of important features which will help reduce the likelihood of a future financial crisis. The amendments include steps to enhance supervisory co-ordination and co-operation by implementing supervisory colleges in legislation, as I have earlier said. The revised CRD will also improve prudential standards by limiting the systemic risks from banks having large exposures to other banks, and the CRD amendments will promote further convergence in the single market by standardising the limits around the type of capital a bank can hold for regulatory purposes. However, these amendments are by no means a silver bullet: much more work at the international level, including through the G20, is needed to strengthen prudential regulation.

Q63 ***Lord Woolmer of Leeds:*** A previous witness has suggested to us that the Directive has rather complicated rules with it, and this could actually result in the circumnavigation of those rules by bringing in new products, and so on. Do you think that is a danger and, possibly equally or more importantly, do you think it is possible that, if Europe is over-zealous in how it approaches these matters, it could drive business overseas or outside of Europe? Is that a danger?
Lord Myners: There is a very neat and difficult balance to be achieved in the matter of regulation. Regulation which is overly prescriptive and represents a serious cost to business will drive business to other centres. On the other hand, I believe that the presence of strong regulation which enjoys a high degree of support and promotes confidence in financial institutions should be a positive source of business. That is to say, it will say, "This centre is well regulated and, by basing my business in that centre, I will, as a consequence, enjoy the benefits of being seen to be part of a good regulatory structure." Can I ask Mr Maxwell if he would like to add anything?
Mr Maxwell: Clearly there is a balance to be struck both around the potential for geographical arbitrage internationally but also the possibility of financial innovation and arbitrage around different products. I think, on the first of those, that that is one reason why we believe, more generally, that the rules for regulating capital and liquidity and increasing the other areas of financial activity should be set internationally with basic standards through the Basel process or other international standard-setting bodies, and we have supported the European Union in following those approaches. I think it is also important to make sure that, while we are protecting against some of these risks arising in the European Union, there is this balance around competitiveness and not pushing business off-shore pointlessly or unnecessarily, and I think if I look at the negotiation on that particular directive around the issue of holding back some of the securitisation on the bank's own balance sheets, we can certainly point to particular improvements that have been made there around the way in which those requirements are calculated, around the scope and around the review arrangements around that how much difference that will in the end make, I think, will depend in part on how the international community changes its rules on capital, on the definition of capital, and around some of the procyclical arrangements for capital, which are probably bigger issues going ahead.

Q64 ***Baroness Northover:*** Minister, in your introduction you mentioned four areas that particularly needed to be addressed, and one of those was credit ratings agencies. You are also drawing a distinction between what you can do nationally and the macro-prudential supervision that you have mentioned, linking that more to international action. We are, of course, looking at the EU in the middle of those two things, and so I wondered if I could ask you about credit ratings agencies in relation to the EU. Will the Commission's proposals to regulate credit ratings agencies improve the reliability of the rating system, is it possible to regulate the quality of ratings and how do the proposals go about doing this, and would an independent ratings body fulfil the need for accurate ratings free of conflicts of interest?
Lord Myners: May I first of all say, Lady Northover, you used the word "reliability". I would also like to suggest to the committee that there are issues around reliance. I think it could be suggested that investors became too reliant on rating agencies. There is no substitute for the investor, or the investor's agent or representative, exercising their own judgment, and to simply say that something had triple A or double A on the label is not sufficient to say that due and proper inquiry was not required. I heard the argument advanced about the complexity of financial innovation, and I have previously said, and perhaps not terribly radically, that perhaps we have had a bit too much innovation in finance in recent years and we could do with a move back towards simpler banking, but it has been suggested that innovation meant that end purchasers—banks, insurance companies, pension funds—came to rely upon the rating agency because the mechanics within the structure were simply too complicated to be understood. I am afraid I am rather old fashioned in that, if I do not understand it, I think I would not buy it, and I am not sure that I would be convinced that I should allow the

hand on my pen, when it comes to accepting the asset, to be in any way influenced or directed by an agency paid for by the person from whom I am buying the asset. So I think a little more scepticism around the use of rating agencies would be helpful. That does not address the question that you asked, Baroness Northover, but hopefully you will allow me to get that off my chest. There are some measures in the proposal that may improve the quality of ratings and the timeliness with which they are reviewed: for example, requirements to manage conflicts of interest. These include rotation periods for the analysts and a proposal for a supervisory board with independent members responsible for ensuring the independence of the rating process and the management of conflicts of interest; in addition, proposed requirements to monitor ratings and review as necessary the immediate disclosure of changes in assumptions and timely disclosure of changes to the ratings themselves. However, ratings are an opinion, and so this does not subtract from the need for investors to conduct their own due diligence, as I said earlier. In addition, ongoing negotiation will change the specifics of the EU proposal, but I think they are directionally sound.

Q65 ***Lord Trimble:*** Forgive me; I would like to preface the question with an observation. I sympathise very much with your comments earlier about having difficulty identifying where the start of the problems were and all the factors that led to it, but I would suggest that the factor that crystallised all the risks was when the property price bubble burst, both in the US and here, and from that point on the situation rapidly moved out of control. As I said, that is more by way of observation. My main concern is looking at regulation and it follows on to some extent from Lord Woolmer's observation about the way in which regulations can be avoided, particularly when you are dealing with things which are designed to be off balance sheet—that makes it worse. But we have got European regulations, and there has been criticism that they have been prepared too quickly and that governments should concentrate on halting the current crisis before regulating a future one. It comes very much to mind that Mr Klaus, the current EU President, commented that there needs to be separation between fighting the fire and writing new fire regulations. Would you like to comment on that?
Lord Myners: I think that a sequential approach might have a certain attraction. Let us focus all our efforts, resource on fixing the problem. I think, in practice, reducing the risk of repetition is part of fixing the problem, because it is part of restoring confidence in our institutions and the structures within which they operate, so I would suggest that we need to do both at the same time, Lord Trimble.

Q66 ***Lord Steinberg:*** Minister, we have all heard within the last few years of hedge funds. I think 20 years ago nobody knew what a hedge fund was—it was called a strategic investment institution—but there does not appear to be any kind of regulation. Either a hedge fund does spectacularly well or ends up in the ditch; both receive enormous publicity. Just recently in the newspapers we have had a hedge fund saying they were shorting Royal Bank of Scotland and then made a substantial profit. Do you think that not only in Britain, in the EU and elsewhere in the world, hedge funds should be regulated and, if so, in what way would you regulate them?
Lord Myners: Hedge funds are a very complex area. In answering a question in the House of Lords recently I said the taxonomy of hedge funds was broad and complex which carries with it risks about generalisation. I would actually suggest that many people would say that there have been very few failures in the hedge fund community as a result of the financial crisis, certainly fewer than many would have forecast if they had, two years ago, been able to look into a crystal ball which showed them what happened to the world's financial markets and were then invited to say, "What do you think the consequences will be for hedge funds?" We need appropriate oversight of all aspects of the financial system, and this will be a key part of co-operative work with the FSA, with the Bank of England and with our international partners over coming months. The November statement of the G20 included a pledge to ensure that all financial markets—products and participants—are regulated or subject to oversight as appropriate to their circumstances. The hedge fund sector itself is not unregulated; UK hedge fund managers must be authorised and regulated by the FSA, although the funds they manage are off-shore. Indeed, the UK regulatory regime for hedge fund managers is widely seen as one of the most rigorous in the world. However, we need to make sure that it is still doing its job. In his recent lecture Lord Turner talked about some of the FSA's ideas in this area, including enhanced information gathering, to strengthen macro-prudential oversight and leaving open the possibility to exert direct prudential controls on larger funds. It is too early to say exactly how regulation in this area should be reformed, but the Treasury and FSA will be working hard with international partners over coming months to develop answers to these important questions. I would say that, in addition to asking questions about hedge funds, we also need to be asking questions about conventional funds, because it would be my contention that one of the areas where the system did not work as we expected it to was inadequate engagement by our main insurance companies and similar investors in challenging the strategies of financial institutions, their approach to risk

budgeting and management and the reward structures that they were following.

Q67 ***Lord Steinberg:*** A small supplementary. You used the words "oversight" and "regulation". Can you explain to me very simply what the difference between oversight and regulation is?
Lord Myners: I can do even more than that; I can invite Mr Maxwell, our expert on the subtleties that distinguish one from the other.
Mr Maxwell: Regulation usually refers to actual hard rules that are written down of some sort. Supervision is the application of those rules to a particular firm or group of firms and going in there and making sure that they are following those rules and monitoring on a day-to-day basis. Oversight is usually shorthand for a process which, at the very least, has information collecting requirements, for example, so you can monitor how a firm is performing, and that might then give the authorities the ability to step in and impose certain types of regulations or rules as necessary. So it is somewhere between the two.
Lord Trimble: I am delighted to see that you see a distinction between supervision and regulation, because we had quite a vigorous argument, with a person who will remain nameless, on this committee not long ago!

Q68 ***Lord Renton of Mount Harry:*** Can I ask you another question about hedge funds. I go back to the very interesting point you made earlier about how the Internet has changed how deposits are placed, and so forth? In a sense it has very much widened the market away from the branches of the major banks, but is not that actually also true of hedge funds? In fact the existence of the international hedge fund does make it impossible to stop hedge funds in many ways?
Lord Myners: I struggle with what interpretation one might place on the words "stop hedge funds".

Q69 ***Lord Renton of Mount Harry:*** It is very simple. You cannot stop people going short.
Lord Myners: You could make it more difficult, to stop people going short. You could, for instance, introduce or reintroduce the old American uptick rule which said that you could only short at a higher price than the last traded price. That would be a very expensive process to adopt in this country, but the Americans have the capability to do that. You could also increase the limitations on stock lending, which is critical to ensuring that short trades can be settled. I have previously said, and indeed written to the FSA on this subject, that I believe that stock lending is a little dark pool of activity in the City which has received insufficient attention and that some of the lenders may not be fully aware of the risks they are taking. In parenthesis, the term "stock lending" is in itself misleading, because these are not loans, they are repurchase agreements, and I have also suggested to the FSA that when they have the time they might like to look at whether the management of conflicts of interest around stock lending are as good as they could be. So I think there are some issues, Lord Renton, or some levers that one could use to reduce shorting, but I think to the heart of your question, it is a global activity and it is difficult to see that one could stop hedge funds. I would also, importantly, want to add that hedge funds can be a very valuable feature of a portfolio. In terms of reaching out for the efficient frontier of balancing risk and return, hedge fund strategies, effectively operated, seek to take the top off the mountains and fill in the valleys, they seek to smooth volatility, and that, if achieved, is a very, very valuable portfolio attribute, but there may be many people who over expressed their ability to deliver against that goal.

Q70 ***Lord Woolmer of Leeds:*** In answer to an earlier question you drew a distinction between architects and behaviour and drew the distinction between regulation and supervision. Most people outside the financial system would think it is the behaviour of people that has been outrageous, and here we are spending a lot of time employing architects to draw up new architecture. What is it about behaviour that concerns you and what are we going to do in Britain, Europe and the world to change that behaviour?
Lord Myners: I think this is another of those issues where one could go back a long way in seeking a response to explain how we have arrived at the situation in which we have found ourselves. I would confine myself to say that it is clear to me that there were some profound deficiencies in the remuneration structures adopted by the investment banking arms of some major banks, which led to a lack of symmetry in risk and reward and some perverse incentive effects in which individual executives of banks were, effectively, induced to take on more risk on behalf of the bank in the knowledge that, if their judgments were right, they would earn very large bonuses, if their judgments were wrong, the bank could absorb the loss and, of course, if their judgments were seriously wrong, society would bear the loss. Who do I hold responsible? I think one has to start off with the senior management of those institutions and their boards of directors, who are, clearly, ultimately responsible for the cultures that they seek to encourage and promote in the companies. There was also a regulatory issue and the FSA has said that this is a feature on which they will now place increased weight; that is to say, if it appears that the institution is encouraging a significant appetite to take on risk, the FSA should reflect that in its regulatory engagement and such things as capital requirements.

Q71 ***Lord Steinberg:*** May I come in and ask you finally—and this not in defence of banking management—would you not agree that the remuneration and bonuses that were received was a result of market pressures?
Lord Myners: I think there is a challenge at the heart of your question. Mr Charles Prince, the past Chief Executive of Citibank but three, famously said the music was still playing and he was still dancing, and he was mocked for that, but at the heart of it was the truth that market pressure required him to continue and the financial world would be harsh in its judgment of somebody who exited too soon. I noted that Lord Trimble, in a previous session of this committee, made the analogy about leaving parties and the wise person does leave the party before it deteriorates, but many are encouraged to stay longer than is good for their health and their reputation, and that was certainly a feature here.

Q72 ***Lord Trimble:*** I said the function of a central bank was to take the punch bowl away before the party got too out of hand.
Lord Myners: That was slightly different, I do thank you for your correction, but I think it was in the same area. I would never seek to misrepresent your views, Lord Trimble. The noble Lord suggests that this was a market, but one would also now question whether some of the large bonuses that were paid were apparently paid for profits which now seem to have run like sand through the fingers. So there were deficiencies in the design of compensation arrangements, and I think that some directors of banks might like to take a moment's quiet reflection on whether the growth in the reward of their most highly paid employees was, by comparison with other employees, entirely a good thing and whether there was not a loss of perceived fairness and, finally, quite frankly, whether some of these bonus arrangements were necessary at all. I am not at all persuaded that bonus payments have productive outcomes. I think good people work hard and they expect to be fairly rewarded for that and the bonus culture just got out of control.

Q73 ***Chairman:*** Thank you, Minister. On that rousing note I think we should thank you very much for coming. We are most grateful to you on a difficult morning. We may want to ask you if you would come back briefly before the end of this inquiry, when we are a little further down the line, but thank you very much indeed for coming this morning, and thank you Mr Maxwell.
Lord Myners: Thank you, my Lord Chairman. I have to say that, in preparing for this session, I have read the transcripts of previous sessions and read your reports, and I commend the good work that the committee does and I look forward to doing what I can in any way to help you.

Examination of Witness

Witness: Mr David Green, International Affairs, Financial Reporting Council, examined.

Q74 ***Chairman:*** Can I welcome our next witness, Mr David Green. You come very highly recommended to us, Mr Green, and it is very good of you to have come. We have read your book,[1] and Howard Davies', on financial regulation and, indeed, some of the questions are steering in that way. I would like to start off by asking you what has the financial crisis taught us about the effectiveness of financial supervision at an EU level—because we are an EU committee—given the needs of a single market in financial services and capital? Can you identify any areas of the current system that contributed to the failure to prevent the recent events in the banking sector?
Mr Green: Thank you, Lord Chairman. I should start by saying that I am here representing my own views and not those of the Financial Reporting Council, which I currently advise. I think the current crisis has taught us a number of lessons that have had wider implications. It has also steered us away from some of the issues that we were thinking about before hand and have now rather faded into the background in relation to the single market itself. It is quite interesting that in the first half of this session with Lord Myners there was not very much discussion about the single market; it was about the problems that we were currently facing. Of course, they are important. I think one of the things that we have learnt is some of the worries that people had about what would happen in a crisis proved to be partially unfounded. There was a huge worry about lender of last resort in the euro area. The ECB managed to provide liquidity in a way that was generally admired and most governments, in the end, stood behind their banks in their cross-border business. What this taught us was that what is crucial here is what actually happens in relation to the behaviour of governments, not of the supervisors or even the banks themselves. There were two areas of difficulty. One was in relation to Fortis, which appears to be a very complicated story and, of course, turns out to involve governments at the very highest level as well as the courts, and I personally do not know quite what lessons one draws from that story. The other is the Iceland story, which we have already had referred to. That has shown us that the presumption on which

[1] *Note by witness:* "Global Financial Regulation: the Essential Guide", Howard Davies and David Green, Polity Press 2008.

the single market is based—that you can rely on home country supervision in many areas, to do business across the EU without any kind of or any minimum level of supervision—is dependent in the banking case (and would probably also be the case if we were dealing with an insurance company) on both the willingness and even the capacity of the home country government to provide resources. I think this is something we have always known but have been reminded about very forcibly. That leaves us with a big choice about which way you want to go in a single market, and I can come back to that a little later if you would like. We have also learnt that the interface between the macro-economic world and the financial system world needs a lot more thought and care. That, of course, has had some discussion. Of course, you refer to the Banking Bill: that is one of the things that is being discussed there. The same applies at the EU level and, clearly, the ECB does have a role in this as the largest central bank in Europe. If you like, I would be happy to come back to that later as well. I think a third issue, and one of the ones that we have been rather distracted from, is that this affair has, as Lord Myners was saying, rather encouraged shrinking back into national markets, and one of the arguments that has been put while arguing for centralisation and prudential supervision is that it is okay to leave conduct of business supervision at the national level—some of the proposals for centralisation propose that. This would be unfortunate, and I think the committee may want to pay particular attention to this in future in that this runs quite a lot of risks. It risks a resurrection of national protection: "We will do business this way in our jurisdiction and not somewhere else". Inevitably, this is a barrier to cross-border financial services, if that is what we want, and that is why I say this raises very big questions if we are still serious about the single market. It also raises questions for supervision as well. It raises a question about the integration of supervision. We had a discussion earlier about the complexity that arose from the FSA being an integrated regulator. Nevertheless, this crisis has shown that an integrated approach is very important. Where did these problems originate? They started in securities markets and derivatives markets, and there was also insurance involved in these securities, and a lot of it related to the conduct of business in these investment products. So I think any tendency to draw from this affair the conclusion that you would look after prudential in one place and the conduct of business in another would be a faulty one but also dangerous. I think those are perhaps the main initial conclusions I draw.

Chairman: Thank you.

Q75 ***Lord Renton of Mount Harry:*** Mr Green, before going back to the question of whether a single European financial supervisor is necessary, I slightly go away from the questions that are drafted, of which I know you received a copy, and note you have spent your life in banking—30 years with the Bank of England, then six years with the FSA. Do you think that this crisis would have happened to the same extent, and almost unexpectedly, if the FSA had not been created and the Bank of England had still been dealing directly with the Treasury?

Mr Green: That is a very challenging question. Perhaps I could try and answer it initially indirectly. Of course, there is full integration of monetary policy and banking supervision in the United States, which is where this crisis started. So to draw a sort of straightforward conclusion that somehow this crisis was caused by this type of split in the UK (and the same is true at the euro area level: monetary policy is separate from supervision) would not be the conclusion I would draw. Even within a central bank the monetary policy function and supervision is separate. It certainly was when I was in the Bank of England. So you always have to construct a relationship between monetary policy and supervision, and I think this does relate a little bit, not to the single regulator, but it does relate to the role of the ECB. I think Lord Turner had some instructive remarks to make in his speech that has already been referred to on this subject. If I may quote: "Central banks and regulators between them need to integrate macro-economic analysis with macro-prudential analysis and to identify the combination of measures which can take away the punch bowl before the party gets out of hand." I think in that statement, which is a very general one, he suggests that there is, if you like, a symbiosis between monetary policy and supervision. Clearly what he is saying here is that a monetary policy is relevant to what happens in the financial system, which is a view I share. It was not held in the United States for much of the recent period, and there has been a big philosophical debate about this, but I think it is very clear that monetary policy is only transmitted through the financial system, so that to imagine that the financial system is one thing and monetary policy is another is likely to lead you into difficulties. I think it may more be the fact that monetary policy was looked at in one frame of mind and supervisory policy in another, without them being related in a number of countries, which led to this difficulty. I think this does lead on, though, to the question of how we deal with this at the European level. There is a need for a mechanism through which this discussion can take place. Lord Turner referred to analysis, but the analysis consists of the monetary policy people and the supervisory people thinking together about what monetary policy should do and what supervision should do, and I think it would be possible, quite easily, to construct such a structure at the EU level, building on existing machinery, if you like. There is a committee, the ECB's so-called Banking Supervision Committee, which brings together all the banking supervisors and all the central banks in the EU, not just in the euro zone. It has long historical antecedents. When the ECB set up there was a long debate about whether the ECB should be responsible for supervision, going back to your earlier question, about how this should be organised. In the end a separate committee of banking supervisors was created. The UK FSA at the time said, "We recognise that, although supervision is the responsibility of one group of organisations who have a particular accountability to parliaments, whereas monetary policy has been made independent in its operation from day-to-day direction by parliaments or governments, nevertheless a relationship needs to be put in place". We proposed that this banking supervision committee should be renamed Financial Stability Committee in order to discuss precisely the kind of issues that we were talking about. At that time the ECB was not very enthusiastic about the idea. My understanding is that this is an idea that might now have some attraction as a way forward. The reason for that for the ECB is that they very clearly recognise that the euro area and non euro areas, and particularly the UK, are nevertheless completely integrated financially.

Q76 ***Lord Renton of Mount Harry:*** That is a bold statement, is it not?

Mr Green: A very large part of the UK banking system consists of euro area banks. I do not know what the latest figure is. A long time ago when I was active in this area, a quarter of the entire UK banking system balance sheet was comprised of other European banks. This is a lot. The City is dependent on the balance sheets of Deutsche Bank, Société Général, BNP and a whole host of other European banks. The largest centre for euro wholesale business is London, and dozens of UK registered banks are counterparties of the ECB. These are the facts. I think, for that reason, the ECB (and I know this from my own discussions with senior members of the Executive Board of the ECB) are conscious that this is somehow a factor that has to be taken into account in constructing these arrangements, and I think, for that reason, that although they have made proposals for a greater role of the ECB in supervision, which is envisaged in the Treaty, they are also entirely clear that a structure that is going to deal with this separation that we have between central banking, or monetary policy, if you like, and supervision needs to be dealt with. I think representation at more senior level, greater analytical resources, a capacity for the macro-economic people to give advice to the supervisors which they are expected to listen to, for the supervisors to be able to say to the monetary policy people, "This is what is happening in the banking system and you may want to take account of this in the conduct of your affairs", will be a strengthening of the system. As I say, a committee already exists in this space; it is just not very used. I am afraid that was a rather long answer to your question about the relationship between central banking and supervision, but I think it is very much at the core of what needs to be done about the future direction of handling the single market issue.

Q77 ***Lord Renton of Mount Harry:*** I think it is a fascinating answer. Thank you very much indeed. I have read with great interest your article[2] of late December on the euro and European supervision. *Does the UK being "out" matter?* is the title you gave to it. Could we just explore that. If we go forward with the real European banking supervision, organised by the ECB or not, do you think it is essential for the UK to be part of it, and will it be part of it?

Mr Green: It is essential for the UK—and, indeed there are, of course, other EU Member States who are not in the euro area—to be involved, and I think the best way will be through a committee of the kind I just described, which is EU wide but clearly has a major role for the ECB; it could even be hosted by the ECB, who host this existing banking supervision committee. I think the prospect of leaving the UK outside a more centralised arrangement is quite difficult to contemplate, for the reasons I explained earlier. The very large proportions of banks, the euro area banks, that some kind of federal system, collective system, let us call it to avoid the federal word, we would need to supervise are in London. They are very significant, indeed, major players in the wholesale markets. Of course, they are also active in the rest of the world. We had the discussion earlier with Lord Myners and Clive Maxwell about global colleges, but I think the idea of there being a euro area supervisory system is a very difficult one, and I do not believe that the senior policy-makers, either in the ECB or the banking supervisors in the euro area, would want to go down that route.

Chairman: Thank you very much.

Q78 ***Baroness Hooper:*** We heard from our previous witness about the role of the so-called supervisory colleges, which the Government supports. Would you like to comment on this as a means of regulating on an EU basis?

Mr Green: Yes. Colleges are useful for the kinds of purposes that were described earlier—information exchange, working out who was going to do what in relation to parts of the group, understanding how the systems work across the group as a whole—and they can help in terms of day-to-day supervision and

[2] *Note by witness:* In "Ten Years of the Euro: New Perspectives for Britain", published by John Stevens.

mitigating risks. They could also, if you wanted them to, undertake a major role in streamlining supervision, which comes back to the single market question. Do you want more things to be identical across the EU? I think people have changed their minds about this. They now actually want a lot of things to be identical, because if they are slightly different it is just as bad as being very different, and only if they are identical can the IT work, can compliance systems work. The trick is to work out what you want identical and what you do not. Colleges could play a role in that. What colleges cannot do is play a role in the closing stages of a crisis, and I think this is not really very widely understood. What happens in the closing stages of a crisis is there is only so much capital to go round and where this capital finishes up on the day the bank closes is critical. We had reference to the Lehman case earlier on. It is absolutely critical. What colleges are not very good at doing is, the night before, negotiating where the money is going to be, because national supervisors have responsibility to their stakeholders, they have responsibility to their national parliaments and they are not really equipped to undertake this kind of negotiation. It is that problem that leads some people in the direction of saying, if we had a collective supervisor, federal if you like, with a collective pot of money, then everybody could rely on this, banks could do their business throughout the EU and we would not be faced with this terrible fight over who gets what when the shutters come down. I think colleges are useful, but there is only a certain amount of weight that can be put on them, if that is an adequate answer to your question.

Q79 ***Baroness Hooper:*** So you would not see any point in formalising them? At the moment they operate in an informal way. There is an underlying question on this as to whether this should be formalised.

Mr Green: Formalising it, deciding on a precise legal mandate, could be a bit tricky, precisely because lying behind this is who is actually going to carry the can when something goes wrong. I think that is the reason why there has been a certain amount of caution about that. The argument for some kind of formalisation in a sort of softer sense is to make sure that they work—that people turn up, that they have a proper discussion, that they provide adequate information and that they do have a negotiation amongst themselves about how the day-to-day supervision is going to be carried out—and that kind of fuzzy strengthening is obviously important. Turning that into legislation on a cross-border basis is, obviously, more challenging, and you would not be able to avoid dealing with "and if something goes wrong, who is responsible?" Currently, we know. It is the national regulator who is responsible for their bit, but if you have legislation which says you are collectively responsible in some kind of way, then we get into those kinds of issues.

Q80 ***Lord Jordan:*** Mr Green, you have touched briefly on the problem of the home/host country divide. Do you believe there are specific measures that would help the EU deal with this aspect in crisis management?

Mr Green: I think the home/host issue it is very difficult, which is why people have been so concerned about it. All the remedies have got challenges of one kind or another. One way of avoiding it is to say we cannot rely on foreign government X, at the end of the day, to bail out the bank or even to have adequate deposit insurance. We now know this can happen, so we will stop branching altogether and we will force subsidiarisation in each jurisdiction, and that is very often what happens in a wider international basis. The difficulty about that, in terms of the single financial market, is that it ties up capital in all the subsidiaries. One of the objectives of the single financial market was to allow branching quite freely so that capital could be utilised in the most efficient way, properly and without let or hindrance to service economic activity across the EU. Subsidiarisation also would be particularly damaging to the wholesale markets and would have a disproportionate effect, I think, on the market in London in that a lot of the activity in the wholesale markets, and the securities and derivative markets that are part of that, is dependent on being able to rely on the credit of the whole bank. So the London branch is the entity involved in the business but, nevertheless, the scale of business can be related to the capital of the parent. If you said all this had to be compartmentalised, then there would be very damaging effects for wholesale markets that operated in that way. So that is not an easy route to go down and, indeed, it is that that drives some people to say, if we want to change, maybe we need to come round to this idea of collective supervision and collective support. Collective means federal in some sense and it requires legislation; there are issues about national sovereignty; there are issues about the EU budget; and that is not very easy either. So, for the time being, there is an on-going discussion looking as to whether there are any other ways out, but this issue is a challenge to the single market that we are relying on, which is why I say this episode has asked real questions about what kind of market we want.

Q81 ***Lord Jordan:*** One of the measures designed to prevent an abrupt departure is a requirement for someone to give notice: specific time periods. Is this something that just could not work in the circumstances? To give notice of intent to close down, for example, or withdraw.

Mr Green: It depends how it is done. What happens in a domestic market is that if you are a supervisor in the UK and you realise that it is most unlikely that this bank is going to be able to continue trading indefinitely, you can put in place all kinds of remedial measures. You can, if necessary, stop it taking new deposits, which is a tool that is available to enable it to wind down to prevent the matter getting worse. It is possible within an EU college that you could collectively exercise supervision in that way, but it is quite difficult, because in a cross-border college you are still left with the question about where is the capital going to be at the end of the day and how do you conduct the very difficult negotiation between the supervisors, answerable to their national parliaments, about what they have been doing about protecting depositors in their country's interests. It is a very difficult issue. It is not just an EU issue either, of course. It is a global issue that is integral to the whole concept of branch banking.

Q82 ***Lord Steinberg:*** We all know that the EU has had a rather chequered history of matters particularly dealing with financial reporting, and we know that some members of it have been distinctly unhelpful to the overall body, but what other ways do you think it is possible that financial supervision from the EU could be improved?

Mr Green: I think the committees that we already have, these so-called Lamfalussy Committees, are able in their discussions between their members to exercise pressure on each other, to try and deal with shortcomings where they arise; where there are divergences in practice. They conduct lots of surveys to find out what everybody does about issue X or issue Y. Lord Myners was talking about strengthening these committees, and I think it is partly to deal with this kind of issue of unevenness of performance of supervision, if you like, that it is desirable to do that. At a certain point you get into an issue about whether a decision by such a committee can become binding on all the members, and we have seen what is almost an oxymoron, the non-binding qualified majority vote. The non-binding is, of course, the tricky bit in all of this, but the intention is to substantially increase moral pressure on Lamfalussy committee members to bring their standards into line. The other way that you could do this, which is one that Howard Davies and I have proposed, is that you create a political presumption as to what is expected. Governments say, "There is a presumption that in certain areas supervisors are expected to come out with identical arrangements." You have to have a process for deciding, as I was saying earlier, where you want them to be absolutely identical and where variation is acceptable, but a lot of the benefits of the single market have not been fully achieved because of this unevenness of implementation, which is a general issue. If there was a political will to derive more of the benefits that were envisaged when the project was originally conceived, then a push towards having more identical arrangements for implementation would make a difference. There have been proposals to have a single European rule book. That, I think, may be going a step too far. You need to have a process, kind of like a cost-benefit process, which decides where it will be sensible to have identical arrangements, for instance, because it will really make a difference to the IT or will make a difference to reporting arrangements or where it could be sensible to have identical arrangements for competition, for instance. I said right at the beginning I was a little bit nervous about this new idea that conduct of business supervision can be left to national jurisdictions.

Q83 ***Lord Steinberg:*** May I come back in, please. With respect, I am wondering whether what you have just said has a degree of wishful thinking about it, and I will give you an example of why I think that lack of supervision is endemic within the EU. We had Commissioner Kallas here to give evidence some time ago and he was talking about OLAF, which was an organisation set up to detect fraud within the EU. He wrote to me subsequently and said that, of 596 cases which they either had investigated or were investigating, there had been one prosecution, and to my mind that is part of the endemic problem within the EU. I was hoping to hear, with respect, something more solid that we could hang our hats on.

Mr Green: I think, clearly, part of this is a political expectation that commissioners will take action. The people who fail to take action, of course, are, by and large, within national jurisdictions, and I think, if I may say so, the interest of committees like this in this kind of question is absolutely critical. I remember, when I was at the FSA, I was rung up by a former colleague who said, "Can you tell me who in the UK Parliament is interested in what is happening to the Capital Adequacy Directive?" At that time—this is a long time ago, while lots of people were interested—nobody was interested in this at all in the national parliaments—and I think that if you are to make progress of the kind that is clearly necessary, to deal with the cases that you describe, then this is a matter of national parliaments saying, "We wish our governments, collectively, to take the necessary action to deal with whatever the issue is." I think in the financial services area there is quite a lot of peer pressure within these Lamfalussy committees, but, ultimately, it is for the national parliaments that each member serves to decide that they want more action to be taken.

Chairman: I think we have slightly diverted ourselves to the side of the banking sector, though it is a very interesting general point.

Q84 ***Baroness Northover:*** I wondered whether I could ask whether the EU rules on state aid to the banking sector have been consistently applied in this current crisis, and do they need further clarification? I would then like to ask another related question.
Mr Green: I think we probably do not know. I certainly do not know. It was always recognised in discussions a long time ago that when support was given to national banking systems, even just liquidity, emergency liquidity support, it was a state aid issue, and I recall, when I was on an inter-governmental committee on banking supervision, there were long discussions with the EU competition people about how you would handle state aid in a banking crisis. What was concluded in those discussions is that you did not have time to make an assessment because, almost always, the decision had to be made over a weekend. We had a slightly surreal discussion because the process requires some kind of prior approval. Would commissioners be prepared to be on call constantly so that on a Saturday or Sunday afternoon, when the decision had been taken, they could give formal approval? But the principle of the thing is that it was always understood that the support would first have to be given and then you sorted out afterwards what needed to be done in terms of dealing with the state aid and the competition issues, and I think that is still the case. A great deal of progress had been made in terms of state aid in the financial services area and, as you may know, there were long campaigns by the Commission against state supported banks, particularly in Germany, who were forced to restructure in such a way that they no longer received what were regarded as improper state subsidies, and I believe there were similar cases in other countries—Italy, I think, though I am not so confident of my ground there. A huge amount of effort has gone on over the last decade into getting a level playing field on state aid. Clearly, the level playing field has now gone and, once the dust has settled, I am sure it will be right for the Commission to come back and try and look at all the different permutations of aid that have been given. It will be a very big job. Lots of aid has been given; liquidity support has been given; we have now got insurance support in addition to solvency support. Trying to sort that out will be a major project, but, again, if there is a political will to keep to the principle of the single financial market to go alongside the single market with goods and services, that is a process that will need to be undergone. It will take some time. There is a question about when you start, and it is very complicated, but in my view it will certainly need to be done, if that is an answer to your question.

Q85 ***Baroness Northover:*** It all leads back to what you were saying before about the same types of things happening in different parts of this. I wondered if I could ask more generally, because it does seem to me there is a difference in approach between you and the Minister. Both of you are looking at what can be done internationally. The Minister seems to be moving away from what can be done within the EU because the national governments have to back it up and so, therefore, things have to be done on that basis. You are pointing to some of the difficulties with that and saying there is at least the EU, the single market. I may not be right in that characterisation, but if so, do you think that it is so difficult to anticipate effective regulation happening globally, even though it may be needed, that at least looking at it EU wide is extremely valuable but it cannot simply be left to national governments, for the reasons that you have given?
Mr Green: There clearly is a set of global issues, and the Minister explained what the Government has been doing in this area—and, of course, it has the chairmanship of the G20. Indeed, the current Prime Minister, when he was Chancellor, was instrumental in setting up the Financial Stability Forum which has come back into prominence, but solving questions, particularly questions like state aid in such a forum, is going to be very challenging. Within the EU we do have this very large element of the single market already in place. We have got all kinds of standardised arrangements—they are not identical but they are very standardised—to allow people to do business across the EU. In the euro area the prospect of not having reasonably standardised arrangements within what clearly is a common currency area will be very difficult. Of course, in the Treaty it was originally assumed that the euro area and the EU would be the same—it was constructed on that basis—but we have got the euro area now and I think the argument for having consistent, or probably approaching identical, arrangements within a single currency area is quite powerful, and, of course, it is that which particularly means that many people see the ECB (which is, if you like, the symbol of this area even though not responsible for regulation) as needing to play a role in the next steps, but, to come back to the question: despite there being global issues, is it still worthwhile doing something at the EU level? My answer is, yes.

Q86 ***Chairman:*** On that note, I think I might thank you and wind up your evidence. Thank you very much for coming. It has been extremely useful. I find myself saying this to people rather a lot. We may want to ask you back again later, but thank you very much for your contribution today.
Mr Green: Thank you. Obviously, I will be delighted to make myself available whenever the committee wishes.
Chairman: Thank you.

TUESDAY 3 FEBRUARY 2009

Present		
Present	Cohen of Pimlico, B (Chairman)	Steinberg, L
	Hooper, B	Trimble, L
	Northover, B	Woolmer of Leeds, L

Examination of Witness

Witness: PROFESSOR CHARLES GOODHART, London School of Economics, examined.

Q87 ***Chairman:*** Welcome everybody and welcome specifically to Professor Goodhart. We are on the air; this session is being broadcast. Professor Goodhart, I am sure you have done this before, but you will get a note of your evidence and the questions so that you can have a look at it. We are being recorded for a webcast; so you need to use the microphone. Would you like to make an opening statement or would you rather that we started asking our questions, which I believe you have already seen?
Professor Goodhart: Would you like to start asking questions.

Q88 ***Chairman:*** Thank you very much. Then I will start. This is kind of the broad opening question. What can we learn from the financial crisis about the effectiveness of financial supervision, regulation and crisis management within the EU and what is wrong with it, roughly speaking?
Professor Goodhart: Let me start with crisis management, because that is what has been happening in the course of the last year or so. I think what is remarkable is that crisis management in Europe has really been done virtually entirely by the nation state. If you look at the guarantees of deposits, if you look at the recapitalisation of the banks, if you look at the guarantees that have been given, they have all been done at the initiative of the nation state. Virtually nothing has been done by the federal bodies, the European Commission, the European Parliament or anything else, and in a sense I think that this is natural under the circumstances, because what you need for crisis management is to be able to deploy money and you need to act and deploy that money relatively speedily. The crisis has shown how rapidly things can go downhill when people start to lose confidence and markets start to crumble. In those conditions you need to act fast and you need to have reserves of money to do what you need to do in a crisis and, effectively, that has been done by the nation state and I think will continue to be done by the nation state until and unless the European Union, or some federal bodies within it, manage to obtain funding, which would have to be very large-scale, to meet the needs of that crisis management. I would just note that that line of argument has, I think, begun to be accepted by the more federalist inclined of my many European colleagues and friends, and the suggestion that has been made in a couple of quarters recently, in a couple of papers in what is known as VOXEU (which is a website) by Daniel Gros and Stefano Micossi and in a Centre for European Policy study paper written primarily by Karel Lannoo, is to use the European Investment Bank (the EIB) to provide moneys for that purpose. I am very glad to find out that the colleagues on the Continent are now appreciating the importance of having a federal source of money if we want to have crisis management done at the European level rather than the national level, but I rather doubt whether the EIB is sufficiently well constituted to provide that source of money. Even though it has got quite large borrowing rights, the cost of recapitalisation, as we now all know, can be very large indeed—whether the EIB would have the funding to do that—and if it used funds for that purpose, it would have very little left for anything else if you had a European wide crisis of the kind that we have now seen. Moreover, since the EIB would be providing the money, it would probably want to take the decisions; otherwise it would be difficult to justify to its trustees using so much money for that purpose, and, if it was to take the decision, it would have to change into a very different kind of body than it is the moment. So I do not think that that really is a practical proposition as yet, though I am glad, as I said, to see my colleagues on the Continent thinking about the question of where the money could come from, other than from the nation state. If the crisis management is to be done by the nation state, because it is the only source of funding to meet the costs of that and because the nation state can do it quickly, then it is probable that supervision will also be done by the nation state. It is not necessarily so—one could envisage a separate body perhaps under the aegis of the ECB doing the supervision—but if something went wrong and the nation state has to pay the money, the taxpayer of each nation has to pay the money, then one would have thought that the taxpayer and the elected politicians would say, "The supervisors have got it wrong, when we were not doing the supervision." It goes back to, in a sense, no taxation or no payment for recapitalisation without representation. If you are going to do the paying, you want, naturally, to be in charge of the supervision to do that exercise. It is quite different for regulation, because with regulation

setting the rules, you do want to have a set of harmonised rules and there the regulation is probably best done, because of cross-border exercises, at the global level through the Basel Committee on Banking Supervision, and so on.

Q89 ***Chairman:*** Thank you very much. The bit of my question that you may not quite have addressed is where the failings lay, or is it implicit in your reply that we have not got the right structure?
Professor Goodhart: We do not have the right regulations either. The regulation structure that we had was essentially focused on the individual institution, the Basel II approach was very much focused on the prudential conditions of the individual institution, and the problem is that what makes sense for the institution individually frequently makes no sense at all for the system as a whole. If an institution suffers a loss, runs into difficulty, the normal response of that institution is actually to cut back on new loans, to reduce the size of its book, to claw back, to act more conservatively, but if every institution simultaneously is doing that, as is actually happening in the world at the moment, then the whole system implodes and liquidity disappears. What we need is a much more counter-cyclical form of regulation to support the micro-prudential approach which is currently undertaken. As you may know, I have been trying to set out some arguments about what ought to be done in a paper, which is known as the Geneva Report on the Fundamental Principles of Financial Regulation, which I hope has been made available to your committee, which actually sets out in some detail some of the major things that need to be done. So I would certainly blame regulation. I would also, I think, blame supervision. The supervisors very much took their eye off concerns about liquidity—not in fact entirely surprising because more or less everyone had. One of the reasons why we have had the recent financial crisis is that there was a general belief in the efficiency and continued working of short-term wholesale markets, and the assumption was that as long as an individual institution, primarily a bank, was sufficiently well capitalised, then it could go always to these wholesale markets and obtain additional funding, so that there was not any need to maintain liquid assets on its own balance sheets. If you compare banking now with banking 30 to 40 years ago, 30 to 40 years ago most banks in most countries held something like 25 to 35 per cent of their assets in the form of public sector debt. At the moment the British banks hold virtually zero net public sector asset and they just allowed their liquidity to run down, as did banks elsewhere, on the assumption you could always fund yourself through the wholesale markets, and that assumption was proven to be wrong, but it was an assumption which was generally accepted, and wrongly accepted, by the supervisors, as is well-known. In this country the FSA has confessed to not taking sufficient concern or account of the liquidity position of Northern Rock.

Q90 ***Lord Steinberg:*** I have a view, which is not generally shared, that greed has come into the equation, and where I am setting myself apart from others and what I want to ask you is that I think that they were paid the going rate for the job and had budgets and targets way beyond the norm to try and produce the bonuses, and so on, that they received. What I wanted to ask you is: where do you think greed has played a part in all of this current situation?
Professor Goodhart: I think greed has played a very considerable part. The attempt to make money plays a very large part in the whole capitalist system, not necessarily for the worse. I remember Adam Smith said that it is the self-interest of the baker and the candlestick maker that drives them, not the social interest, and the way that greed gets interrelated with the social interest is that, if you produce something that people want to pay for, then you are going to make money. The problem here, I think, was that the greed led them to take positions which, wittingly or not—in some cases it was wittingly and in some cases they simply did not understand—obtained relatively high short-term returns at the expense of excessive risks which were assumed, and had to be assumed in the event, ultimately by the taxpayer and by society. So there was overall either an under assessment of the risks that were being taken or the structure of compensation, which was far too short-term, encouraged quite a lot of bankers and others to take short-term risks, to take risks because they could obtain very large returns in the form of bonuses in the short-term; whereas if things went wrong in the longer-term they thought that they would get bailed out—not they personally but that the bank would get bailed out—and there would be a limit to the amount that could be clawed back from them.
Chairman: Lady Northover, would you like to pick up the rest of the issue on regulation?

Q91 ***Baroness Northover:*** Yes. They were shown to be right, were they not, in that they were bailed out?
Professor Goodhart: Yes, and that is, in a sense, one of the problems. Another of the problems, which is equally the case, is that there is a concern that banks have become too big to fail, in some cases too big to save, as in the case of the Icelandic banks, and we all know that this is a problem. Yet in the course of trying to rescue the system, what we have done has been to fold some of the weaker banks, medium, in some cases large, into the bigger banks, making the whole problem even worse and reducing competition: in this country the encouragement for Lloyd's to take over Halifax Bank of Scotland (HBOS) against what

would normally have happened under competition policy, and in America the merger between Wachovia and, eventually, Wells-Fargo and WaMu going to another bank—I cannot remember exactly which—Bank of America taking over Merrill Lynch; and they become enormous, huge giants and the question of what can and should be done with them is one of great concern. I do not know whether you have had a chance to read the G30 recent paper on regulation. It was written primarily by Paul Volcker and it is very clear that he is enormously concerned about the question of how one deals with banks that have become in some senses too large for the economy in which they are situated.

Q92 ***Baroness Northover:*** Can I probe further what you have said about regulation. You have in your earlier answers addressed this to some considerable extent, but I wondered if I could ask: is large scale reform and financial regulation required? What, form should this regulation take and at what level (national, EU or global) should this take place? Some of this you have already addressed, but maybe you could go into that further, in particular the possible role of the EU in regulation.
Professor Goodhart: I think there is a very considerable need for regulation to be altered, not necessarily more, but better. In particular I think there is a need to move away from focus on the individual institution to focus on the system and how the individual institution interacts with the system and, for a variety of reasons, that really means trying to limit the extent to which the individual institution builds through issuing debt on its initial capital stock (i.e. its leverage and its own rate of growth), so that you need to have what I describe as macro-prudential controls which relate to leverage and also to the rate of expansion of credit for the banks interacting with the present mechanism of Basel II. I think there ought to be other mechanisms as well. You need to have liquidity regulations and, again, one way of trying to enforce liquidity regulations is to have a sanction so that if a banking institution has too little liquidity, it has to, again, take on rather more capital to offset the fact it has got too little liquidity. Finally, I should very much like to see some limit on the loan-to-value ratio. One of the things that has made the housing crisis particularly difficult to deal with has been that there has been a shift from loan-to-value ratios of 95 or 100 per cent, even, in the case of Northern Rock, of over 100 per cent, down to 75 to 80 per cent. So people who were just getting on the housing ladder who thought they could do it pretty painlessly, as recently as a couple of years or two or three years ago, now have to get together a huge down payment, and if your parents cannot help you on that, it actually means that new buyers in the housing market are actually going to be rationed out of that, excluded from the housing market, for several years. If you get most new buyers excluded from the housing market, it is very difficult to see how the housing market is going to recover. If one, again, had measures to prevent these swings in the loan-to-value ratio, I think that would be very helpful.

Q93 ***Baroness Northover:*** The various levels. You have talked about how, if nation states are bailing out institutions, then regulation and supervision is going to need to be at that level. What role does the EU potentially play?
Professor Goodhart: Relatively little until it can undertake crisis management, until and unless it is actually capable of doing the recapitalisation, of doing the crisis management. I must confess, I still have worries about the question of the speed with which the EU could act at a federal level, and the need for speed is very considerable. So that even if it actually had the resources, would it be able to move quickly enough? Everyone saw after the bankruptcy of Lehmans that markets declined with quite remarkable speed and everything unravelled, and if it had not been for the ability of governments, particularly the Government here, to introduce recapitalisation mechanisms within a matter of weeks, it is perfectly possible that the economy could have been in serious freefall, and the idea of whether the European community and the Commission could actually get a crisis arrangement into place, even if it had the resources to do so, quickly enough is, I think, a question that would need to be considered quite carefully.

Q94 ***Lord Trimble:*** You mentioned Basel II a moment ago. We would appreciate it if you could give us your views on both Basel II and the Capital Requirements Directive?
Professor Goodhart: Basel II was, I think, an excellent effort to try to consider carefully, and in discussion with the industry, what a sensible prudential way of handling their business would be for an individual institution. It had its various failings. It was also, I now think, capable of being managed, manipulated, "gamed", particularly by the big institutions. Some people may regard it as capture, some people may regard it as undue influence, but my view is that Basel II actually had a particular benefit for the really large institutions, and some of those really large institutions, within the confines of being able to work in accord with Basel II, were able to raise their leverage ratios, as a ratio of debt to aggregate liabilities, to levels that were, in retrospect, astronomical and, in almost every case, way above the levels of leverage that the hedge funds had been employing. Ratios of 50:1 were seen among a number of the largest and most prestigious banks in Europe, including the UK. That, I think, was one of the

reasons why these banks took on quite a lot of the subprime debt: because they were able to take on the tranches from the relevant CDOs and mortgage backed securities which had a treble A rating, which, particularly when they also involved insuring the initial loss, implied that the risk weighting of these assets was virtually zero, and, of course, in the event, as we all know, the risks turned out to be quite considerable.

Q95 ***Lord Trimble:*** Essentially, in fact Basel II involved assessment of risks, and if everybody was arriving at the same assessment, they were in accordance with the Directive, and if that assessment turns out to be wrong, everything goes pear-shaped?
Professor Goodhart: Yes. Of course, nobody is really in a very good condition to assess risk, and indeed the ratings agencies failed fairly dismally to do so. The ratings agencies, and virtually everyone involved, worked on the assumption that US housing prices would not fall, and they had not fallen over their data period, they had not fallen significantly over the US taken as a whole since World War II.

Q96 ***Lord Trimble:*** What about the Capital Requirements Directive itself and the changes proposed there?
Professor Goodhart: The Capital Requirements Directive of the EU is almost always a derivative from the proposals set down by the Basel Committee on Banking Supervision, and to a degree I think that that is inevitable, because the financial markets are globalised rather than European and, therefore, it is highly desirable to have a common basis of operation for North American and Japanese banks as well as European banks.

Q97 ***Lord Trimble:*** I have seen it suggested in the press that the current further increases of capital requirement in the short-term, in the present term, is making the crisis worse by forcing the institutions to build up capital rather than engage in other activities?
Professor Goodhart: I think that is true. The proposal that I want to see is to have the banks and hedge funds and other highly leveraged institutions required to hold much more capital, at a time when everything seems to be rosy and there is a boom and everyone is taking on leverage and everyone is expanding and buying assets and asset prices are going up, to provide themselves with a buffer so that this can be run down. After all, this is the biggest worldwide financial crisis that we have seen really since the 1930s and capital is supposed to be there as a buffer to absorb losses, and this is a moment when you expect losses and, therefore, capital ought to be run down.

Q98 ***Lord Trimble:*** If we are going to have a thorough counter-cyclical approach of building up balances in good times and running them down in the bad times, how on earth do you frame directives and regulatory provisions to deal with that?
Professor Goodhart: I do not think that that is difficult. I think that you can frame the directives to relate the amount of capital the banks need to clearly measured criteria, leverage ratios, rates of growth of bank assets and what have you. I think that is easy enough. What is more, I think it actually has to be set down as rules on paper. The reason for that is that during a boom everyone thinks that everything is wonderful and they always think that it is going to go on forever, "This time it is different", so to speak. In the great phrase of the Chairman of the Fed, McChesney Martin "the role of the central bank is to take away the punch bowl just when the party is going", and the thing is that that is extremely unpopular. I do not know if you have ever tried to take away the alcohol from a teenage child's party just when things are getting lively; it is not a popular activity, and you will always find people who say that it is not only unpopular but not necessary, and that means you have to have specified rules for doing that. I think the process and the principles of that are relatively straightforward. What is a much more difficult exercise is when everything is going pear-shaped, as now—everything is difficult, there are lots of losses, there are lots of declines—for the regulators to say this is actually the moment when you should be allowing your capital to come down to meet these losses; this is very difficult to explain to the market. During declines and depressions and crises the constraints on banks are much more likely to come from the market than to come from the regulators and supervisors. Indeed, I frequently say that we could get rid of every single regulator and every single supervisor around the world now and for the next two or three years it would make no difference whatsoever, because everyone is now so scared, so risk averse, so trying to pull in their horns, trying to cut down the size of their balance sheet that the regulators and supervisors are entirely and utterly unnecessary. You could get rid of the whole lot and save a bit of money. They are not necessary, but it is not them that are actually, for the most part, now setting the agenda; it is the markets that are much more setting the agenda than the regulators and supervisors.

Q99 ***Lord Trimble:*** So as well as being counter-cyclical we have to be counter-intuitive as well.
Professor Goodhart: To some extent, yes. The purpose of capital is to absorb losses. Losses come when times are bad, so you ought to allow banks to run down their capital to some extent—not obviously to a stupid level which endangers everyone, including the

depositors, but you should be allowing capital to be run down—but you can only really do that if you have built it up and you have a sufficient buffer in the good times.

Q100 ***Lord Trimble:*** Thank you, and thank you for the source of the punch bowl analogy, which I thought came from Alan Greenspan.
Professor Goodhart: No, it was McChesney Martin. It was decades before Alan.

Q101 ***Lord Woolmer of Leeds:*** Taking up that point, I understand entirely the proposition that reserves of capital should be built up in good times and run down in the bad times, but that has not happened and that is not where we are now. Given where we are now, which is inadequate capital, no excess capital run down, have the Member States within Europe and the Union itself responded to the situation as it was and is, as opposed to what it should have been like, and what further, if anything, can be done, or should be done, in the coming months?
Professor Goodhart: I think I would start by challenging the claim that the capital now is inadequate. There has been considerable recapitalisation through governments, many banks now have really quite a lot of capital, and there is a concern in some fields that the capital is now sufficiently large that when things get better they may actually try and expand again in order to restore their return on equity. So I am not sure that further recapitalisation is necessarily the correct answer. The concern is rather, I think, that there are lots of assets out there which might, particularly if our economies get worse, turn bad and suffer defaults and other losses. At this stage I think that there is, at any rate, an argument that the better course would be for the Government, effectively, to provide insurance, not against the worst assets. We frequently talk about toxic assets, but a lot of the mortgage backed assets which are treble A, in so far as they have a market value at all, are being valued in markets well below their probable valuation on a discounted cash-flow basis, and it would probably be a much better use by government of its money to provide insurance against all losses for the better of the mortgage backed securities that the banks now have and get them off their bank's books and, therefore, reduce the bank's leverage, so that the capital ratio improves even though there is no further actual injection of capital by government.

Q102 ***Baroness Northover:*** One of the things that we were looking at before, which links in again to the level of regulation, is about the possible need to reconsider the home/host country divide. I wonder if you could comment on that?
Professor Goodhart: Yes, this is perhaps one of the most difficult questions in this whole area. It really is an extremely difficult issue. I think I would start on this by repeating a phrase that I first heard from Tom Huertas, who is a very senior official in the FSA, and he said that a cross-border bank is international in life but national in death. Effectively what he means by this is that experience shows that when there is a cross-border bank, each country involved is going to look after their own bit and only their own bit, and you saw that with Lehmans, where, effectively, the US put Lehmans into Chapter 11 and they put a sort of wrapping over Lehmans US, the broker/dealer, so that it could continue as was, so that it could continue as a going concern, but they simply cast aside, without any concern, Lehmans UK—it is actually called Lehmans Europe, but I like thinking of it as Lehmans UK—Lehmans Asia and the rest. Not only that, but we discover after the event that the whole of Lehman UK's liquid assets had been shifted back to the US over night and were not available to Lehmans UK. If you look at the cross-border banks in Europe, Dexia and Fortis, effectively what happened was that each nation state took its own bit: with Dexia it got carved up, the French took the French bit, the Belgians took the Belgian bit, with Fortis it was the Netherlands, Luxembourg and Belgium, each divided up their own, and to some extent the same was true of the Icelandic banks. When there are real problems, everyone looks after their own, and that, I think, means that a country which is a host country has got to ensure against the possibility that a crisis may occur, and dealing with a crisis is a major responsibility of the regulator and supervisor that it maintains control and, what is more, if you are an Eastern European country such as, for example, Poland or Hungary, then effectively almost all the banks are foreign and it is your responsibility, as the regulator/supervisor in these countries, to ensure that you have a continuing, reasonably functioning financial system, and you simply cannot afford to allow your subsidiary to be gutted by the home country when the home country head office runs into difficulties. So my conclusion from that is that the experience of this crisis implies that we really ought to give more weight to the decisions of the host country and, more than that, I have been saying that I think that regulation ought to be counter-cyclical. Cycles differ from country to country. Spain and Ireland had financial cycles which were quite different from Germany, and that means that there is an issue of one-size-fits-all on the regulatory side, just as much as there is a problem of one-size-fits-all on the interest rate and monetary policy side. One can overcome this in a larger federal area, but I think, again, that the necessity is to have sufficient unity and sufficient agreement so that there is a fiscal instrument which can support the monetary instrument. The difficulty

with the Euro zone and monetary union is you have got a single monetary union without the support of a single fiscal union, and that causes a lot of difficulties. I think that one of the areas where it causes particular difficulties is in this regulatory field, and until the EU moves much more towards political and fiscal union, which I would be perfectly happy to see, I think that there should be a shift effectively back towards host country control rather than home country control. In my view, the colleges of supervisors are—I think Adair Turner said they are really a mechanism for exchanging information. They simply are not a sufficient basis on which to build an appropriate home/host regulatory structure.

Chairman: Very interesting. It is a bit like the paraphrase that you campaign in poetry and govern in prose. So perhaps you regulate in poetry and crisis-manage in prose, something like that. It is an interesting and real quality field, of course. Lady Hooper, could you pick the bits out of your question which have not been answered?

Q103 ***Baroness Hooper:*** Yes. I find it very fascinating, and until your last reply I thought I had clearly established in my mind the distinction that you had drawn between the crisis management role, the supervisory role and the regulatory system role, and, if I understood you correctly, the first one and possibly the second one are better done at national level, and in the third one there is a case for harmonisation. If there is, therefore, a case for putting increasing co-operation between supervisory bodies, how can it be done? Is the model of the so-called colleges of supervisors a good one? Should the ECB (the European Central Bank) be the appropriate vehicle for centralising it—I think you suggested that VOXEU had suggested the EIB—or should the Lamfalussy Committees be upgraded in order to perform that function? In saying all this, Lord Turner (and the Turner Report in due course), we understand, is saying that it is impossible, or would be impossible, to have an appropriate European supervision; so I leave it to you.

Professor Goodhart: I am really with Lord Turner on this. Exchanges of information, I think, are important, helpful and useful, and I think that it is desirable that supervisors of a very large cross-border bank should get together on a regular basis and exchange information, but that is about as far as it goes. When it comes to crisis management, I think it gets forced on to the host country because the home country looks after its own. There is, I think, a problem in the present financial crisis that one of the natural responses of the Government, which is providing funding and recapitalisation to its own banks, is to say to that bank, “Please concentrate on providing lending within our country”, so that effectively what is occurring is that all these cross-border banks which are now having to go cap in hand to government are effectively withdrawing from countries in which they have subsidiaries and in which they have branches, and that is a distortion of financial flows, and to some large extent I think it is a pity. I understand why it has occurred; I do not see what else could happen. The Lamfalussy Committees, CESR, CEBS (Committee for European Banking Supervisors), I think, do very good work, but, again, they have got no money and they really have very little power. They can propose harmonised ways of doing things, harmonised regulations, and I am very much in favour of having the principles harmonised between countries even if the counter-cyclical application will vary from country to country. I think they certainly do excellent work, but I think that they are not going to be the basis for the new regulatory system any more than they really provided a basis for dealing with the current crisis.

Q104 ***Baroness Hooper:*** And the role of the ECB?

Professor Goodhart: The ECB, undoubtedly, would like to get involved much more in supervision and regulation, and I think that it should have more information but, again, the ECB does not have much capital and the ECB is not in a position to recapitalise a bank—it does not have the capital to do so. It can provide liquidity; it cannot provide capital. Even when you are coming to providing liquidity, the ECB has made it very clear that it wants lender of last resort actions to be done by the national central banks rather than by itself. So, again you have the problem that if the ECB was to dominate supervision, say, of the major cross-border banks which are head-quartered in Europe, then there would be a problem, if it ever came to a crisis, that they would have been doing the supervision and then the ECB would have to turn to the national taxpayer to bail out the various cross-border bits of these large banks, and there would be, I think, a disjunction between the supervision done at the European, federal level and the crisis management, which would have to go back to the national level. There are those who say that that disjunction does not matter, or it can somehow be finessed, and that you could move towards having the ECB supervise the group of large cross-border European headquartered major banks without being able to do the crisis management, but again, speaking personally, I have never understood how you can separate crisis management from supervision. The locus which does the crisis management, because that is expensive and costly and difficult and needs to be done with democratic legitimacy, ought, I think, at the same time to have command over the way that supervision is done.

Q105 ***Baroness Hooper:*** Could one make the comparison with, for example, European environmental policy, where there is regulation which is applicable throughout Europe but where the actual supervising or, should I say, monitoring is done on a national basis? Indeed, the crisis management is done on a national basis more than at a European level, would you say that was a fair comparison?
Professor Goodhart: The comparator that I am aware of, which is near your field, is that there is a treaty on nuclear spills, so that if there should be a major nuclear disaster there is an agreed procedure which determines how nation states actually would bear the burden. With a Dutch colleague I actually looked for an alternative mechanism whereby you could have, in advance, agreement on how burden sharing might be done at the nation state level. It could be an alternative to having a pot of money at the federal level which could do the recapitalisation, if you could agree in advance how burden sharing could be done, but although there has been some consideration of that at European level, it has effectively been blocked by a number of countries, for a variety of reasons, but ex ante burden sharing might be a possibility.
Chairman: I was struggling to decide whether we had really covered our question six. I think we have. Could I get Lord Woolmer to follow up a bit however.

Q106 ***Lord Woolmer of Leeds:*** To follow up on Lady Hooper's question on the home/host country divide, these are issues all tangled up there, are they not? Most of these institutions are global, so when we are talking about host country instead of a home country, this goes to the heart of how Japanese banks, American banks, British banks, and so on, "are actually regulated and supervised". In practical terms, if one wanted to move more towards host country supervision, how would this impact on relations between the United States, for example, and Europe in terms of home country banks and host country banks? How would the Americans take to individual European Member States wanting to start to supervise and regulate banks on a host country basis? That is my first question. The second one, which is related to it: I understand entirely where you are coming from and I have a lot of sympathy for it, but does it not mean that banks would in a sense be sliced up into a series of branch banks, as it were, and this would have considerable implications to the way in which banks operated global banks and how they use their capital and, of course, the nature of global markets? Would you like to comment separately on that one?
Professor Goodhart: Let me take the second one first. Your point is absolutely correct. The way that regulation and supervision is currently done effectively provides, or tries to provide, a level playing field so that the cross-border bank can effectively decide on the allocation of its capital and the allocation of its liquidity from headquarters without any concern about the way the business is divided between its various branches and subsidiaries. With respect to subsidiaries, this would no longer be the case under the proposal that we are suggesting, and there is no doubt that the proposal that we are suggesting, with the greater weight on host countries, would mean that some aspects of the easy and efficient globalised working of these huge cross-border banks would be subject to, at any rate, minor frictions, it would make their life less easy, which means that the kind of proposal that we are making is unlikely to find favour with the Institute of International Finance and some of the biggest banks. It is quite a radical proposal in that sense. There is one qualification that I would make in this respect, and that is that you need to be very careful about the distinction between branches and subsidiaries, because subsidiaries already are supervised and regulated to an extent by the host country. The proposal that we are making would imply that the host country would introduce somewhat different controls on local capital and local liquidity than exist at the moment. So even with a subsidiary it would make life more difficult for the really big global bank. But there is a problem that the branches are not subject to regulation and supervision and, as a result, in this paper that we have been doing, one of the proposals that was included in that paper, and which in fact I included, it was my particular responsibility, was to say that any host country, when it designated that a branch within its own country was regarded as systemically important, would have the right to demand that that branch becomes a subsidiary and, therefore, subject to its own supervision and regulation. So your point is very well taken. Again, the exercise that I and my colleagues have been proposing is an attempt to try and ensure that countries can control the riskiness and destiny of their own financial system, and I think the implication of that is that the unfettered and completely frictionless globalisation of the financial system has to be subject to certain additional controls which will make the global system somewhat less frictionless than it has been in the past. There is a trade-off between efficiency and risk, and we feel that there has been some tendency to allow the financial system to get into a position of adopting excessive risk in order to try and pursue maximum efficiency, and we want to shift the balance slightly in the other direction; I think only slightly.
Chairman: Thank you very much.

Q107 ***Lord Steinberg:*** You said earlier on, when we were talking about credit ratings, that they failed dismally, and we can all see the results of that quite clearly. From an EU point of view, the Commission is

proposing to regulate credit rating agencies. Do you think that is going to help both in the short-term and in the long-term?
Professor Goodhart: My answer to that one is, no, and the reason for that is that what went wrong was the model building and the assumptions that went into the models that the credit rating agencies used. There is, I think, very little likelihood that the kind of bureaucrats and supervisors who will try to control the credit rating agencies will actually be in a position to improve those models. They are not model builders, that is not their particular capacity, so what would happen if the EU comes to try to regulate the credit ratings agencies is that they would actually become party to the blame when things go wrong in future. They will not actually make it better, because the difficulty is to get better models to do the modelling in a more sensible way, to speed up the exercise, and that is not something that supervisors and bureaucrats can do. What we really need to do, instead of regulating them, is to get them out of the exercise altogether. The credit rating agencies are being used primarily because both the institutions and the regulators have been lazy. Instead of actually coming to a judgment themselves, they have said that, as long as Moodys and Fitch call something treble A, then you can buy as much as you want of it and the risk weighting will only be such and such; so it has meant that neither the regulators nor the institutions have actually had to do their own due diligence. It has been way of saving the regulators and the financial intermediaries time and effort. The problem is that they have given far more weight to these ratings than the rating agencies themselves would want. The rating agencies never wanted to have their ratings made into an integral part of the regulatory structure, and yet they are, they have been—they are a key part of, at any rate, the standardised framework of Basel II, they were a crucial part of some aspects of Basel I. I think the need is much more to say that you should not rely on credit rating agencies for anything, rather than to take a line, "What we are going to do is regulate you", because you will just actually make the whole thing worse, in the sense that people will put even more weight on the credit rating agencies' ratings because now they say it is not only these clever credit rating agencies, it is the whole weight of European regulation, so we can certainly rely on them because there is a regulator sitting in Brussels who is there to say everything is all right, and, of course, the regulators and supervisor, whether he is sitting in Brussels or London, cannot. I think the European Union in this respect is going rapidly down exactly the wrong road.

Q108 ***Lord Steinberg:*** That is a very clear answer, professor. Very, very quickly then, what will you do to replace them, obviously not having a very high opinion of them?
Professor Goodhart: I think that the first line of wisdom is to realise that they are relatively faulty, and they are going to be particularly faulty when it is a new product. When it is a new product you do not know how it is going to behave over a cycle, particularly in a downturn, so that the main requirement is that both the directors of the financial intermediaries have got to make their own judgment and defend their own judgment and the supervisors have got to ask each intermediary on what basis—

Q109 ***Lord Steinberg:*** Instead of passing the blame on to somebody else?
Professor Goodhart: Yes. In a sense, the buck was passed to the credit rating agencies in a way that the credit rating agencies actually did not want to happen. They did not want to get involved in this regulatory framework; they were pushed into it.
Lord Steinberg: Thank you.

Q110 ***Lord Woolmer of Leeds:*** Turning to areas where some people think there is insufficient regulation, things like hedge funds, credit default swaps and so on, first of all, do you agree that they are not sufficiently regulated? You may not agree with that. If you do agree they are not sufficiently regulated, what if anything should be the principal underlying different approach in those areas?
Professor Goodhart: Can I deal with hedge funds first, because that is a slightly different issue from CDS. Hedge funds and private equity, and a few other intermediaries along those lines, are fairly heavily leveraged. Individually they are not like these huge banks; they can be allowed to go bust. I notice here, although admittedly it was an exception, that Amaranth was very large and went bust without that much difficulty and a huge number of hedge funds had to close down in this crisis and nobody other than those who had money there actually noticed. Even Madoff, which was huge—it was a tremendous embarrassment and a huge loss of money to large numbers of people, but it had no effect on the financial—

Q111 ***Lord Woolmer of Leeds:*** Systematically you mean?
Professor Goodhart: Yes, systemically. These institutions are really important only when they move together. They are systemic as a herd; they are not systemic individually. What that means is that I would try and have macro-prudential controls over their systemic effect, which again means that you worry much more about their leverage and you worry much more about their rate of expansion than worrying about their specific portfolio. They should be allowed to choose whatever portfolio, within reason. Obviously Madoff was a fraud, but, within reason, they should be allowed to make their own

choices, but when they all start expanding or cutting back simultaneously, again I think that there is reason for concern and, again, I would like to see controls on their rate of expansion, particularly during boom times. So I would not have macro-prudential controls. In the report that we gave, that was one of the areas where we had most difficulty: what do you do with systemic as a herd? We all agreed on micro-prudential controls, but some wanted micro-prudential individual controls on the institution as such. I was all for just macro-prudential controls. The CDS market is different; it is a different set of issues. There is one set of issues which I think everyone can agree with, which is that when a derivative market like the CDS market gets big enough, the transactions ought to be made through a central counter-party clearing house. There is a debate, which is not yet resolved, whether you need to go on to a formal exchange or whether it is sufficient simply to have a central counter-party, and I am not particularly familiar with that debate, I would not want even to express a view. There is another concern as well, which is that CDS is a way, effectively, of shorting an institution's credit, and just as there is a concern about a naked short in the equity market, so I think there is a concern about a naked CDS when you are not actually hedging it because, particularly where the CDS market is quite thin and there is already some concern about the institution, by effectively buying CDS, or buying insurance, you can actually drive the CDS rate up, and the institutions' rate at which it can borrow in the market is related to its CDS rate so that it is possible for speculators to manipulate, in a thin market, the CDS rate to a point that it drives the rate at which the institution can borrow so far against it that it makes the default of that institution become more likely. So there is at any rate in my mind a real question whether it would be possible, feasible, and/or desirable, to have the same kind of controls on naked CDS as it is to have on naked short-selling. I think in the CDS market, where an institution actually has an interest because it holds some of these in its own portfolio and wants to insure against default, that is absolutely fine, that is the ordinary mechanism for using these derivative markets for hedging, but where you are using it for pure speculation and the market is thin, there are worries in my mind about the possibility of naked speculation effectively forcing the institution into default, whereas otherwise that might not need to have happened.

Q112 ***Lord Woolmer of Leeds:*** Which Member State and which country might undertake such regulation or supervision? What would a host or home country distinction mean?

Professor Goodhart: I think that getting to central counter-parties is step number one, that I think is absolutely necessary and I think that virtually everyone is now agreed on it, though again there are problems of which I am not really privy, I do not really understand. There is a concern in Europe that several in Europe want there to be a separate central counter-party for CDS in Europe in addition to the central counter-party and market that is going to be set up in the US. Why we need a separate European system it is not entirely clear to me. Why it cannot all go through a central counter-party in the US, I do not know. Whether this is pure turf or whether it goes further than that, I just do not know enough.

Chairman: Thank you very much, Professor Goodhart. We have trespassed considerably on your time, but thank you for staying with us. It has been most useful.

TUESDAY 10 FEBRUARY 2009

Present	Cohen of Pimlico, B. (Chairman)	Renton of Mount Harry, L.
	Haskins, L.	Steinberg, L.
	Hooper, B.	Trimble, L.
	Moser, L.	Watson of Richmond, L.
	Northover, B.	Woolmer of Leeds, L.

Memorandum by the British Bankers' Association (BBA)

1. The British Bankers' Association (BBA) is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK and international banking issues. In addition, 37 professional firms are also associated with us. Our members, whilst predominately banks, engage in activities which range widely across the financial spectrum, encompassing services and products as diverse as primary and secondary securities trading, insurance, investment advice and wealth management, custody, as well as conventional and non conventional forms of banking.

Summary

2. The BBA believes the EU has an important role in formulating a policy response to the financial turmoil. Nevertheless, we believe that it is of utmost importance that the EU does not respond in isolation.

3. A regional EU solution can be counterproductive unless there is global coordination and a global framework. In this respect, we strongly support the work of the G20 and the Financial Stability Forum (FSF) in formulating a coordinated global approach. We believe the EU can play a leading role in this global context, but only if it avoids separate, regional approaches.

4. With regard to the current EU proposals on the table, the BBA believes that proposals on refining the capital requirements of firms, the regulation of credit rating agencies, deposit guarantee schemes and accounting standards are part of the answer to making the international regulatory framework more resilient in the future.

5. We also advocate greater efforts on improving early warning mechanisms for individual institutions and cross-border cooperation between Member States in times of crisis.

6. While we oppose the creation of a single EU regulator, we advocate the creation of an EU body for financial stability which would report to the EU Member States. In addition, the Committee of European Banking Supervisors (CEBS) should be given greater resources and status to allow it to provide the analytical rigour to detecting risks to financial stability.

7. Finally, we support the proposals to create colleges of supervisors for cross-border financial institutions, although ideally these should have a global framework to avoid costly regional duplication.

Current Commission Proposals

Prudential Financial Regime

8. We believe that enforcing a prudential financial regime is certainly one part of the answer to the question of how to prevent a repeat of the current turmoil. Obviously, if any change in the Basel II Accord is to be introduced, sufficient time should be granted to the industry to comply with the new rules.

9. We note that the focus of EU regulators in recent recapitalisation proposals has been to require firms to hold levels of core Tier 1 capital significantly in excess of the minima prescribed in the Capital Requirements Directive (CRD). This has inevitably encouraged banks to hold a buffer over this core Tier 1 capital requirement, which has knock-on effects on the markets' (and rating agencies) expectations about core Tier 1 capital levels in the future. The current harmonisation of capital definitions being proposed in the CRD is welcome. We need the same definition of capital in all Member States; it should be clear what assets can be considered as Tier 1 and core capital. Regulators should be prepared to widen their view of the acceptable constituents of regulatory capital to include hybrid Tier 1, as well as Tier 2 and Tier 3 capital.

10. The gross leverage ratio employed in the US did not prevent losses on sub-prime assets or the liquidity strains arising from their sponsoring of SIVs and conduits. This palpably demonstrated that leverage ratios do not necessarily work. Furthermore, as leverage ratios are not risk sensitive, Basel II represents a more sensible approach to the definition of banks capital requirements.

11. We are also concerned that a leverage ratio could introduce its own perverse incentives, such as encouraging a shift into off balance sheet and riskier (higher yielding) assets, as well as being difficult to apply internationally whilst there are different definitions and application of capital/ accounting rules.

Capital Requirements Directive

12. The amendment of CRD originally arose out of a need to correct a number of errors and omissions that became apparent when banks started implementing it at the beginning of 2008. With the financial crisis underway, the European Commission combined technical amendments to the original Directive with measures designed to respond to the crisis on supervisory arrangements, hybrid capital, securitisation and large exposures.

13. Two "preventative" measures designed to address some of these issues were a) the introduction of a quantitative retention requirement on risk transfer vehicles (securitisation) and b) the creation of the college of supervisors to overlook pan-European banking groups with the consolidating or lead supervisor given significant powers.

14. Regarding the securitisation proposal, we raised objections to the suggestion that originators should be required to retain a share of the risk (minimum 5%). Such a move is unlikely to solve the perceived inadequacies of the originate-to-distribute model while they would seriously impact the securitisation market. A reduced scope in the Council's general approach of 2 December 2008 has improved the original proposal. Even better is the draft report from 27 November 2008 by the Rapporteur in the European Parliament, Othmar Karas MEP, who has proposed a further reduction in scope. Nevertheless, we continue to be extremely concerned about the proposed investor obligations, deviation from which would attract punitive capital charges. We believe these obligations will constrain securitisation as a significant funding source. We also note what the Chairman of the Financial Services Authority, Lord Turner, said in his oral evidence to the Committee on 25 November 2008 that the FSA did not think the European Commission's proposal on securitisation is a crucial reform.

15. Regarding the establishment of the colleges of supervisors, we are very supportive of this idea and in particular the ability of the consolidating supervisor to take the final decision in instances where college members cannot come to a consensus. Regrettably, this has now been watered down by the Council's general approach, which we believe is a missed opportunity. We also emphasise that a regional based EU college would only be of partial benefit to global banks and that relevant third country regulators should also be included in the college process.

Credit Rating Agencies

16. Regarding the Credit Rating Agencies (CRA) Regulation proposal, we believe CRA have for a long time played a key part in major financial transactions. We do not have a strong preference between a voluntary code, such as the International Organisation of Securities Commissions (IOSCO) code, or formal regulation, such as the European Commission's proposal for a Regulation, as long as the outcome is a credible regime that is globally consistent. If a voluntary code route is preferred it must operate with credibility and any oversight mechanism must be effective. For a regulatory route, we believe the system must be proportionate, globally consistent and non-protectionist and not raise significant barriers into the CRA market.

17. While recognising the political pressure for action, we believe that the EU should avoid creating regulatory gaps that would result from misalignment of the proposal with existing standards (eg, the IOSCO Code and the Securities and Exchange Commission (SEC).

18. We are seriously concerned about the damaging consequences of the proposed extraterritoriality regime in Article 4—that institutions are only allowed to trade instruments rated within the EU. Responding to the proposals, the BBA along with other London based trade associations noted that Article 4 is cast in such a way that the EU seeks to exercise global control over the credit ratings industry. The effect of this will be to substantially limit the ability of EU regulated financial institutions to make use of non-EU related credit ratings for regulatory purposes, even where they are well founded ratings taken into account by equivalent non-EU entities. Furthermore, European investors will be substantially limited in their flexibility to invest in regional (eg Asian) securities that are rated by local CRA that lack the resources or desire to establish an EU-registered subsidiary.

19. Our preferred approach for the European Commission's proposal for a Regulation would be:

— A regime which places responsibility for registration, monitoring and enforcement with the national authorities, and which provides for mutual recognition.
— A clear division of responsibilities and powers between the lead (home) supervisor and the host supervisors.
— A joint Committee of CEBS and CESR to produce guidelines to deliver convergent behaviour by national authorities, making reference as appropriate to the Code.
— Supervisory co-operation between national authorities regarding registration, monitoring and enforcement.
— Removal of any duplicative material within the CRD.
— Clear, independent and objective criteria for determining from where a CRA should be supervised.

Accounting Standards

20. We have been supportive of the work undertaken so far by the International Accounting Standards Board (IASB) in reviewing its standards and guidance under its remit from the FSF. On 13 October 2008, the IASB agreed an amendment to International Accounting Standard (IAS) 39 to permit firms to reclassify, in rare circumstances, non-derivative financial instruments from the trading book to another category within IAS 39. This moves International Financial Reporting Standards (IFRS) into line with US General Accepted Accounting Principles (GAAP). Following a request from the FSF, the IASB has also issued guidance to help firms value financial instruments in illiquid markets. The IASB and the US Financial Accounting Standards Board (FASB) have also established a new high-level global advisory panel to identify the accounting issues which require their urgent and immediate attention.

21. Although European policy makers identified reclassification as a key issue for the IASB to address in the short term, there was much pressure from some sections in Europe for the EU to take its own action on this issue in preference to working through the IASB. We strongly opposed this as it would have led to a new "carve-out" which could potentially have led to the US ceasing to recognise without reconciliation to US GAAP, financial statements prepared in accordance with IFRS from European firms with US listings. Further, it could have fractured the IASB and led to the creation of a new EU standard setting body.

22. Consequently, we agree with the G20 that the governance of the IASB should be further enhanced to ensure that it operates under appropriate levels of transparency and accountability, but stress the need for any changes not to compromise its political neutrality. Careful consideration must be given to how the IASB can identify and address urgent issues in an appropriate and timely manner. We would also underline that the IASB has made significant progress towards becoming a global standard setter in recent years and that it needs to be supported in this task.

Protection of Bank Deposits

23. Following the recent market turmoil and resulting bank failures, the BBA recognised and supported the need for enhancements to the Deposit Guarantee Schemes (DGS) Directive to support consumers.

24. The BBA did not oppose the proposed increase of the minimum level to €50,000 as the increased level of cover should go some way to address the current problems with consumer confidence as well as strengthening consumer protection. The UK, of course, already exceeded this level of protection. However, with regard to a further increase ie to €100,000, we welcomed the decision not to move to the higher level before a cost benefit analysis has been completed. The BBA's own analysis for the UK authorities confirms that the existing level of £50,000 already covers the overwhelming majority (in excess of 97%) of relevant depositors. A further increase to €100,000 would have only a marginal impact on the overall level of coverage.

25. We also welcome the move to harmonise the coverage level. We believe this will help avoid market distortion across Europe. The experience in 2008 of unlimited coverage in Ireland had competition implications in the UK. Depositors relocated their deposits to Irish bank branches operating in the UK or alternatively directly cross-border to Irish institutions.

26. As regards to the payout timeline, the European Commission's original proposal of three days was unrealistic. In August 2008 the FSA, together with the BBA and the Financial Services Compensation Scheme (FSCS) commissioned Ernst & Young to undertake research to review the costs and benefits of various options for accelerating FSCS payments to depositors. The research found that for small and medium sized banks the majority of depositors could receive compensation between 7–10 days based on cheque payment from the

compensation scheme. The operations of large or very large banks were found to be of such scale and complexity that final settlement would take considerably longer and orderly payout for such institutions could best be achieved by separately providing access to or transfer of current accounts and payout of other savings products. Hence, we welcome the compromise agreement by Council and the European Parliament on extending the European Commission's proposed payout delay from three days to 20 days, with a possible 10 day extension. The proposed five days for authorities to determine a bank's inability to meet its commitments is also welcomed.

Other Issues

27. We would also like to note that the European Commission issued on 18 December 2008 a consultation on introducing legislation of hedge funds. Whilst we do not oppose greater regulation of hedge funds, we note that the G20 Summit in November 2008 called for coordinated action in this area. We are concerned that by rushing ahead in this area the EU is unilaterally taking action without first achieving global consensus on what needs to be done.

28. Finally, the European Commission has called for a central counterparty (CCP) established in the EU to clear credit default swaps (CDS). We are concerned about the European Commission working towards a regional European solution when industry has been working towards a global solution to the problem in consultation with decision makers on both sides of the Atlantic. Market participants are continuing to assist the efforts of central clearing service providers, through dialogue and feedback on the technical challenges to be surmounted in establishing efficient, sound clearing houses.

Further Legislative Opportunities

29. We see deposit guarantee schemes as an important financial stability feature in stressed market conditions as they underpin consumer confidence and act as a brake on potential bank runs. Events have shown however that in certain circumstances, there are limitations to the impact that schemes can have on maintaining consumer confidence and financial stability. We therefore stress that the European Commission should place prevention of banking failures as the primary objective when considering how best to protect the interests of depositors. Furthermore, the effectiveness of the measures undertaken by the Member States should be improved by limiting them to effectively viable banks.

30. Events during this turmoil have shown that it is crucial to deflect the worst impact on depositors by maintaining the existing infrastructure of a failing bank. By retaining some critical services for consumers, there need be no disruption to customers' access to funds or a situation where depositors need to deal directly with a depositor protection scheme. In the case where a medium or large bank was allowed to become insolvent or fail operationally (as opposed to a financial failure) trying to arrange a compensation payout within a number of days of compensation to all of the bank's eligible depositors would be absolutely impractical. Any attempt to conduct such a fast payout would carry many other hidden dangers and complications, such as increasing the risk of fraud.

31. One of the important questions for the internal market is how the deposit guarantee schemes are funded. In many EU countries deposits are quite concentrated in a relatively small number of banks, which are often active across national boundaries, either within the EU or more globally. We would question the need to harmonise funding models given diversity in banking markets and systems across the Member States. Pre-funded and post-funded models have both their advantages and disadvantages.

32. It is unlikely that any pre-funded DGS would be able to amass sufficient funds to pay out depositors in the event of a major bank specific failure. The Icelandic scheme is pre-funded and was found to be completely inadequate. Even if a pre-funded scheme had enough funds to cover major institutions, it is doubtful whether the existence of such a fund would actively prevent its failure in the first place. The existence of a pre-funded scheme in the United States did not stop the run on IndyMac bank and its subsequent failure. The market in the US is very different in nature to most European banking markets including in the UK.

33. On early warning mechanisms and crisis management, we believe progress is necessary on achieving consistency across the EU in the criteria for invoking standing liquidity facilities of central banks and developing common early intervention mechanisms across the EU. It may be necessary to review the Directive on winding up credit institutions to this effect.

34. We also believe that when circumstances allow, the temporary facilities and state guarantees that governments have provided to many banks should be dismantled to allow normal market conditions to resume. A specific time-frame for an end to public capital injections must be built into the schemes, as mandated by the European Commission Guidelines on the rescue packages. We are particularly concerned

about the differences between the various bail-outs in the EU Member States, which may contribute to an uneven playing field in the EU.

35. When considering the various issues surrounding both crisis prevention and crisis management, there are processes and protocols in place that are useful in producing successful outcomes such as central bank coordination, cooperation between central banks and supervisors, and early warning systems and early intervention mechanisms. Building a common approach to these processes and protocols across EU Member States would strongly increase the likelihood of successful crisis prevention and management without reaching the stage of fiscal burden sharing. At the very least, this strengthening would reduce the impact of this thorny issue in the exceptional case(s) where it was seen as necessary. In such cases, public cost would be shared according to the Common Principles elaborated in the MOU on cross-border financial stability of 1 June 2008.

EU Supervisory Reform

Cross-border Supervision of Financial Institutions

36. Now is also not the time for promoting, as some have done, a single pan-EU regulator, either at the European Central Bank (ECB) level for the Eurozone or the EU as a whole. In the absence of further harmonisation of legal underpinnings, notably aspects such as insolvency and contract law, a single pan-EU regulator is neither a practical proposition nor realistic. Supervision is still very much a national responsibility and the responsibility for ultimately bailing-out a failed institution remains a national concern. Therefore we continue to believe that the home supervisor should lead and take final decisions for cross-border banks in a system with colleges of supervisors.

37. However, we do believe that more can be done to promote financial stability at an EU level than before. To improve financial stability we have developed two proposals.

38. Firstly, we advocate a formalised European Financial Stability Forum (EFSF) developed out of the existing roles of the EFC and the FSC. The EFSF should be a body which includes finance ministers, central banks and supervisors and report to the Member States with whatever actions it considers should be taken. Such a body would improve the monitoring of macro issues arising in or impacting on the EU.

39. Secondly, we would like to see a substantially enhanced role for the Committee of European Banking Supervisors (CEBS) in co-ordinating and bringing coherence to regulatory arrangements, while retaining the direct link with a majority involvement of the individual Member State regulators. Its responsibilities would include helping the consolidating supervisors establish colleges of regulators for the relevant cross border banks; a key role in maintaining the focus of the colleges on the relevant issues; a mediating responsibility should consensus not be achieved in a reasonable time period; and playing an active role in increasing the quality and calibre of regulators across Europe. Decisions should remain non-binding. This enhanced CEBS would require greater resources in terms of finance and personnel and would be well-placed to provide assistance to a body overseeing financial stability, like the EFSF.

Colleges of Supervisors

40. We remain convinced of the value of colleges of supervisors and recognise that their role and operation needs to be reviewed and reformed in order to meet the future requirements. In brief, all cross-border banks should have a college of supervisors which should be chaired by the consolidating supervisor. Colleges should have an inner core grouping consisting of the home state supervisor and supervisors from other countries where either the bank has a significant operation from its perspective or it is deemed to be systemic by a jurisdiction.

41. The colleges should have a clearly defined remit of issues, including capital and liquidity issues, and should seek to ensure that rules are applied equivalently to bring about equivalent outcomes in the various EU countries in which the bank operates. Whilst we understand the desire for a single set of rules across Europe, the different legal frameworks and cultures raise many impediments to a successful outcome.

Home and Host Country Divide

42. Whilst we support a strong consolidating supervisor process, we also understand the political pressures in the EU for host-country powers. Indeed the Icelandic experience in 2008 also showed that the UK would have needed greater oversight over the activities of those banks that operated in the UK through branches. We believe this area needs more work and we need to establish processes to resolve disagreements between supervisors (without expecting that in every case discussion will eliminate disagreement) in colleges. We

suggest that there should be simple procedures by which both information requests and supervisory decisions may be subject to informal challenge by other regulators with a legitimate interest.

43. In our view a supervisory college provides an effective forum for identifying and understanding differences between regulators. Such differences may always be resolved bilaterally and CEBS already has a procedure in place to allow mediation between disagreeing supervisors.

44. A better resourced CEBS should be able to challenge supervisory decisions and particularly in the event of disagreement in a college to mediate those decisions. CEBS will also be able to set a reasonable timetable for a college decision to be made.

45. Ultimately, of course, there also has to be a global solution. Simply creating an EU structure would undermine the ability of firms to operate in third country jurisdictions and would also affect the major EU financial centres, whether in Frankfurt, Paris, London, Milan, Madrid or Amsterdam.

Working Practices

46. We believe the current crisis has shown shortcomings in the way the EU institutions address financial services issues.

47. With regard to the workings of the EU institutions, we stress that the European Commission is a policy-making and not an operational body. The European Commission can review rules and regulations to avoid certain situations occurring again in the future but it cannot take decisions to address issues affecting national banks, which therefore remain the purview of national authorities. The primary and final responsibility lies with Member States and national taxpayers. In crisis situations the role of the European Commission is to support the Member States' activities through, for instance, its role in competition law.

48. Indeed, the European Commission's competition authorities have shown some flexibility when reviewing Member States' rescue plans or bank support schemes. Such fast-tracking is welcome and gives greater certainty to market operators in distressed times. Consideration should be given to formalising such processes in times of crises.

49. French President Nicolas Sarkozy showed the primacy of the Member States in a crisis during his period presiding over the European Council. We believe our proposal to create a European Financial Stability Forum (EFSF), which reports to the Member States, will help considerably in the future to have a coordinated European response to a financial crisis and not merely a disparate number of EU national solutions.

Global Supervisory Reform

50. The UK banking industry is outward looking and therefore the global crisis that was triggered by the US sub-prime market has impacted with severe consequences. In addition to the action taken by the UK authorities, international regulatory bodies—under the aegis of the FSF and more recently the G20—have set in motion an action plan to coherently address the shortcomings in the regulatory framework for financial institutions. These measures are comprehensive in nature and are supported by the UK Government which appreciates that problems associated with a global industry need to be addressed on a global basis.

51. The BBA shares the UK Government's vision of a global financial system based upon global standards developed by specialist standard setters and enforced at the national level. This can and should be achieved through the development of existing structures. Existing global institutions should be made to function better, rather than creating new institutions.

52. Given the marked evolution of the financial world since many of the current international institutions were put in place, any debate on the future of the international regulatory system must include as wide a group of nations as possible. Such debates should include new and emerging financial centres in order to achieve global consistency and cooperation in the future. We suggest that the UK Government uses its upcoming chairmanship of the G20 to lead the call for an open and inclusive debate on the new global regulatory settlement and a fundamental review of the membership of the international organisations—Basel Committee for Banking Supervision (BCBS), IOSCO, the International Monetary Fund (IMF), the World Bank and FSF.

53. The BCBS, in particular, would benefit from a thorough reassessment of its membership. Of the 13 Committee members, 10 are European and just one is from Asia. This clearly does not reflect the current balance of international financial centres.

54. The FSF has already taken steps to expand its membership beyond the G7 but if it is to function efficiently in the future, then it will be vital for new financial centres to be represented. The IMF and World Bank must follow suit.

55. It is inevitable that some national politicians and regulators will react to an international crisis by retreating from international solutions and adopting their own local or regional approaches. Such approaches not only significantly increase the compliance costs of doing business across jurisdictions but also reduce competition in local markets to the detriment of consumers. If the international institutions and global standard setters, which should be used to deliver global solutions, do not ensure that they are transparent and open in all that they do, this will only increase support for local and regional solutions.

56. The EU and its institutions do have a critical voice and influence in maintaining financial stability, but not in isolation. The IMF and the FSF have recently agreed on a revised and clearer distribution of responsibilities. We believe it essential that the EU uses these bodies as conduits for inputting views.

57. As mentioned already, we consider that a European body for financial stability, such as our proposal for an EFSF, should be set up to help the Member States agree a unified set of views about global financial stability issues, and provide a distinctive voice for the EU in the global financial stability dialogue and action.

58. Although it would be beneficial for the EU to develop financial stability-specific dialogues and consider these in conjunction with major global partners, multi-lateral solutions are vital. Typically, these could be undertaken through existing frameworks such as the Transatlantic Agenda or with the Association of Southeast Asian Nations (ASEAN). Again this does not involve the creation of new entities.

27 January 2009

Examination of Witness

Witness: Ms Angela Knight, Chief Executive, British Bankers' Association, examined.

Q113 ***Chairman:*** Welcome, Ms Knight, and accompanying team, to Sub-Committee A. We are on the air. You have got in front of you a list of the Committee's interests that have been recorded. We are recording this session for a webcast so please, therefore, use the microphone. You will get a transcript of what is said during the session. If you would prefer to start by making an opening statement, please do, otherwise we can start asking you questions, whichever you would like to do.
Ms Knight: Can I first of all thank you very much indeed for inviting me here and thank you also for asking the BBA to put forward a submission to your Committee, my Lord Chairman. As far as an opening statement is concerned, I thought we were going to go straight into questions so I am happy to do either.

Q114 ***Chairman:*** We will do that and I will kick off, if I may. In your written evidence you cite strong objections to the part of the Capital Requirements Directive which aims to ensure the originator keeps part of the risk in securitisation transactions. If this proposal remains in the Directive, even if it is watered down, do you feel there is a risk that financial institutions could relocate outside of the EU? This is one of these proposals which looks, as it were, to the general reader to be quite a sensible one but I know the BBA opposes it and I would like to get clear in all our minds precisely why. If you are not going to do that, how else would you regulate securitisation?
Ms Knight: It is one of these areas which keeps on moving and changing, so the situation a few weeks ago on the proposal for retention under the CRD is different from the proposal today. As to what is going to be the final outcome, we still remain uncertain because there are various amendments that have been tabled by the European Parliament, so we have not come to completion. The proposition as it stands at the moment, if I include those amendments that have been made, are firstly that out of the retention proposal are syndicated loans, and we think that is a very good idea.

Q115 ***Chairman:*** They are not included.
Ms Knight: Also out of the retention requirement are what I would refer to as the simple securitisations, those, for example, which relate to retail mortgages, loans on credit cards and so forth. By narrowing down the scope by these amendments to the sorts of securitisations where serious question marks have been raised—and one can understand the reason why the Commission has brought this forward—has meant that retentions is now in a very different place—that which is "plain Jane" is out of the requirement and that which is more complex is in the requirement, but, as I say, we have not yet got to the finishing line.

Q116 ***Chairman:*** Can you give me an example of a more complex sort of securitisation which still remains the subject of the requirement?
Ms Knight: A lot of the structural products over which there have been some concerns about transparency and so forth would have a retention requirement. There are people who will say a retention is de facto wrong because there is a better way of getting to the sensible outcome. What is the sensible outcome? That is that the originators of securitisations have a long-term responsibility for their performance. The way that the Commission has looked at it is simple, understandable and it says "x per cent must retained". What others will say is

that clarity and some responsibility for repurchase is another way of ensuring that you retain that long-term responsibility for that which you sell. I am not sure that one can say that one route is right and the other route is wrong. Those who will say a retention is always wrong say it will limit the market, and the answer is, yes, it will limit the market, but those who do not like something which is just all about disclosures and so forth will say if these are the only requirements then somebody will find their way round. There are arguments on both sides. From the BBA's perspective, we do believe that there are a lot of those simple retail securitisations and, of course, the syndicated loans that should not have the retention, so we are in favour of that. Also, we are believers in a greater degree of clarity and transparency requirements might be laid on by authorities here or elsewhere. Sorry, I have given you a long answer to your easy question.

Q117 ***Chairman:*** No, thank you. So the EU is beginning to accept the idea that the simple, the plain vanilla secured loans should not, in fact, be subject to this requirement.
Ms Knight: Yes. It is something that has come and gone. There are a lot of interested parties, as you know, and all have got a locus in it. At the end there will be some sort of negotiation and we hope that we get the right outcome. There is certainly a wider acceptance and agreement now that all securitisations do not sit in the same boat: that not all securitisations are complicated, that securitisation is extremely important in order to assist in getting things like the mortgage market moving again and are very important as well in terms of the provision of credit. That too has concentrated minds away from what I would call the theory or philosophical proposal into what are the practical realities.

Q118 ***Chairman:*** What is your feeling as to where it is going to come out, an alternative method of regulating securitisation?
Ms Knight: I hope, first of all, that as far as the Capital Requirements Directive amendments are concerned it will come out, as I have said, with the simple and syndicated loans out of retention. What I also hope happens is that the discussions that take place in Basel results in common standards for everyone because it would be a great pity if Europe went in one direction and the rest of the world went in another. The Basel standards are not mandatory but have tended to be employed by most major countries in some form or another around the world. I accept that the US did not absorb Basel II into its own requirements but, nevertheless, you have got a lot of countries that sit around Basel—not quite enough—and you also have a lot of adoption of Basel standards—not quite enough—but it is the one international body that can make prudential requirements which are generally adhered to. As the securitisation has come up the prudential requirements route, if you like, then it is something that has to be looked at at Basel. We want to have an end game which at least brings a reasonable degree of harmony in the different countries, not least because if you do have something which is perceived to be inappropriate, too harsh or more expensive in one major country or one major region compared with another which is also considered to be appropriately regulated then your firm or bank might not shift countries but that aspect of the business may shift. There will always be a certain amount of competition—and I think competition is a good thing—but certainly one of the outcomes from this credit crisis has to be that there is a greater degree of common standards, particularly in the prudential areas, applied as internationally as we possibly can make them. That is why there is an importance that Basel and the EU work together in this area.

Q119 ***Chairman:*** Can I just be get clear in my mind what that might come out of. What would an agreed Basel standard about a complex product look like? Would it say, "You have got to buy it back after 10 years"? I am having difficulty imagining it.
Ms Knight: I quite agree with you. What I do know is the EU, for example, is trying to sell its retention proposals on securitisation into the Basel arena, which is a perfectly sensible thing to do from their perspective, and others are trying to sell the broader approach which requires transparency and some form of alternative longer term commitment. We may well come out with a mixture because in the end compromises are done and those compromises often give a certain degree of flexibility underneath to local jurisdictions. There is a tension between harmonisation and flexibility and it is like a lot of these boundaries, you know when you have gone too far in one direction once you have crossed it. Self-evidently, there will have to be a certain amount of flexibility there because there are different legal requirements around the world. I would expect that there will be some form of a compromise that is done that probably absorbs a mixture of the proposals of the EU and some of the other propositions that are sitting there on the Basel table.

Q120 ***Lord Trimble:*** Turning to capital requirements, I think you said in your evidence that you regard Basel II as "a more sensible approach" to capital regulation. Could you explain why?
Ms Knight: We said it was a more sensible proposal, we did not say it was right, so perhaps I can put that down as a starter for 10. Basel I was fine, it was the first decent attempt to get some harmonisation in capital standards and it was fairly broad-brush. They

moved to Basel II to get something that was much more sensitive in terms of applying capital to the actual risks that were being run by a particular bank and that in turn meant that banks risk controls had to be more sensitive and a greater need to understand precisely how the various parts of the portfolios of the banks that adopted Basel II were performing. Basel II has only just arrived and it is quite difficult to judge something on its performance at the height of one of the greatest economic crises we have had in living memory. Certainly it is an improvement on Basel I in terms of sensitivity but it has highlighted a number of things which it has not got right of which what is widely called the pro-cyclical nature of Basel II being probably the one that most readily comes to mind. By that I mean that if in the good times you run on lower capital levels then in the bad times you have suddenly got to build up these capital levels. The point at which the economy turns down, the point at which there is often a requirement for a bank to do more, especially if other lending is exiting the country, as is the case here in the UK, is that very point that a bank is required by the rules to start building up capital against the assets that it holds. That is why it is pro-cyclical and that perhaps is one of the main areas that does need to be addressed.

Q121 ***Lord Trimble:*** We had some evidence given to us recently saying that really you need to be countercyclical the whole way through in this and to build up capital in the good times in order to have a cushion that you run down in bad times because if you are trying to build up capital in the bad times are you not then accentuating the problem?
Ms Knight: Of course you are and, therefore, what you have been told is entirely correct. As I understand it, there were several years of debate on this very issue before Basel II was agreed and, in effect, those who said it was going to aggravate a downturn have de facto been proven to be correct. There are another couple of points, if I may, that head around the side but are pertinent as well. The first is that Basel does allow a bank to operate what is called a through the cycle regime, and a through the cycle regime in turn allows greater recognition to reserve more capital in good times than in the downturn. However, of course, we have not had Basel II in place long enough for that to have been agreed at the start as being a method that the banks could use. Secondly, we remain unsighted as to whether that could result in enough capital anyway. On the side of it lies the international accounting standards, which also impacted at the same time, which in effect say you can only reserve capital against a known problem and you cannot reserve capital against an unknown problem. In a simple world we would all hold provisions on a just-in-case basis, so the new accounting standards actually were significant in their interplay here as well. In Spain they did something different. In Spain the Central Bank said, "No, we think Basel is pro-cyclical so our banks are going to have to hold more capital". I think actually Spain said, "We're going to interpret it this way". Nevertheless, they imposed that requirement.

Q122 ***Lord Trimble:*** And the Spanish banks have done better than others?
Ms Knight: So far the Spanish banks have done better. They have a lot of small internal ones but I put those to one side as they are mutuals and they are in a different place. Their international banks certainly went into the downturn holding more capital as a result and Spain also disapplied the relevant international accounting standard. I would say to you it is one thing if you do this in Spain, I think it would have been quite a different matter if the UK the largest international banking centre, arguably in the world, also had disapplied both the Basel standard and an international accounting standard.

Q123 ***Lord Haskins:*** There is a paradox in all this. The European Single Market is extensively regulated by the EU, but the engine room of the Single Market, which is the banking system, is not, that regulation remains effectively with Member States. Howard Davies suggested in the *Financial Times* a few weeks ago that there was a case for a much more comprehensive EU regulatory approach to the banks. He was referring to two things: first of all, the Icelandic bank situation, and we know what happened there, and, secondly, to the tendency towards protectionism because there is a view that a lot of the European banks are putting money away from the British banks and creating a lot of instability and vice versa. What do you think about the practicality of introducing substantial EU regulation of banks?
Ms Knight: I certainly think there is a case for some change, yes, and that begs the question what change, how do we bring it about and for whom. The key question about change really is for those major financial conglomerates which are operating in a multiple of jurisdictions. The reason I use that terminology is because if you are operating cross-border you are in a whole different position than if you are operating locally and, secondly, because banks own insurers and some of the activities of insurers anyway even if they are not owned by a bank are quite difficult to distinguish from banks themselves, so I think it is change for the larger cross-border conglomerates. We have improved the co-ordination of their regulation. At the moment, in effect what happens is that in different countries their lead regulator will be different. Some have a combined regulator, as we do with the Financial Services Authority, and others have left their central

bank in charge of banking. There is a mixture out there. The original intention was for what were then known as the Level 3 committees in terms of banking CEBS, the Committee of European Banking Supervisors, to be a forum whereby a greater degree of common rules were brought about. The idea was fine but in practice it has not worked so well. We believe there are some good examples both in Europe and around the world which we can use and should adopt more widely. Again, I say "around the world" because we cannot have one solution for Europe and another for everywhere else for an international industry. There are some Colleges of Regulators which work extremely well where all those regulators where the bank operates are in the room from time to time, and there is an inner core of those regulators from countries where either the bank has a systemic impact from the country's perspective or it is a significant operation, so that means instead of having large numbers of regulators in the room you have got a smaller number. So you have got a small number in a room, it is chaired by the home state regulator and they come to agreements on a number of issues and some of these have worked quite well over a number of years. We believe that is a model that needs to be strengthened. We think it is a model which does need to have particularly some of the prudential issues to address—capital and liquidity are the obvious two. We think that CEBS needs to be looked at again and perhaps given some more teeth, so if you have got a college which cannot come to an agreement within the requisite time then it makes it come to an agreement within the requisite time. If you have got the largest 40 financial institutions across Europe, say, which is a properly operating college which has prudential and liquidity as two of its primary requirements to address, then I think we would be in a much better place. We can get there quickly as well because it does not interfere with the laws in different countries; nor does it cut across how the different countries are monitoring and supervising themselves. Another aspect is that there is a terrible tendency only to look at the execution of a rule rather than at the business model. Regulators generally need to pull back from the detail to address the business model. There is also something about the calibre of regulators. It is an awful thing to say but I am afraid the calibre of regulators and competencies not only varies within countries but varies from country to country, so there is something there that needs to bring up an awareness. Would that all stop an Iceland? There is something about an Iceland which this partly would address but the other aspect of an Iceland is different and that is the degree of liquidity that an entity has to hold in any one country. The FSA has made proposals on that where, in effect, it is saying, "You've got to hold some liquidity in the UK against each activity, whoever you are" and I think that may be an issue which is going to be very controversial but would also be important in an Iceland type case.

Q124 ***Lord Haskins:*** The colleges that you were referring to, the immediate approach is an admirable one and I accept it is entirely based upon voluntary co-operation, there are no sanctions as such that the colleges can apply, therefore the enforcement still remains with nation states.
Ms Knight: That is why I said CEBS with teeth to you. Whilst I would much prefer, as you rightly say, a collegiate approach which gets the right results in good time and then properly enforces, I live in the real world too and know that will not always be the case. We need another entity and we have already got one. I am all for building on what we have got rather than create a whole load of other new institutions. Let us use what we have got and think about the operation of CEBS as the authority which puts, where necessary, a firm hand up behind colleges and also, as you rightly say, says that what has been agreed also does need to be applied. The area where I think it is very, very difficult to get to is what happens when sensible "business as usual" or regulators steering entities away from difficulty moves to crisis management. The point when you get to crisis management is the point when money might be involved and I do not think you can say that a college of regulators or a CEBS can take an action which would then result in one jurisdiction having to put up taxpayers' money. Just as you say what they can do, I think you have to say what they cannot do and to me, therefore, that says there must be some operational governance route by which CEBS reports through to, say, Ecofin, so that you have the finance ministers there at the time when they are needed.

Q125 ***Lord Woolmer of Leeds:*** Good morning. You have spoken already at some length about CEBS.
Ms Knight: Yes.

Q126 ***Lord Woolmer of Leeds:*** That is extremely interesting. In your written evidence you also advocate a formal European Financial Stability Forum and the text says, "to provide assistance to the body overseeing financial stability that you are proposing". Could I ask one or two questions about that. First of all, what would be the legal basis for the creation of a body like a European Financial Stability Forum and what powers do you think it should have? What would be the relationship of CEBS to that body because you have just said CEBS should have teeth. Who is having the teeth, is it CEBS or the Stability Forum? Could we deal with those first and perhaps one or two afterwards.

Ms Knight: Yes, you rather look like you have got another set of questions too and they are coming along later. One of the things that we need to do is a much better job of assessing when something has the potential to become systemic and then do something about it. If we look at the Financial Stability Forum for a moment, that has produced some very good papers but implementation of what they were proposing, or picking up their concerns and doing something about it, was something that did not happen. Stability forums themselves need to have a means whereby their papers are not just parked as very interesting tomes. The reason that I think we could do with a European Financial Stability Forum is we have already got a couple of committees out there which sit in the firmament, they do not have a particularly good reporting structure and they do not have all the relevant people around the table. "Relevant" in our view is regulators, central bankers and finance ministers. We think that the creation of a European Financial Stability Forum to assess those circumstances that are either happening externally and have the ability to impact on the EU or are starting to be created within the EU, is a good thing and because you have put the relevant people around the table that is also a good thing and will help long-term in crisis management. I do not believe in having bodies which do not have reporting structures and it would report to Ecofin. So, in effect, CEBS would deal with the business as usual of regulation, the colleges, the ensuring that what is decided as far as possible gets implemented. It would inform on a regular basis the European Financial Stability Forum as to what it has found and what it sees during its normal operation and, also, when and if it has a particular problem, say, with a particular entity or in a particular country. That, therefore, starts to bring information together in a way that is more appropriate. It then enables the finance ministers to decide whether or not they wish to take action having seen some concerns or points raised in these other fora. In terms of its legal basis and the spectrum of issues it would address and who would be on it, we have produced quite a long memorandum and I will let you have that with pleasure rather than go through it in detail. We have given some thought to this and, in addition to those points I have made already, we think it could play a vital role if you have a large financial entity operating in a number of jurisdictions that gets into serious difficulty because you have got the regulators, the central banks and finance ministers already round the table.

Q127 ***Lord Woolmer of Leeds:*** Having finance ministers, the FSA for example, the relevant regulators, central banks, on a body like that would be a very substantial organisation. That would be extremely unwieldy, would it not? The role as I understand it in the BBA's mind is that this body would keep an eye on things; recognising the time that matters require crisis management is a different ballgame altogether. So this is not crisis management and it is not just day-to-day regulation, this is something that brings everybody together. Do you need a body like that, after all there are only two central banks and a number of key finance ministers who meet anyway? What do you need a body like that for, I do not understand it.
Ms Knight: It is called politics because what you cannot do is you cannot say, "These are the ones inside the tent and those are the ones outside". So what you do is have something where everybody is inside the tent but, as you know, some people are rather further in the tent than others. If you like, you would expect it to operate in both an inner core and a plenary fashion, I think it would be extraordinarily difficult if you decided that some of the countries of Europe did not have a place at the table.

Q128 ***Lord Woolmer of Leeds:*** David Green suggested that the European Central Bank's Banking Supervision Committee should be given a larger role in coordinating supervision, which on the face of it would be simpler. Do you agree with that at all?
Ms Knight: That can work for the eurozone but there are more countries in Europe than are inside the eurozone. It would be a great pity, and it is something we have said time and time again in our various submissions and not just here, that if we start to split Europe up into those in the eurozone and those out from a supervisory perspective. That would take the largest financial centre out of the structure, so we would start to have a greater variety of regulation potentially in Europe, than we have now. We do think that we need to look at financial regulation on a Europe-wide basis and not just do it on a eurozone basis. That is the issue that we have with that proposition, although we accept that it is a good proposition.

Q129 ***Chairman:*** If I can just pick up on that. Mr Trichet, I think, was making a bid for the ECB to become the European supervisory authority on the basis that he could take the rest of us in as well as the euro zone.
Ms Knight: Yes, I think he has made a bid for a few more things as well actually.

Q130 ***Chairman:*** He does not convince you?
Ms Knight: Fair enough, making a bid to increase the things that the ECB does and especially coming from its perspective, clearly does have a validity about it. I say again Europe is much than just the eurozone and I think that we need to look at regulation on a proper EU-wide basis otherwise we will end up with one system that sits there under ECB, another system

here in the UK and the same for other countries who are not euro countries. I think some of the statements of the ECB have also been designed to make us all think about these things a bit better and that is the right way to go because it is very easy to say, on the one hand, "We have got this problem, this credit crunch, this crisis, so everything has got to change", that is one end of the spectrum. At the other end of the spectrum is, "Let the crisis pass and then we will just carry on as we were before". I do not think either is correct. Sometimes it does concentrate minds wonderfully when someone comes along and says, in effect, "Well, I'll do it all". It makes people think what is it that works right, what is it that is appropriate and particularly how are you going to be able to address properly entities that operate in a multi-jurisdictional basis as do 40-plus of the major financial institutions of Europe.

Q131 ***Lord Watson of Richmond:*** My apologies for my late arrival. One of the rather frustrating things for this Committee in taking evidence is that we are told on the one hand that the signs of impending disaster were clear to be seen, but we are also told no such signs were evident and nothing could be done. So one of the questions I would quickly like to put to you is, in terms of all these regulatory options which appear to be on the table, where do you think we have the best chance of really having an early warning system?
Ms Knight: I think personally that whilst a number of people can legitimately say without the use of hindsight they could see an economic down-turn coming, I am not sure there is anyone who can really legitimately say, "And I knew it was going to be like this and I knew it was going to be round the globe and I knew that the securitisation market was going to dry up in toto and I knew that liquidity would go away." I do not think they did. I think self-evidently there is and there was a number of signs relating to the fact that we had some bubbles and they were going to burst—whether they were commodity bubbles, whether they were energy bubbles, whether they were housing bubbles, we had some bubbles which were going to burst—and there were some good warnings on that, but in fact those warnings were not heeded. Therefore we have to find a mechanism which actually can say these bubbles are developing, that has got the people who have some idea of what the consequences can be, and when this entity says, "Ah, there are these bubbles, there is this problem, whatever it may be", then countries go away and say, "We now need to think how we address this."

Q132 ***Lord Watson of Richmond:*** So the authority and credibility of whichever body emerges is going to be absolutely essential because otherwise governments and public opinion are not going to take any notice?
Ms Knight: Absolutely. That is one of the reasons why one has to broaden up the Financial Stability Forum—the G20 is not too bad—and one of the reasons why one has to broaden up Basel, because they do not have enough of the new economies around the table. They do not have India, they do not have China. They tend to have the old economies and not the new economies, and the new economies are arguably going to be the quickest out of this recession anyway. These are also probably some of the most cross people around because they see it as a western problem and they were not even at the table deciding whether to do something or not.

Q133 ***Lord Watson of Richmond:*** That is very helpful. So much of this is all about looking backwards, we really need something which will look forward.
Ms Knight: It is so much easier now to analyse what has happened.

Q134 ***Baroness Northover:*** I find myself wondering about some of your answers on the last question and it links in to what Lord Watson has just asked. In some ways, what you seem to be talking about is early warning signs, as it were, as opposed to supervision, something which would certainly benefit the industry, almost major credit rating agencies done on a national scale, as it were. But since in the end those proved to be not particularly helpful and that has a negative effect upon those working in your industry as well as the rest of us, it does seem to me when you are looking at that kind of European Financial Stability Forum you were talking about this being something which would produce more warnings—
Ms Knight: Yes, I did.

Q135 ***Baroness Northover:*** —as opposed to something which would supervise better for the rest of us.
Ms Knight: I do not see it as a supervisory entity, I see it as an early warning entity, and that is why we call it the European Financial Stability Forum, to in effect mirror the Financial Stability Forum which is far more global. As far as the actual regulatory and supervision aspects—the two are slightly different—are concerned, there is a whole list from better supervision to more appropriate rules, to getting the right standards correct, to deciding what should or should not be regulated. I think the list is quite a long one. As far as better supervision is concerned, I think that can be brought about in one's home state by not just looking at how well the rules are executed but looking at the broader aspect of the supervision of the entity. I think on a broader basis across Europe, the rules and the supervision need to be the functions of

the college of regulators with the firm hand of CEBS behind them. But do not forget we have to have the international context as well because most big financial conglomerates do not just operate in Europe. The next part is the question—what is it you regulate? We have been concentrating, for example, on securitisation issues, on capital issues, but we also have entities which fall predominantly if not entirely, outside the regulatory sphere at the moment. Hedge funds are one and the concentration of attention on hedge funds is—did they short or did they not short a particular stock; yes or no. I believe that the attention on hedge funds should be in a different way and that is—do they or do they not collectively have a systemic effect? If the answer to that question is yes, then they need to be looked at from at least some form of prudential standards and liquidity standards. The other question which you could ask is the shadow bank one. Do we have entities which are not banks but undertake some of the basic activities of banks, of which maturity transformation is the obvious one? Some will say there are types of mutual funds which have almost that activity because an investor can take cash out straight away if they want but the fund is investing long, so in effect that is a maturity transformation. If that is what your actual core function is, should you not also have some more of the prudential standards of a bank? That is a second question which needs to be explored in some detail. The third are those entities which are not doing either of those things but which have a material effect on the operation again of a bank or other financial institution, and into that category the most obvious candidate is rating agencies. Really to say the whole of the structure required one to use a rating agency for certain products is not wrong. A financial firm had to go external, but the way in which ratings have not proven to stand up this current situation is very evident indeed. So as far as the rating agencies themselves are concerned, I think the areas that need to be looked at are broadly along the lines of the IOSCO standards which have been produced. These say you have to have proper separation out of the whole of the payment side; then those who maintain the rate they have to be of the same sort of standard as those who give the rate in the first instance; you need to have proper divisions between the two; there has to be a lot more transparency on, for example, the methodology of how a rating agency produces a rate. We know of things which were rated highly which suddenly then got rated down very rapidly indeed. That happened to countries such as Iceland. Right now as far as many of the banks are concerned they are holding capital according to that which the rating agency thinks they should hold, which is in excess of that which the regulators are requiring. So we have an impact from the rating agencies which is quite significant. As far as I am aware, certainly the major ones are quite prepared to step up to the plate. Again, what we do not want to have is a European solution and not a global solution for entities which operate around the world and which are important for banks and other financial institutions outside Europe as well.

Q136 ***Baroness Northover:*** If I can bring us back to what happens within Europe, we have had quite a lot of discussion in the Committee about home and host country supervision, and Professor Goodhart who was here last week was talking about greater reliance on host country supervision and that being a departure from the home country control on which the single market is based. How is the re-thinking of this—and obviously there are very strong attractions to this—going to affect the way the financial industry is internalised at a Member State level, and if we seek to avoid that, how is that to be done?

Ms Knight: The reason we went to the home/host model which operates at the moment, albeit imperfectly, was to free up the single market. Anything which moves back from that will put a constraint on the single market because it will put a constraint on the cross-border flows of finance and capital. So the debate which needs to be had is what are we going to sacrifice? I think we are at the start of that debate rather than at the end of that debate. We have given a little thought within the BBA on those matters but it comes back to another of the reasons why we are trying to promote very strongly the college of regulators but with the right people there, an inner core and with CEBS on the side. If you say, inside the inner core of the college of regulators are those regulators—including, obviously, the home state—of countries in which the operation of the entity is either significant or systemic, that would put all the major host country regulators in the inner core of that college, having to share information and having to come to agreements. I could give examples but as I have received them second or third hand I will not go into detail but the relevance is about right. It has always been said that the UBS college worked well, and of course UBS did have some early difficulties, but in Fortis's college they fought like rats in a sack. That is why one has to decide how a college operates, who should be in there and it has to have some structures about it. However, I do believe that if you have got both your major host and your home states inside the one college you are going to be able to effect better outcomes, better controls and more appropriate responsibilities than we necessarily have done to date. If you add on to this the liquidity proposals that the FSA has put out—and what they are consulting on is whoever you are, whether you are a subsidiary, whether you are headquartered or whether you are a branch, you have the potential to fall within liquidity requirements and hold some liquidity in the country under certain circumstances—they are highly controversial but it certainly is another way of trying to get to a result which says we still have a single market, we are not going to put too many restrictions in place, but we have got some perhaps more appropriate regulatory controls in future than we have at the moment. But I say again, we are at the start of that discussion rather than the end, and it is not an easy one.

Q137 ***Chairman:*** Before I leave this subject can I mention the Banking Bill which we are taking through the House of Lords as we speak. The Banking Bill puts the responsibility for financial stability squarely on the Bank of England. That is partly what inspired the ECB to point out that they could do it for not only the Euro zone but the rest of us, that financial stability was in fact a role for central bankers, and yet I do not think you are quite agreeing. You are suggesting it is a role for all sorts of people but cannot be left to central bankers?
Ms Knight: This is nothing against central bankers, let me say that before I start. If you have that role here in the UK with the Bank of England, you have also got the British Government there and the FSA, but if it is the ECB and, for example, it is a French entity which gets into difficulty then the French Government has to come in. So it is not as simple as if it is one country, one government, one regulator, one central bank. That is why I say it in the way I do. I do think the Banking Bill though will have a significant effect on other countries in Europe because we are the first, I think, to formally codify an early intervention process. Whilst we all know that early intervention processes have taken place in the past and all been done surreptitiously with all sorts of different sorts of fudges and in smoke-filled rooms and so forth, the very fact that a major country in Europe codifies an early intervention process will have a rolling effect. The way in which the dynamic between the ECB and indeed the local central bank and indeed the local government works out will be an interesting one to watch.
Chairman: Thank you very much. Lord Steinberg, inasmuch as your question has not yet been answered, would you like to ask the rest of it?

Q138 ***Lord Steinberg:*** Thank you very much, Lord Chairman. My question follows on and you gave a partial answer to Lady Northover when you were talking about rating agencies and in your written evidence you have got quite a big piece on credit rating agencies. Earlier in your evidence, you were critical I believe when you talked about the calibre of some of the regulators involved. Would you say the same thing about rating agencies insofar as one of our previous witnesses gave evidence to the effect that he thought that rating agencies were a bit lazy, also that excessive reliance had been placed on rating agencies and whether you got a AAA or a B- made a big difference to not only the quality of the bank or the financial institution but also in the public's eyes affected them considerably? Could you please give me what you think you have not already answered on that?
Ms Knight: I will have a go. Starting with your point, am I critical? I think it is very easy for us all to be critical. The truth is that everybody holds responsibility, everybody made mistakes, everybody missed things. As far as the rating agencies themselves are concerned, I think you have a very fair point that there became an increasing reliance on rating agencies. In effect you were not rating your product for the purposes of sale, yourself, you went out for that independent rating in order to obviously give it a greater degree of credibility. Also within the Basel requirements the push was all in that direction. Some would say, having done that, how much should you have checked? The answer is probably more in some instances but, equally, you do not keep a dog and bark yourself. There comes a point where you either do something in-house or you use a third party; the push was all to use the third party. Frankly, I think a lot of that will remain. You will not be able to park all your responsibility over to a third party and there will be a division at which more will be required to be checked in house than put out, but there is a long-term requirement for independent rating and I think that is beneficial to the market. What it does mean is that one has to look at the rating agencies themselves from transparency, calibre, conflicts of interest perspective and in a way which is wholly different from the past and you have to put that within a broad regulatory framework in order to do so properly. So I am not sure it is laziness or something like that. Was there a desire for banks to ensure they got the best possible rating with the rating agency? Of course, because the better your rating, the better your stature but also it is cheaper for you to raise debt. If you are creating some sort of structured product, are you wanting to create something which is Triple A or are you not? If you are aiming to make something which is Triple A, you will want to have a discussion to ensure you get that as right as possible. So there has to be that proper interaction. I think we have got the balance wrong though and I think that in effect the standard setters have passed a lot of responsibility over to entities which were completely outside the regulatory framework and I think that was one of those decisions where the consequences were not fully recognised at the time.

Q139 ***Lord Steinberg:*** Obviously the rating agencies rely on individuals who have come up with the ratings after their investigations into whatever company they are examining, do you think that the calibre—and I

am using that word deliberately—of the people involved could be improved and how would you recommend it would be improved?
Ms Knight: As I understand it, there has been a lot of focus on the individuals who make the rating in the first instance, and there was much less focus on maintaining the rate and those who were involved in maintaining the rating part of the organisation. Clearly it is as important to have the rate maintenance as it is to make the rate in the first instance, because that means you have high calibre people there who go and check that what it was at the start is what it is now a period of time later. So I believe attention needs to be paid in that area and there also needs to be mobility between those who maintain the rate and those who make the rate in the first instance. I am told there was a slight white collar/blue collar aspect to it beforehand and in the discussions we have had with rating agencies they have realised that and they certainly have put a great deal of emphasis on change and that change includes, as you rightly point out, the right sort of calibre of people in all parts of the operation.

Q140 ***Lord Steinberg:*** In relation to the EU as it is presently composed, we have a mixture of what we call rich countries and poor countries. How are we going to be able to properly handle those weak countries whose particular standards might not be our standards?
Ms Knight: The first way we can help weak countries in the EU is for the strong countries to turn their economies around, and without doing that you cannot really do anything. Secondly, how does one generally ensure that we bring up standards as much as we can in the regulatory area as in other areas on a common basis? In the more detailed memorandum which I will send you on what we consider to be the roles and responsibilities of some of these entities which we would like to see created, standards is one. Assisting and helping those who obviously have not been at financial services as long as us, are relatively new perhaps in terms of joining the EU; helping them in terms of knowledge, in terms of providing means whereby they can get the experience and get up to the standards of the rest as quickly as possible. We did think that was part of what the EU needed to do.

Q141 ***Lord Watson of Richmond:*** You may think it is unfair but I think there is some evidence the rating agencies in the event were virtually a barrier to proper scrutiny; they represented a careless shortcut. I am very concerned, going forward, that the quality and calibre, to use Lord Steinberg's words, of the people involved in the rating agencies is very significantly improved. They are one of the real points of weakness in the system as it existed before the collapse.
Ms Knight: And I think we would agree with you there. I think you would find certainly one or two of the rating agencies—they are not going to say that publicly—have started to step up to the plate.
Chairman: In order not to keep our witness until lunch time, I am planning to speed up a little and if necessary to ask you to answer some of the last questions in writing. I would particularly like to go over the ones which bear on the written evidence we have already had. Lady Hooper?

Q142 ***Baroness Hooper:*** You have covered the ground pretty thoroughly in terms of the early warning mechanisms and crisis management but in your written evidence, in paragraph 33, you suggest that it may be necessary to review the Directive on Winding up and Reorganisation of Credit Institutions to develop a common mechanism. Would you like to discuss that a little further?
Ms Knight: Firstly, if we put in an early intervention mechanism for entities operating in the UK then manifestly that plays into that existing Directive. Secondly, if one looks at the Lehman's collapse, that is going to take an awful long time to unwind, so all this says to us that we have a Directive here which was fine for the time but now it is no longer appropriate, so we need to look at it in the light of (a) experience and (b) legislative change.

Q143 ***Lord Moser:*** Could I go back for a moment to global financial regulation? You dealt with one or two questions earlier. A couple of weeks ago, when Lord Myners was here, the Committee talked about that and Lord Myners and his colleague talked about the role of the IMF and the FSF. Could you say a word, not about that, but about the Basel Committee on Banking Supervision and its role in this structure of global regulatory organisations?
Ms Knight: Basel does prudential and is where I would start. Whilst it can do other things and does come up with some pretty good proposals and commentary in other areas, I think at the moment the focus is on getting the capital and prudential standards right, and that means reviewing the existing Basel II Accord. Basel though is a committee which is predominantly European, has only one Asian country at the table, and there does need to be international acceptance of prudential standards. So if I have to make a change, I would say that Basel has to be more representative in terms of those sitting around the table and focus on prudential issues.

Q144 ***Lord Moser:*** It will be through that special committee?
Ms Knight: That is what I would like to see it do, yes. It is a committee which is part of international settlement issues which that grouping also looks at. But its claim to fame is on the prudential side and that

is where I would leave the prudential responsibilities in terms of standards.

Q145 ***Lord Moser:*** I hope it is not too cynical but I have a sort of horror that in the years to come there are going to be a vast number of global and regional regulatory/supervisory organisations all having meetings twice a year in attractive places, all in touch with each other, meanwhile the individual banks will go on behaving as badly as they have done in the past. If I can just put in one tiny anecdote. The word Lord Steinberg used was "calibre", I hope that will also extend to the calibre of the banks. I say this because in the middle of all this crisis I had to go to the headquarters of NatWest to make a rearrangement of one of my accounts. I was put into a fairly senior officer's office and she asked me which country Zurich was in. I thought that was fairly dramatic. Anyway, leaving calibre on one side, is there a worry that this global emphasis will actually take us in the wrong direction?
Ms Knight: Absolutely, is the answer. Like you, my Lord, I think it is very easy to set up very interesting, informative talking shops with all the right people which are not connected to what it is that is required in terms of the outcome. It is arguable that that has happened in the past because we have had a number of serious commentaries about asset bubbles, about the sort of upward spiral we were in as economies, but nothing was done about it. So the question we have to answer today is, what do we do about getting the right people together in the right sort of fora to come up with the right sort of outcomes? That is today's question. Tomorrow's question is, and how do we keep them at the job? What tends to happen, and I hope it will happen this time but I cannot promise you any more than anybody else, is that we put in place a series of bodies and some prove their worth and those are the ones which, because they have proven their worth, garner up the influence and power that is needed. Whether or not one can ultimately disassemble some of the others, I do not know, but I do not think we have got the right bodies around the world yet, I do think we have to strengthen some of the ones we have, and as part of looking at what should be an international framework we have to link them together properly. Like you, I also think we will end up with a plethora of ones we do not need, so tomorrow's question is to concentrate on the right ones and not the others.

Q146 ***Lord Moser:*** We have to accept, do we, that to get NatWest, to stick with my example, to behave better and to only do things they actually understand, we have to rely on global and regional, including EU, leadership, intervention, et cetera, et cetera?
Ms Knight: Let me answer the question in two parts. The first is, do not forget there are an awful lot of banks, not just in the UK but in the world; some banks have got into difficulty, many have not. So I think we have to be very careful to say, do we need X or Y to make the banks behave properly? We need to accept an awful lot are doing pretty well. The second thing is that the responsibility for any entity, any business, first of all rests with its management. Within certain industries, because they are of a critical nature be it in terms of safety like railways and airlines or because of their importance to the economy, banks and other financial institutions, there is a second set of rules and requirements. In our instance it is financial regulations, which exist around them. That is why you have to concentrate on getting that financial framework right as well. What you do not want to have is continuation of too many variations around the world.

Q147 ***Lord Moser:*** Yes.
Ms Knight: I think we will see a flight to the good and well-regulated countries, away from those which may not have been so well regulated. In turn I think there will be enlightened self-interest which brings up the standard of some of that regulation in the other countries. If you have a global industry, and we do—and there are two things which can be so easily globalised, one is media and the other is financial services; you are never going to unglobalise them—you do need to address at least some of the standards on that global basis and that is why global institutions are important.

Q148 ***Lord Woolmer of Leeds:*** Some huge disasters have occurred in banks and financial institutions in the United States and the United Kingdom, how can you say that it is important to have good regulation and the countries which do not have regulation have to learn from those who do? The watch of the FSA and in the States is precisely where the implosions occurred. If I was in some other countries and I was listening to the United Kingdom lecturing me on the need for better supervision and so on, I think I would laugh.
Ms Knight: I think they are actually.

Q149 ***Lord Woolmer of Leeds:*** Surely this cannot just be about ensuring the United Kingdom and America are listened to more carefully. That does sound awfully smug really from the outside. Is the light touch regulation of the UK and so on credible any more? How do we get there? We cannot lecture the rest of the world on behalf of our stock because it is too low.

Ms Knight: I was not intending to.

Q150 ***Lord Woolmer of Leeds:*** I do not mean you personally.
Ms Knight: It is for exactly those reasons that I say we need to broaden out the membership of such things as the Basel Committee and the Financial Stability Forum because at the moment they are heavily concentrated either in a region or biased towards two or three countries. Do I think that the FSA regulation itself needs changing? This is back on my old hobby-horse, which says you have to regulate the entity and not just look to see whether the rules have been executed. Lord Turner has been making some very strong statements to that effect and I think he is right. When the crisis started, or should I say when the crisis became obvious, which was Northern Rock and that was September 2007, there was a huge amount of quiet laughing everywhere I went at the UK, because up until that point the UK's stock was rising high in terms of how we put regulators together, and I think we had lectured the world a bit too much on what we called proportionate but was converted into light touch regulation. Certainly in the various EU groups, we got it in the neck as the BBA I cannot actually blame anybody for doing that. At that time though the EU thought it was broadly going to stand to one side, that this was just an Anglo-Saxon problem, until a number of the major European banks also got very substantially hit, UBS and Credit Suisse in Switzerland, and so on around the world. So whilst you are absolutely right, and I entirely agree, lecture we must not, we really must not, on the other hand do what the UK always does extremely well, which is a lot of public hanging and flogging. There are some jobs which are rather more uncomfortable than others in trade association land at the moment! Also, I think the UK as a consequence of this is likely to make more rapid changes, but lecture we must not. We must take very much a partnership approach with fellow countries and learn from the different supervisory techniques around the world, of which Spain is a good example, in how they changed to apply the capital rules and put in what they thought was a good way forward.
Chairman: I would like to get one more question in from Lord Haskins, which is spot on what we have been talking about.

Q151 ***Lord Haskins:*** What we have talked about here is, on the one hand, the failure of corporate governance and, on the other hand, regulation. The argument which has been put to us is that the banks have got too big, too diverse from 25 years ago when they were just in the business of borrowing and lending, they have got into investment banking, insurance, all sorts of things, which means that the managers find it difficult to manage the complexity, and the non-executive directors find it difficult to understand what is going on, and the regulators have an impossible task trying to regulate this complexity. Is there not something fundamentally wrong in the way modern banks in Europe and America have been restructured in the last 25 years?
Ms Knight: It is the question which is going to be argued about for some considerable time ahead. Let me give you my personal view. From a general business perspective, any business which has got a variety of different products, a variety of different customers, a variety of different wholesalers supplying it, is more likely to ride recessions and downturns and the various different fortunes of company or country economies than a narrowly based entity with only two or three products, one supplier and only a sector in terms of its customers. So there is something there which is as appropriate to recognise with a bank as it is with any other company. If you look at the failures which have occurred they have occurred much more in the narrowly based institutions, either the mortgage banks or the independent investment banks than they have in the broader based banks. The next question is, if you are going to allow broader based banks to continue, which I sincerely believe you should, what is there which needs to be addressed particularly to ensure that some aspects of the bank do not cause huge collateral damage on the other. The part that people are worried about with collateral damage is the retail banking part, the part which banks us as individuals and the banks which provide finance for the corporates. That tends to be the part which people are worried about. As for the other aspects, you would not be able to get, particularly corporate finance, at the price you get it at the moment with too much change and so it is quite difficult. Then if you start drilling down into other activities, we are certainly back to where we have been earlier. Should there have been, for example, much more capital required in the trading book than was the case? I think most would say the answer to that is yes. So now let's see what "yes" means. Did the value at risk models which were used (a) work (b) not (c) somewhere in between? With some of course they did work but not with everybody. I think I would be very disinclined to say that a multifaceted, multinational should not exist. We have them in a lot of other areas. What I do think is that such aspects as risk control, such aspects as who occupies what position, how your reporting line operates, as well as the kind of corporate governance that is needed, is where attention should be paid rather than saying, we allow conglomerates and multi-jurisdictional entities in everything else but not in banking.

Q152 ***Chairman:*** Thank you. Lord Renton is dying to ask about the very important subject of credit default swaps, could you bear with us for another five minutes?

Ms Knight: I think this is the point where I say, "I know nothing"!

Q153 ***Lord Renton of Mount Harry:*** It is very good to see you again!
Ms Knight: And you!

Q154 ***Lord Renton of Mount Harry:*** We have not talked about credit default swaps yet or credit derivatives. I have the strong impression, having listened to some of our witnesses talk about nothing else, that a great many chief executives and chairmen simply in this big area did not know what their technicians were doing and did not understand it, and that is actually one of the reasons why so many of the deficits now being declared are so much bigger than was expected. I am told in Lehman Brothers' case, for example, there are so many different sets of boxes which do not marry with each other it is going to be very hard to ever sort out where Lehman Brothers is or is not. Do you agree, on that basis, with the suggestion there should be a clearing house for derivatives of this sort, not just credit default swaps but generally? With the vast market in derivatives which now exists there does need to be more control in the future, better understanding of what is happening, but should this be an EU clearing house or a global clearing house as perhaps the Americans are suggesting?
Ms Knight: I think the answer is yes, yes and yes again really to most of those points. Derivatives are actually a vital part. We all use derivatives, we just do not really know that we do. How can I get a fixed interest mortgage? The answer is, because there are derivatives. How do I hedge an exposure to something? The answer is derivatives. It is like everything, do not damn the thing itself but question the degree to which the derivative pile rose. On credit default swaps, yes, there does need to be a clearing house, and that is the right place to start. Derivatives do use clearing, so they are not all out of the mechanism. The credit default swaps clearing house is then absolutely the place to start. I think I say to you, that if one is looking at it from a technical perspective and from an operational perspective, then you need one global clearing house, but because the exposures are quite large and can have an impact on monetary policy, I am not surprised there is a desire to have one in the EU as well. So to my mind, what needs to be allowed is firstly some choices—do not mandate that you have to have one entity. Rather let's talk about ensuring there are against a reasonable timetable as rapidly as possible clearing houses created for CDSs. Secondly that the technology is similar and that they knit together, because otherwise you can have a whole load of something done in one, say the EU one, and a whole load of something else done in another one, say the American one, and the two have not talked together so you end up with some of your problem resolved but maybe another one created. So a half and half answer to your question, for which I apologise, but I do not think we can say it is an either/or, there has to be recognition that there is this monetary policy aspect on the back of it so the key is to give some options, strong timetabling and making sure they do knit together.

Q155 ***Lord Renton of Mount Harry:*** In this respect, I suspect you would agree with Trichet's suggestion that there should be a European clearing house?
Ms Knight: Can I say the London clearing house has already started trials, because it has actually got there with its software for a type of credit default swaps called an index. An index apparently is an easier one for systems than any of the others. There is a significant number of banks who are trialling this already with the London clearing house. There are strong operational risk issues, so it is going to take a little while to get to the end but there is something there already. Sometimes the debate is not quite the one you say, the debate is whether there should be a euro zone one linked to the ECB, but we are back on the growth and size of the ECB. I think the practitioners would say that they want something which works and the timetable means we are getting there—and there is another one which is getting there as well—and they should be the ones we focus our attention on.
Lord Renton of Mount Harry: Thank you.

Q156 ***Chairman:*** On that note I should thank you very much for giving us so much time. We will want to write to you on a couple of questions we did not get to but thank you very much and your colleagues for coming to give evidence to us. It has been extremely useful.
Ms Knight: Thank you very much indeed.

Supplementary memorandum by the British Bankers' Association

1. *Does the BBA believe the IMF or FSF should provide an early warning system for financial trouble, or should it be a combination of both?*

We believe the FSF and IMF have complementary roles to play in providing an effective early warning system and, in this context, support the recommendations made by the FSF in its April 2008 report on enhancing financial stability as to how this could be achieved.

We agree that the IMF should report the findings from its monitoring of financial stability risks to meetings of the FSF, and that in turn the IMF should incorporate the conclusions reached by the FSF into its bilateral and multilateral surveillance work. In its role as coordinator of the international standard setters, the FSF will then be well placed to identify the enhancements which need to be made to the individual regulatory frameworks to mitigate risks to financial stability.

In our view, however, the communication of risks is as important as their identification. We therefore welcome the recommendation made by the FSF in its October 2008 report that the FSF should deepen its dialogue with the private sector in this regard and give more information on the nature of risks and vulnerabilities. In particular, the FSF should give more visibility to its risk assessments and related action points.

2. *Is there a need to regulate "pockets of unregulated activities", such as hedge funds?*

It is not our view that Hedge Funds have been at the root cause of the problems afflicting the global financial markets.

It is imperative for markets to preserve regulatory and governance frameworks that maintain the highest levels of integrity and investor confidence. This can however, be achieved without compromising opportunities for adoption of new technologies and innovation in trading strategies. Hedge funds play a valuable role in creating value, and the freedom that hedge funds have in their investment strategies allow them to contribute to the establishment of more accurate market prices.

However, it is clear that some of their investment strategies have become somewhat cavalier, with substantial sums being made and lost intra day. Those strategies have contributed to disorderly trading and extreme short term price volatility, one example being Volkswagen. Some of the activities of hedge funds do not seem to have contributed to long term growth and stability.

Hedge funds have not previously been subject to direct prudential supervision, partly because it was not expected that their failure would have systematic consequences. However, it has since become clear that there was a systemic issue, and they have contributed to the volatility of the markets through their de-leveraging. Despite the fact that hedge fund assets only constitute a small part of overall assets under management globally, their ongoing trading has actually represented a much larger share of global trading. The BBA considers that such risks should be managed across the whole of the market. Indeed, wholesale firms already have effective risk management measures in place to deal with the risks arising from dealing with all of their counterparts, including hedge funds.

It is also imperative that any enhanced regulatory regime is adopted on a global basis, as opposed to an isolated EU solution, which would not lead to an optimal outcome. There is a balance between mitigating risks and maintaining an environment in which innovative strategies of EU funds add value, and the funds can remain internationally competitive.

3. *Do state aid rules need to be revised in light of recent bank bailouts?*

How can the EU ensure that the single market is not disrupted through unfair advantages gained through bank bailouts?

In general terms, we believe that the European Commission Competition authorities (DG Competition) have played their part in ensuring that Members States' support packages have been consistent with EU state aid rules, as well as responding speedily to Member States' requests. In some cases (Ireland and France), the EU competition authorities have sought, and obtained, changes to, original proposals.

DG Competition has examined a range of support mechanisms from direct capital injections to state guarantees for debt issuance and asset buy back schemes. It has analysed these measures against a particular set of criteria to ensure that state aid rules are respected, and that, as far as possible, level playing field conditions exist. They have also drawn a distinction between institutions that are on the verge of failing and those where confidence factors are undermining a particular institution. The onus has been on national authorities to ensure that the appropriate restructuring plan is produced should the duration of the state aid be expected to be a lengthy one.

We believe that DG Competition has struck the right balance between its clear role in guarding against abuse of the bailout measures in the single market, whilst allowing for temporary measures to stabilise markets. In order to ensure a minimal disruption to the single market due to the bailout, a specific time-frame for an end to public capital injections must be built into the schemes, as mandated by the European Commission Guidelines on the rescue packages. Therefore, DG Competition's interventions do not suggest that the current system is flawed.

Looking further ahead, we would expect the Commission to eventually undertake some analysis of the effect of state aid intervention in the banking sector—they already summarise and publicise these on a regular basis.

We believe that, in order to ensure that the single market is not disrupted through the bank intervention measures, the temporary facilities and state guarantees that governments have provided to many banks should be eventually dismantled to allow normal market conditions to resume, when the circumstances allow. This will clearly need to be managed carefully, but is essential so that institutions do not become completely dependent on state intervention in what are usually market mechanisms of capital-raising, funding and asset purchase and sale.

March 2009

TUESDAY 24 FEBRUARY 2009

Present	Haskins, L	Trimble, L
	Northover, B	Woolmer of Leeds, L (Chairman)

Memorandum by Graham Bishop[1]

Background Comments on Drivers of Change

1. Will this crisis mark the beginning of a period of rapid, but evolutionary, change in financial markets that will return them to the basic role of intermediating the flow of citizens' savings into profitable investments for society? There are solid grounds for believing this will occur.

2. In a world of low nominal returns—at least in money and fixed income markets—investors are likely to look for every possible reduction in costs. When so much investment is destined to provide income in retirement 20–40 years ahead, the impact of a one percentage point reduction in annual costs (or increase in annual returns) compounds into a retirement income that could be 30% higher. That is quite sufficient to promote a relentless bearing down on intermediation costs for many years to come. Moreover it will impact all the way along the value chain in securities trading as well as for mutual funds, life insurers etc. The drive to achieve economies of scale was a major driver of cross-border integration of financial institutions as the legal frame work permitted it. Unless the single market itself disintegrates, that driving force will resume once markets return to normality.

3. For the financial markets, MiFID should be seen as cementing into place the keystone of the bridge between savers of funds and the users of them, following two decades of work. The philosophy of open and competitive markets is a fundamental political driver of the EU, and is not an aberration that may suddenly disappear. The second driver of change is technology—making possible the systems proposed by MiFID. Changes in the approach to trading large portfolios—enhanced by bulging retirement savings—seem entrenched and institutional investors of the EU are likely to continue to diversify their holdings to form pan-EU (or at least pan-Eurozone) portfolios. Moreover, the culture of cost control via new techniques is central to their management philosophy.

4. Could the regulatory backlash unwittingly prevent the development of a genuinely single market in financial services? Or could it re-inforce the single market? This is the most intriguing question: could the crisis turn out to strengthen the trend towards a single financial market? There are many deep and powerful cross-currents at work, but the policy responses must all reflect the driving forces of the need for low-cost/high-returning savings for retirement income and the implications of continuing technological advance.

5. Further comments on the topics below are in Appendix I

- Could the City lose it pre-eminence within the EU?
- Securitisation—maintaining the economic benefits.
- Trading securities on-exchange.

1. *Current Commission Proposals*

6. Deposit Guarantee Schemes: The need to boost retirement income means a continuing, relentless search for incremental return by unsophisticated investors. Clearly they did not appreciate the risks that they were running in the past few years. But if the solutions to the crisis reduce "moral hazard" then the drive for return will manifest itself in a different set of risks within a few years. The design of deposit guarantee schemes that give complete protection to the vast majority of depositors may turn out to be an example. The plan removes the concept of co-insurance, raises the thresholds and proposes that pay-outs occur within three days of the due time. This combination opens the way to major risks in the future as most citizens will not need to care at all about the riskiness of deposit-taking institutions. The proverbial stable-door is being deliberately unlocked and left wide open.

[1] Graham Bishop is an independent analyst of European financial regulation—founding his own consultancy in 2000: www.GrahamBishop.com

2. *Further legislative opportunities*

7. The starting point for reform is the explicit decision by the G20 Heads of Government that "no market segment, no territory, and no financial institution should escape proportionate and adequate regulation or at least oversight". Self-regulation by the financial system has been seen to fail but public regulation has fared no better. Indeed there is a growing recognition that public regulations have failed the citizens. The spectacular Madoff fraud makes that point more eloquently than any politician's speech. Will voters really believe that more of the same failed regulation will ensure that such a crisis does not recur in the future?

8. A solution? Perhaps the key will be found in the governance arrangements that must align the long-term interests of the individual employee, the corporation and the public good. But the stick in such arrangement probably lies in the ease with which a defective corporation can be compelled to exit the market—together with those employees who brought about the problem. A multitude of smaller, actively competing players is more likely to produce this discipline than a series of behemoths that are believed to be too big to fail. The thoughtful reviews scheduled by the Commission for the period after the current rush of legislation should provide the breathing space to consider different models.

9. However, the open question is whether the EU Member States have the political appetite for such innovations. Their current unwillingness to agree to the group support regime in the Solvency II Directive shows a disinclination to give real financial power to the European level. That bodes ill for the continued development of an effective single financial market if Member States in practice choose "less Europe".

10. A risk that should be thought through now: The much-discussed possibility that an EU Member State might consider defaulting on its public debt should be sending a clarion wake-up call to political leaders. This is the time to amend banking regulations to ensure that the system is not fatally undermined by such an event. The application of a 0% risk weight to the debts of a state where the market has already priced the debt as outside EMU entry conditions (two percentage points above the average of the three best performing inflation states) is questionable to say the least.

11. If that State had gone through the Excessive Deficit Procedure (EDP) to the point that sanctions were being applied then there can hardly be any logical reason why the capital requirement would be less that the standard 8%. But bank regulators cannot decide on such a politically–sensitive change by themselves. It requires ECOFIN to have the courage of the convictions that made them apply an EDP sanction to follow it through to a logical conclusion. If they will not take such a step, then earnest discussions about early warning systems are likely to be seen as a fraudulent sham by the voters who are forced to pay the subsequent bill.

12. Bank regulation: The Basel Committee may come up with re-inforced rules to prevent this happening again and higher capital charges for riskier activities. Should society have any confidence that these rules will not be gamed again by the unscrupulous or reckless—if the temptation exists before their eyes? So changes must also flow with the grain of human nature.

13. The December meeting of ECOFIN said that it "expects the European working group on pro-cyclicality, consistent with the FSF and Basel Committee work, to deliver a first outline by end 2008 leading to a first report by March 2009 to be finalised no later than mid 2009". Again, the strong commitment is to work as part of the international bodies, so there should be no divergence in regulatory response within the EU. But there is no mystery about the Basel Committee's general intentions as these have already been published—see Appendix II.

14. Many of these have been rehearsed in various fora but perhaps the most contentious is the issue of overall leverage ratios. Setting such a ratio at too low a level in current economic conditions could lead to a further contraction in the availability of bank credit. That would be the exact opposite of the stated purpose of the various bank re-capitalisation schemes. But agreeing on what the right ratio should be may require a degree of sharing information about the consolidated on and off balance sheet exposures of international banks. That brings back the question of co-ordinated supervision—and not just within the EU, but with jurisdictions such as Switzerland and the US.

15. But it seems unlikely that the risk-weighted asset system would now be abandoned as it does produce much valuable evidence on banks' riskiness. Could the dampening of pro-cyclicality be accomplished by using "dynamic provisioning"? If so, who will have the power to set the levels for an international bank and who will decide on the geographic distribution of the available credits? These are dramatic political questions in the current climate. That will stimulate some vigorous debate.

3. *EU Supervisory Reform*

16. EU policy reactions: Amidst the exigencies of the moment, it is possible to draw some political conclusions about the EU method of responding to an external crisis and these include the following:

17. For the first time, the euro area made policy decisions as an entity defined by participation in the single currency.

18. The euro area set the agenda for the EU's decision to call for global action, including a Summit of the G20—thus changing the map of the countries at the world's economic top table.

19. The EU showed the ability to take executive and legislative action promptly in a crisis—perhaps the hallmark of a genuine political entity.

20. The Delarosière Group will report on 25th February, and begin the process of re-shaping the EU's financial framework that will be followed through by the next Parliament and Commission in 2009–14.

21. All three EU institutions—Council, Parliament and Commission—are now thinking about the medium term issues. Importantly, Parliament (co-legislator in this field) approved overwhelmingly a proposal that "reiterates their calls on the Commission to propose measures to strengthen the EU regulatory and supervisory framework and EU-level crisis management, including on banks, credit rating agencies, securitization, hedge funds, leverage, transparency, winding-up rules, clearing for over-the-counter markets and crisis prevention. The Lamfalussy process should be strengthened, including colleges of supervisors for cross-border institutions and a clearer role and legal status for the Level 3 committees (which bring together all the Member States' banking, securities and insurance supervisors). Parliament also wants to see proposals drawn up for effective cross-border crisis management".

22. So the issue that is now firmly on the EU's table is not just what regulations, but which institution should apply them. Even the OECD argued that the Euro area needs more centralised and integrated supervision of banks and financial markets to help prevent a recurrence of the financial turmoil. It recommended creating either a single EU-wide supervisor or a central agency to work in conjunction with national supervisors.

23. On the institutional set-up, ECB President Trichet has made several strong statements. He favoured a strengthening of the informal groupings, in particular the FSF and the G20. "The FSF is unique in that it links all the authorities and institutions that have a systemic influence on financial markets, which are very largely decentralised and—for many of them—independent from the political sphere".

24. The Delarosière Group: The work of the Delarosière group will make a major contribution but the outcome of their thinking may have been fundamentally pre-determined by its remit. It is required to come forward with proposals for an "integrated and sustainable European system of supervision". Moreover, six of the eight members have spent much of their career as central bankers so they may have paid particular attention to the ECB's calls for a greater involvement. Indeed, the remit echoed the construction of the "European system of Central Banks" in calling for proposals for a "European system of supervision".

25. However, it would be pointless to put forward a series of recommendations that have no chance of being accepted by the Member States. Any substantive shift of real power would need a Treaty amendment and there is no chance of that happening in the current political climate. However, there are many tinkerings that can be done by giving the level 3 Committees a greater legal status, a European mandate and a requirement to co-ordinate. The European way is to take modest, evolutionary steps that can turn out to be highly significant in the long term.

26. ECB role in crisis management: ECB President Trichet pointed out that "Reflections have started on the specific role that could be played by the ECB and its Governing Council", though he is always careful to say that the Governing Council has not yet taken a position on this topic. But he recalled that a close relationship between the central bank and the banking surveillance authority was of the essence. He has frequently pointed out that Article 105.6 already exists in a fully ratified Treaty. It explicitly mentions the possibility for the member states to decide to confer upon the ECB specific tasks in the domain of financial supervision. That is likely to be a pivotal point in the debate.

27. It is now widely accepted that the key 40+ cross-border banks should each have a "college of supervisors". But what does this really mean in terms of the dynamics of power at the critical moment of a crisis? ECB President Trichet pointed out that they will improve the effectiveness, efficiency and consistency of the supervisory action. But he went on "However, it remains to be seen whether such a framework will suffice, or whether further improvements will be needed. The key challenges now lie in its implementation".

28. Early Warning Systems: The calls for an early warning system multiply, but they are likely to remain entirely pointless until the issuing body has both the power and the willingness to take practical steps that would bring the risky situation to an end. Many public bodies are now pointing to careful—but buried—

phrases in their Financial Stability reports. Sadly, they cannot record any actions taken as a result of the warning!

29. The UK housing boom offers a particular example of the failure of the "government" to act when they had easy administrative tools to hand in the form of prudential regulations. They could have raised banks' capital adequacy requirements sharply on residential mortgages that were say more than say 90% loan-to-value ratios. Instead, they remained at an average of about 40% of the standard 8% capital requirement (or a leverage ratio of 12.5 times capital). Why did they not take such actions? Some might argue that the banks' lobbyists would have been too powerful but the real reason may just be the more prosaic lack of confidence in their own diagnosis and an unwillingness to "take the punch bowl away in the middle of the party". Until politicians—and their officials—have that independence of mind, then effective early warning systems are likely to remain a delusion.

4. *Working Practices of EU Institutions*

30. As well as grand statements by the EU, there were also a raft of apparently more mundane decisions—but the common thread is that the EU moved quickly as a group—though in some areas as the Eurozone rather than the EU. There are legitimate criticisms that these moves were made rapidly and that some of the proposals did not seem to have the agreement of all stakeholders. Two examples (in addition to the earlier comments about Deposit Guarantee Schemes):

31. The initial proposals on Credit Rating Agencies have been widely and heavily criticised for failing to understand some of the technical mechanics.

32. Accounting standards were amended very quickly to give a level playing field with US standards. In particular, the details of the mark-to-market and fair value accounting system were "clarified" so that bank's management can apply their own pricing to some of the distressed assets they hold. The bankers may have been satisfied, but the investors who own these companies were rapidly pointing out that the accounts were about to become opaque at the vital moment when outside investors are trying to assess the genuine worth of these securities. Such observers also include counterparties trying to assess the riskiness of a bank, so this may turn out to be counter-productive.

33. Whilst cavilling at some of the details, the central point should not be lost: in a crisis (and not without argument/backsliding) the EU (and the eurozone in particular) proved itself able to take prompt decisions in a way that bears the hallmark of a single political entity. History may note this development more than the shortcomings of individual policies.

5. *Global Supervisory Reform*

34. In the continuing fog of the financial crisis, some outlines of the future shape of financial regulation have begun to emerge. There will be much more international co-operation—with the term "international" now defined far more broadly than just the EU plus US. G20 Leaders have agreed an action plan and intensified co-operation. In a common declaration, they agreed on a set of five common principles for reforming financial markets and launched an action plan of 50 measures to be implemented in the short and medium term—see details in Appendix III.

35. Leaders underlined that "intensified international co-operation among regulators and strengthening of international standards, where necessary and their consistent implementation is necessary". The striking feature of these commitments is that regulatory changes are to be orchestrated at the international level—starting with G20 and then flowing downwards through the work done by the Financial Stability Forum (FSF) and the Basel Committee.

36. At present, the EU feels it is making the running at the G20 but that may reflect the effective absence of the Bush administration at the November meeting. The new Obama administration may have a tougher agenda for the April meeting. Speaking at her confirmation hearing before the Senate Banking Committee, Mrs Schapiro outlined future SEC regulatory reform initiatives that she intends to undertake when she becomes the new SEC chair. Her comments raised many questions but perhaps the biggest challenge to the "global response" came when she said she will "proceed with great caution" in regard to International Financial Reporting Standards. "I will take a big deep breath and look at this entire area carefully", and then underlined that she does not feel bound by the existing "roadmap". By the time of the April G20 meeting, it should have become clear if the US is really resiling from its commitment to international leadership on reform.

Appendix I

37. Could the City lose it pre-eminence within the EU? The City of London already exists as a formidably efficient "cluster" of resources and its ranking vies with New York. Undoubtedly, its self-confidence has been heavily shaken by the crisis. But does that mean that it will lose its standing?

38. London has become the financial centre of the eurozone and has prospered as the euro has grown in importance and in some respects begun to rival the dollar zone. If the euro zone were badly damaged by economic and political developments, then it would be hard for London to maintain that role. If the US tried to repatriate some of the dollar zone activities, that would be damaging. However, questions raised by market participants about London include tax policy and applications of regulations. So it also remains within the sovereign power of the United Kingdom to deal London a severe blow.

39. The EU is committed to following that through into its own regulatory structure—rules which are then binding on London-based entities as well as those elsewhere in the EU. Indeed, the push to harmonise rules more closely should prevent Member States from indulging in covert protectionism. So that should encourage "the City" to revert to its earlier stance of positive support for the potential benefits to it of the Single Market. There is evidence that is exactly what is happening.

40. That should not be surprising as the City has already benefitted hugely from the EU-wide build up of financial assets for retirement income. The more those assets seek higher returns by dis-intermediating low-yielding bank deposits, then the more the City's unchallenged role as the centre for issuing securities will be re-inforced. But the players must earn back investors' trust that those securities say clearly what they are, and do not contain any hidden bombshells. There must be an uncompromising reversion to the ethical standards under-pinning the London Stock Exchange motto: "My word is my bond".

41. Securitisation—maintaining the economic benefits: There is an unresolved conflict at the heart of the debate on appropriate capital adequacy standards for deposit-taking banks. Given the scale of these banks in the modern economy, a sizeable amount of economic capital must be committed and the shareholders will push for the highest possible returns on that capital. It was that pressure that drove many commercial banks into unwise "investment banking" activities in recent years—with disastrous consequences.

42. The greater the quantum of capital that needs to be properly remunerated, the greater the required spread between deposit and lending rates. That opens the door even further to the process of securitisation—loosely defined as the provision of credit to the economy by the issuance of securities that will be held by long-term investors—ideally.

43. Within the spectrum of securitisation, there is the classic bond issued by a major industrial/commercial organisation. There will be a full prospectus to set out the company's current financial standing and the specific rights of the particular bondholders. The issue may well be buttressed by one or more opinions from an independent Credit Rating Agency (CRA) where the investors rely on the assessment of the likelihood that interest payments will be made on schedule and the principal repaid at maturity. In the classic distribution of such bonds, the investment bank that arranges the issue would find a number of interested buyers amongst its client base and might only buy the bond from the company momentarily before on-selling to the ultimate client. So the bank had relatively little need for capital as it was really just acting an as agent.

44. But that was a description of the bond market up to about the mid-1980s! Should we seek to return to that? Can we split up the basic economic functions of a commercial bank (that takes liquid deposits, transforms the maturity a little and makes illiquid loans); an issuing house that has little need of capital as it is merely the agent of the borrower; and an investment house that purchases various risky assets using its own equity capital, leveraged with loans from knowledgeable investors/commercial banks?

45. The central problem of the financial crisis is that "universal banks" combined all these legitimate functions during the 1990s and then management lost control of the risks actually being run. Moreover, the regulators proved as incapable as the management to understand the true risks.

46. However, securitisation has many genuine economic benefits that should not be lost. Commercial banks fulfil a vital function in taking deposits (for periods of up to a couple of years) that are capital-certain and transforming them into illiquid loans—perhaps of a somewhat longer maturity. Moreover, they have the specialised staff to monitor the borrowers. But there are a wide range of borrowers who need longer term funding. They should be able to go direct to savers and achieve a different set of economic arrangements, especially of the length of the loan. The saver gives up the absolute capital-certainly of a bank deposit but gets the ability to sell his security before maturity if he wishes.

47. These observations hark back to a simpler age where the lack of technology made it easy to distinguish economic functions and enforce sharp divisions. The challenge now is to devise a set of rules that keeps the benefits. Hence the rising chorus of calls to split off the investment house function from banks that are underpinned by public deposit guarantee systems. As some would put it, split off the "casino"!

48. Trading securities on-exchange: Turning to equity markets, the Basle Committee is consulting on some fairly radical proposals that would eliminate the 4% weighting for a well-diversified, liquid portfolio of equities. Instead, they would bear the standard 8% weighting. So equity dealers would face a doubling in their required capital and make them much less inclined to act as principals, rather than as an agent of the investor in executing orders on an auction-based exchange.

49. MiFID has already brought a profusion of competing order execution venues so the loss of some contribution from dealers might not reduce liquidity excessively. But the need to maintain competition in trading individual securities certainly raises the importance of resolving the clearing and settlement issue so that trades can be carried out anywhere in the EU and settled easily. In the past year, we have all seen that the unimaginable chance seems to have crystallised frequently. So, one lesson from the crisis is: there should not be any reduction in participants' cost structure that inadvertently opens the door to crisis decision-making being done outside the control of the EU's democratic authorities. The electors who have to pay the bill may not feel the marginal cost-saving was worthwhile.

Appendix II: Basel Committee Strategy

50. The key building blocks of the Committee's strategy are the following:

51. Strengthening the risk capture of the Basel II framework (in particular for trading book and off-balance sheet exposures).

52. Enhancing the quality of Tier 1 capital.

53. Building additional shock absorbers into the capital framework that can be drawn upon during periods of stress and dampen pro-cyclicality.

54. Evaluating the need to supplement risk-based measures with simple gross measures of exposure in both prudential and risk management frameworks to help contain leverage in the banking system.

55. Strengthening supervisory frameworks to assess funding liquidity at cross-border banks.

56. Leveraging Basel II to strengthen risk management and governance practices at banks.

57. Strengthening counterparty credit risk capital, risk management and disclosure at banks.

58. Promoting globally coordinated supervisory follow-up exercises to ensure implementation of supervisory and industry sound principles.

Appendix III: G20's Agreed Actions and Principles

59. Some 31 concrete immediate actions should be taken by 31 March 2009, including the establishment of supervisory colleges for all major cross-border financial institutions. The immediate actions to be taken by Finance Ministers are:

60. Mitigating against pro-cyclicality in regulatory policy.

61. Reviewing and aligning global accounting standards, particularly for complex securities in times of stress.

62. Strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of over-the counter markets.

63. Reviewing compensation practices as they relate to incentives for risk taking and innovation.

64. Reviewing the mandates, governance, and resource requirements of the IFIs.

65. Defining the scope of systemically important institutions and by determining their appropriate regulation or oversight.

66. In concrete, the action plan to implement several agreed principles includes:.

67. Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles. The medium-term goal is to create a single high-quality global accounting standard.

68. A review of the scope of financial regulation should be undertaken, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated.

69. Credit Rating Agencies are to avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products and should be registered.

70. Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.

71. The need for central counterparty services for credit default swaps is underlined.

72. Regulators should develop enhanced guidance to strengthen banks' risk management practices.

February 2009

Examination of Witness

Witness: Mr Graham Bishop, examined.

Q157 ***Chairman:*** Good afternoon, and thank you very much for meeting with us and giving evidence at quite short notice; we are most grateful to you. I hope you do not mind if we do not go through the usual courtesy of inviting you to give an opening statement as we have a lot to get through, but, if there is something you would have said, I am sure you will find a place to say it.
Mr Bishop: I will weave it in, my lord chairman!

Q158 ***Chairman:*** In your very interesting written evidence, you say that the "disinclination to give real financial power to the European level . . . bodes ill for the continued development of an effective single financial market". Do I understand from that that you think that greater supervisory and regulatory powers need to be centralised at EU level in order to ensure that the single market continues and strengthens?
Mr Bishop: I think the disinclination I had in mind there was Solvency II, the Insurance Directive, which is now in its final stages of going through the Commission and Parliament. The key there is the group support regime, and this goes to the heart of the whole question: will a State, particularly in the current framework of financial turbulence, really believe that the parent company of the insurance subsidiary in their country in some remote place hundreds of miles away, a different culture, when things go wrong, will that parent really be forced by the home regulator to hand over the cash to send it to a foreign country perhaps at greater risk to the policy-holders in the home country? That is the question, and at the moment the Member States are making very heavy weather of that because this is the heart of Solvency II, and there are many other points, but the political power part is their Solvency II. The second point you made about whether things need to be supervised, there is without doubt a layer of financial institutions, particularly in insurance, but also in banking, where they are so cross-border, as we have seen, that there is just no practical alternative to having a more centralised control. We have created a single currency, we have created a single market in financial services, and it is not perfect yet and not finished, but the whole purpose of that was to drive forward the integration of the financial system. It has happened and some of it has slithered backwards at the moment, but nonetheless it is still dramatically more integrated than it was. The EU has set up a legal and regulatory framework to force the banking community and financial institutions to operate as a single economic entity and yet they are regulated by a series of legal pockets which are not completely connected, shall I say. That cannot go on, and we are just seeing exactly the consequences of that disconnect between the economic functions and the jurisdictional nature of the regulation.

Q159 ***Chairman:*** For example, how could the Commission ensure that national bail-outs of banks and institutions do not damage the single internal market? If some countries bail out and some do not and they do it on various terms and conditions, including, "You must lend to British companies" and so on, how can you ensure that this does not actually damage the internal market?
Mr Bishop: You cannot ensure it and that is the problem. One of the big questions is going to be competition policy and the way it is applied in two or three years' time because at the moment all these bail-outs are just being nodded through because of their rescue aid, and that lasts six months, and at the end of the six months the Member State concerned is meant to come forward with a restructuring plan. At the moment, even those are being nodded through under Article 87(3), I think, or something like that, of the Treaty, but that is under temporary and exceptional circumstances that things can be permitted. We will give it a couple of years and I hope that temporary and exceptional will have stopped, so the Commission, in my view, will undoubtedly come back and start saying to these large banks which have been created, and of course we have had some examples here, "Are you competitive? Are you in fact channelling funds into your own home market at the

expense of customers elsewhere?" There are the Eastern European countries who may easily say, "You're taking our deposits and then you're lending it back home into the UK", or wherever it might be, "and you're starving us of credit because of your domestic banking's problem", and that cannot go on. You cannot have a single market which is fragmented in that way by the home State regulator trying to draw, in talking about banking, banknotes back into its own country.

Q160 ***Chairman:*** So you think at the moment that those actions, important though they are at national level, are beginning to fragment the single market to a degree?
Mr Bishop: There is a clear risk. I am not sure that there are any concrete examples yet in the financial sector. In the automotive industry, you can certainly point to some of the subsidies which have been given to, shall I say, French car-makers, so there are tendencies all the way through, but the great thing here, and we should never lose sight of this, is what would have happened without the European Union. If we did not have the Treaty of Rome saying, as amended, that everything must be fair and equitable treatment, where would we be now? I have no doubt we would be in a protectionist mess already, let alone with what is coming.

Q161 ***Lord Haskins:*** I have a slightly more detailed question about credit rating agencies. It seems from the outside to me that lots of us think that actually sorting out the credit agencies should be a relatively straightforward issue, and they have worked successfully for most of their lifetime, but it has only been in the last 20 years that they have got into some difficulties, but you sort of suggest that there are quite technical difficulties in sorting them out. Can you explain that, please?
Mr Bishop: Yes, and I agree entirely. Throughout my career, the rating agencies were a very mundane, boring sort of entity, but they moved away and it is the securitised credit where they departed from the straight and narrow. The first problem of course is this basic conflict of interest that the issuer pays. On the other hand, everyone—

Q162 ***Lord Haskins:*** That was always there though.
Mr Bishop: Well, when I first started in the City a long time ago, investors did buy directly from Standard and Poor's and the like and Moody's, investors purchased opinions, but, when the investment banks are giving away research free, there is not a lot of market for buying it from those sorts of people, so it has disappeared and, frankly, it will remain disappeared. I do not believe the investors when they say they will pay. Their record over the years in the cost-cutting world today is so great that they will not pay, so we are stuck with the inherent conflict of interest. Then you go to the complexities of CDS, CDO^2 and all the rest of them, which are outside my knowledge, I have to say, half the time, but the agencies become transparent and they have been required to be transparent and publish their models and so forth, so the investment banks are simply gaming them. You can look up the model, duplicate it, put in your own cashflows, go along to the agency and say, "Okay, we make it a AAA on that. What do you make it? If you do not agree it is AAA, then why not? That is what your model says, so are you not applying your rules?" There is a big problem there and how do you get round that, and this is what I was thinking about. The Commission's recommendation is that you have a series of independent directors and independent companies where you have companies, rating agencies, in different countries. If you require a non-executive, independent director to have such a level of expertise which could only be acquired from being in the industry for a long time, yes, they may be notionally independent, but your pool of talent to draw on is very small, so I am not sure, and it is a corporate governance thin end of the wedge and it also increases the pressure on the non-executives to be ever more knowledgeable to the point where they become executives, and who is it who is going to risk their professional reputation by taking on this role which becomes intensely mathematical when they cannot necessarily keep up-to-date with it?

Q163 ***Lord Haskins:*** The difference is that it is a much more complex job than it was 30 or 40 years ago when we used to look to Standard and Poor's or whoever and they gave the rating, that was the end of it and you knew where you were. Now, you are saying, it is so complicated that we cannot revert to that sort of independent process?
Mr Bishop: We cannot for the credit derivatives and securities which have derivatives embedded in them. Going back to the government bonds or corporates or mortgage bank bonds, et cetera, conventional mortgage bonds, it is not a problem and the old model works perfectly well. It is where you go to say that XYZ is AAA and it is one of these complex derivatives and, because it is labelled "AAA", then, as a bank holding it on your balance sheet, trading book or the bank book, that rating has defined the capital required and, therefore, the rate of return on equity which you, as a bank, can get.

Q164 ***Lord Haskins:*** So, therefore, the logic is to abandon all ratings on these derivatives?
Mr Bishop: On the derivatives, I am almost inclined to go down that direction. Just let investors do their own due diligence. If they want to buy them, let them do their homework themselves completely, and they do. The hedge funds, which may have a bad

reputation in some ways, nonetheless, when you go and talk to them, they have got people who are absolutely on the staff and capable of doing all this rating of these derivatives themselves. I am not so convinced of the average large financial institution which is taking the public's money.

Q165 ***Lord Haskins:*** So there is even more responsibility on the non-executive directors?
Mr Bishop: Yes, a pool whose survival may be in doubt in some ways.

Q166 ***Baroness Northover:*** Or you ban the derivatives or you do not allow the big institutions to deal with them. That is the other side of what Lord Haskins is saying.
Mr Bishop: I am sure you cannot ban derivatives. The genie is out of the bottle, and they are not a bad thing, within reason. It is the excess and the excess is not subject to rules. This is a fundamental problem and I hope it came through in my submission, but we will not avoid this problem in the future by a set of rules. We have to make sure that people are properly motivated and ethically driven. If they are not, they will run circles around any regulator you care to name, as they have done.

Q167 ***Baroness Northover:*** Which leads on nicely to my question: do you believe any changes to the Basel rules on capital adequacy and the new rules on liquidity will help to prevent a repeat of the crisis in the future?
Mr Bishop: Well, the answer is yes, they are part of the answer, without a shadow of doubt, but these are profound changes which are being rushed through. Maybe "rushed" is the wrong word, but it is being pushed quite fast. To use an example, the Basel Committee has published a consultation on capital adequacy standards, many consultations, but on that in particular, and one of their little sentences there is that they propose to abolish the four per cent capital adequacy charge for a diversified portfolio of equities which would normally be eight per cent, but this is where the trading book capital reduction was misused by dealers and, therefore, they had relatively low amounts of capital, very large diversified portfolios and they were taking a bet on markets holding a large portfolio of equities. It has gone wrong, so the Basel Committee is just going to delete that and make it eight per cent and what will the consequences be? I would bet that the liquidity and equity markets will be substantially reduced because dealers will not make markets anymore. Now, that means that we will go back to a quote-driven auction system of stock exchanges, and that may well be a good thing and we will see more prices and more frequent prices for large companies, but we are talking about the top 200 and 300 companies. For the other 1,000s, which are the mainstay of our and European economies, who makes markets in their shares if the dealers do not? The dealers know that, if they hold it for a while, there is no effective way of hedging it if they have bought some shares from somebody, but, if they hold it for a while, they have to have a large amount of capital and they need that capital remunerated, so a wider spread and higher cost of capital for small companies. The effects have perverse consequences, but I am sure that there is absolutely no doubt that Basel will toughen the capital adequacy requirements, and I suspect they will also bring in an overall leverage ratio, which is important. I have been observing these things since the days of Peter Cook and the Cook ratio in the 1970s and we moved to the point where the eight per cent capital adequacy rule was the other way round at $12\frac{1}{2}$ times leverage ratio. Then we introduced risk weightings and that was always going to produce some diversities, and one of the risk weightings is government risk at zero, and we might come back to that, so we should not have had more than $12\frac{1}{2}$ times leverage, except for these risk weightings. Now, in the FSA's recent report on financial stability, there is a spectacular series of graphs on the leverage ratios of various banking systems and there is UBS at 100 times, Deutsche Bank at 50 times, the average British bank, and the colours were such I could not quite make it all out, but in the 20s and 30s bracket, and with RBS and Lloyds, if the Government does indeed nationalise them completely, that is why the ONS is saying that the national debt will go up by 100 per cent of GDP because the size of these balance sheets is just enormous, and yet it was meant to be $12\frac{1}{2}$ times maximum with a few exceptions gamed by the lawyers all the way through, 100 times; astounding.

Q168 ***Lord Trimble:*** Going a little bit further on leverage ratios and all the rest of it, I get the impression that one of the problems with these derivatives, certainly from the point of view of the institutions that initially created them, is that the derivatives are off their balance sheets, yet they are, to some extent, part of the way in which they operated and that is how they increased their leverage, so, when you talk about leverage ratios, do you not have to have a way of ensuring that all these derivatives appear properly on balance sheets rather than be off the balance sheets?
Mr Bishop: I agree entirely.

Q169 ***Lord Trimble:*** Is anything being done to bring that about?
Mr Bishop: The first thing is that the SIVs, which were one of the biggest single things, have just disappeared and most of the banks will have to bring them back on balance sheet, and that of course was one of the reasons why suddenly their balance sheet totals shot

up; there was a fixed level of capital, so their ratios went through the roof, so they will not do that again. On the derivatives and this off-balance sheet question, I am not an accountant, but I have always been astounded that accountants can sign off, "This is a true and fair value" when a large chunk of the risk, as they knew or should have known, is actually not measured in the numbers. Then, when you are talking about one of these massive bank's balance sheets, you talk to partners of the firm of accountants, major firms, they all say that, without being in there at the audit, you have no hope of really understanding what that bank is about, and that must be wrong.

Q170 ***Lord Trimble:*** This comes back to what you were saying about our rating agencies, that there is still an exercise where you want actually to encourage firms to exercise their own judgment rather than rely on the rating, but, in order to exercise their own judgment, they need to be able to look at a balance sheet and see everything that is there instead of having all these things off the sheet.
Mr Bishop: Yes, and one of the most amazing things was the change in IAS39, which is the mark-to-market stuff. The Commission was pushed and they then pushed the IASB very hard to the point where they questioned whether their own independence was going down the drain, but they were pushed to make a rapid change so that companies or banks could take assets off their trading book on mark-to-market and put them on the bank book, where it is some sort of historic cost, and backdate it for the last quarter. That is all very well and the Commission agreed to this and pushed the IASB and it was done and a number of banks used it and we certainly saw that their losses were smaller than expected, and then you began to hear from the investors, saying, "Just a minute, what does this balance sheet mean? Why do we trust that bank? What is it that is our security as an investor, as a bond-holder or an equity investor? You have just deliberately, at the vital moment, obscured the real value of what it is we're trying to invest in".

Q171 ***Lord Haskins:*** That raises the question in my mind, in doing this investigation for several months, of the role of the auditors and the accountants in this, whether the EU or national governments, should be doing more about the enforcement of proper presentation to shareholders of what is going on in the businesses.
Mr Bishop: Yes, how can you actually achieve it when what has become more and more apparent is that the chief executives, the senior executives, of these large firms did not know what was happening anyway. That is the grim truth of what came out of the past six months or year. The chief executives, and, I presume, the chief financial officer does not know either, how do they explain to the regulator, let alone the shareholder?

Q172 ***Lord Haskins:*** That suggests that these organisations have just got too complex to manage and raises the question about demerger, again an EU issue, in looking at the structure of these new banks as to whether they are viable.
Mr Bishop: They are viable because they did not become a state bank.

Q173 ***Lord Haskins:*** But, assuming they are not, can they continue with this range of complicated services that they provide which, as you say yourself, the chief executives cannot get round to understanding themselves? It is a crazy situation.
Mr Bishop: I suspect we will see a lot of these entities broken up either by the regulators or by the shareholders, with RBS just going to sell off a fifth of its balance sheet, some of the asset management firms will get sold off, and the competition authorities will certainly be looking at this. At the EU level, as I mentioned, the restructuring is one thing for rescue aid, but the restructuring over the next two years will become very important here, and that is where, I suspect, the Commission will come in very hard, as far as the Member States allow it, to break up some of these entities.

Q174 ***Lord Haskins:*** So they have the powers to do so? It does not quite fit under competition rules, what we are talking about. Would they have the powers to advise a demerger for those reasons?
Mr Bishop: They need a couple of competition failures to make such recommendations, but, when we are talking about restructuring which is now the case, then they can say it. For example, Credit Lyonnais, despite the efforts of the French Government, went from being the largest bank in the world to being split down so that it was a fifth of its previous size and all sorts of things split off and finally it was then bought by Credit Agricole, so the competition authorities do have the power under the state aid rules to say, "No more state aid. This must be restructured to the point it doesn't need it", and it is in that moment that they have the leverage to get these entities split into manageable entities if things go wrong in the rest of the market.

Q175 ***Lord Trimble:*** Should we be looking at the US anti-trust legislation which has been used to prevent firms getting too big, or something of that nature?
Mr Bishop: I do not know, and I do not know enough about the way that has worked. Obviously, there are the celebrated Standard Oil/AT&T-type cases, but I do not know.

Q176 ***Lord Trimble:*** I am just thinking that what you are saying is rather reminiscent of the fate of all the conglomerate firms that were put together 20-odd or so years ago and then they discovered that this was not actually a good way of running businesses and they started to go back to smaller units, and you think it may be happening here. We had evidence recently actually from Professor Goodhart who was worried that some of these large banks were getting too big for the size of the economies of their host countries, so that seems to reinforce what you seem to prefer in terms of going back to smaller units and having a large number of smaller units.
Mr Bishop: But we cannot do that alone, and this is where the G20 context is extremely important. If we, Britain, decided to split all our banks back down into the component parts from which they came and the EU did not do the same, then we would have a problem and our banks would soon get gobbled up. If the EU did that as well, well, then the question is: do the Americans go the same route?

Q177 ***Lord Trimble:*** The question of who gobbles up whom is going to hang on who is the more efficient.
Mr Bishop: Yes.

Q178 ***Lord Trimble:*** And it might be that the smaller units are more efficient than the larger ones.
Mr Bishop: Efficient, yes, but profitable, scale, balance sheet size, that is often the way in fact, that the large entity has gobbled up a more efficient, smaller competitor partly to disguise the fact that they are more efficient.

Q179 ***Lord Trimble:*** Until the larger one pays far too much over the odds for something which is indigestible.
Mr Bishop: Yes, and we have some current examples!

Q180 ***Lord Trimble:*** I would just quote more from your evidence, paragraph 13 of the written evidence, where you have in bold the word "pro-cyclicality". Again, Professor Goodhart was saying to us that he thought that these regulatory things should be going contra-cyclically rather than pro-cyclically, if I am understanding him correctly.
Mr Bishop: Yes, and I am actually quoting an ECOFIN minute there. What we have realised is that the combination of capital adequacy rules and accounting standards, and impaired value must be recognised immediately, that that combination is dramatically pro-cyclical, so the question for the working party on pro-cyclicality is how to stop it.

Q181 ***Lord Trimble:*** I had not seen the brackets.
Mr Bishop: Well, it is in inverted commas somewhere there, but the problems of pro-cyclicality, and I just quoted the ECOFIN's minutes without perhaps—

Q182 ***Lord Trimble:*** Sorry, I got the wrong end of the stick.
Mr Bishop: No, the point is absolutely correct, that we need to tackle a pro-cyclical financial system, but that is terribly difficult to do.

Q183 ***Lord Trimble:*** To get back to what should have been my question, the question of group supervision and so-called "colleges" of supervisors, do you think they are going to be effective?
Mr Bishop: I would hope they would be.

Q184 ***Chairman:*** So would we all!
Mr Bishop: Well, first of all, the Committee has recently published 10 principles for the operation of colleges which is worth skimming through, it is motherhood and apple pie stuff, and then CEBS, the Committee of European Banking Supervisors, came out with a 20-odd-page paper on how these colleges should work in practice. As you read through, and I have said this to some of my Euro friends and they do not like me for saying it, but, as you read this through, your heart sinks. It is all very worthy and we will try our utmost to reach agreement and all these sorts of weasel phrases, but, in the end, what we are talking about and what this practice has revealed is: at the end, who has the power, the power to require something to be done and back it up with the force of law or the force of taxpayers' money? It is a question of real power. When you come to these colleges, at the moment are they going to have the power? Now, tomorrow, I think it is, Jacques de larosière produces his report which we are all eagerly awaiting, and I suspect we are all going to be disappointed.

Q185 ***Lord Trimble:*** We had evidence earlier along similar lines, but it is actually slightly different in terms of saying that the crucial question is: who is in a position to bail out, who is in a position to produce money? That may not be necessarily the same thing as the power, but it is usually the host country which is the country which has the power to bail out and the capacity to bail out. The other thing which was said to us in evidence is that, if a business or a company of this nature is about to go belly up, the crucial question is: where are the assets at the moment at which it does that? That determines which country's administrators get a hold of the assets and that is a crucial question as well.
Mr Bishop: Yes, and bankruptcy law is a very difficult question because it is founded in disasters past and "This must not happen again" kind of responses by the Legislature, so the holding of assets, but, if you are going to have a single market, you cannot have the requirement that assets are held in a particular country because, if you do, then all the assets of a

particular bank, if we choose an Irish bank, an Irish-registered bank, all its assets must be kept in Ireland and yet some of them are German mortgages or mortgages on German property, and to start requiring that all to be localised, that is the end of the single market. With UCITS, the idea that all the assets should be directly under the control of the depository in their own State is now being freshly looked at again in the light of Madoff, but it is a fundamental problem of how does the host country with the lead regulator really control it and, so far, we have no answers. The reason that, I suspect, the de larosière group will disappoint is that, in my view, there can be no change in the Treaty now. Certainly, I do like going round knocking on doors at election times, I believe that is a very interesting political thing to do, but the idea of going round the Republic of Ireland knocking on doors, asking them to approve a referendum to move banking powers from Dublin to Brussels and on in a G20 context, sort of global, I would find that quite difficult. You might like doing that.
Lord Trimble: I shall observe from afar!

Q186 ***Lord Haskins:*** As you have pointed out, there is a paradox in this crisis. On the one hand, you have got protectionist pressures which are, if anything, undermining the single market and the whole concept of Europe and, on the other hand, a recognition by all the members, and it is not just a European thing, that there must be more power to regulate, so you have got this sort of contrast. On the one side, we are saying that countries are going to look after themselves more and, on the other side, we are saying, "No, no, no, if this is going to work, we're going to have to introduce EU regulations and international regulations which actually undermine the sovereignty of those countries", and it is a huge dilemma as to which way it is going to go.
Mr Bishop: This is the vital point and actually Lord Turner, made some comments in one of his recent speeches, and I paraphrase it, but we are now at the point, particularly this country, where it is either more Europe or less Europe, and I detect in the City quite a noticeable change of attitude from a while ago. If we go back to 1992 and the FSAP, there was a very strong feeling that we needed more European rules. Then they began to appear and perhaps required more capital, et cetera, et cetera, and then there was a swing against it, but now there is the feeling that either we go forwards or backwards, so we are now at the point of inflection as to whether we go forward. For the large entities, the top 10 insurance companies, the top 40 banks, and it may be more than that, it may be less, depending on which day you are speaking about it, but, roughly speaking, those sorts of numbers, do they have to be regulated at a European level, but who has got the power to say, "You're being shut down", or, "We are going to lend you an amount of money which is not a liquidity support from the ECB, but actually the taxpayers of country X are going to buy your bonds, buy assets from you and they are going to take a loss because we regulated you"? That is the point of inflection that we are at.

Q187 ***Lord Haskins:*** The ECB is talking along these lines for euro members at the moment.
Mr Bishop: Yes.

Q188 ***Lord Trimble:*** A movement in that direction would require Treaty revision.
Mr Bishop: That is absolutely the key point.

Q189 ***Chairman:*** Well, first of all, would it require an amendment to the Treaty?
Mr Bishop: To my knowledge, there is only one clause in the Treaty which would permit an amount more pan-European regulation and that is the one that Jean-Claude Trichet always quotes, 105 para 6, which gives the Heads of Government, acting by unanimity, the power to give some banking (but not insurance) supervisory tasks to the ECB. Everything else, as far as I am aware, and I would be very interested if someone comes to you and points to a different Article, but everything else would require a new element of the Treaty, in other words, a change of Treaty which would have to be ratified in the way I was just describing. Ireland, the Republic, and Denmark, I think, both of them, if there is any shift of power and if this is overtly to shift power from them to a centre, they would have to have a referendum, and I do not see the appetite when we have all the problems with the Treaty of Lisbon at the moment, so the only element which is operational to create a greater degree of centralisation now is the ECB clause which Trichet keeps talking about.

Q190 ***Chairman:*** But that only applies to banks, does it not, not to insurers?
Mr Bishop: Yes, but where does that leave the bank/insurers, the financial conglomerates?

Q191 ***Chairman:*** Can we come back to that issue because it is a very central issue, is it not?
Mr Bishop: Yes.
Chairman: Baroness Northover, was going to pose a question on the home/host country divide and I wonder if you just want to probe a little bit more on that.

Q192 ***Baroness Northover:*** Yes, you have been discussing that quite a bit already, but is there a need to reconsider the home/host country divide?

Mr Bishop: Yes, for the big pan-European banks, and actually, to put that into perspective, before the latest round of changes, and I am not quite sure of the numbers now, but something like two-thirds of the banking assets in the eurozone were held by the top 45 banks and the top 15 had a third, that order of magnitude, and I am sure it has not changed much, but for those, yes, some shift away from home regulator to a pan-European one, I think, is essential. Then, when you are talking about the home and the host, I feel very sorry for some of the new Member States where their banking system is completely owned and controlled from outside their country and they can have changes in the credit availability in their country just imposed from aboard from somewhere else, and they have no jurisdiction over it. There is nothing they can do, but they just simply have a giant credit squeeze because bank X decided to repatriate all its lendings, as we were saying earlier, back to its home country, so what role should the host member have there? I feel that they should have a role, but there is a risk, if we go too far down that route, that we finish up fragmenting the single market again, that, instead of having the economic entity which is drawing in the deposits and making loans across the EU as a whole, it would then be fragmented into reporting to 27 different regulators, so how to get that balance is again very difficult. I see clearly the reasons why some of the smaller Member States can feel that they are being bullied by the financial system.

Q193 ***Chairman:*** Of course a not dissimilar problem is in relation to the USA and the UK and the USA and Europe, is it not, of very, very large multinational banks based in the States, one or two of which have come unstuck?
Mr Bishop: Yes.

Q194 ***Chairman:*** And that has had effects in the UK and in Europe and indeed resources have gone flying back into the States, so it is a problem at a global level, is it not, not just in Europe?
Mr Bishop: Yes, and we talk about the colleges and implicitly we are talking about the EU, but the practical reality is that a number of the players in London are not just EU, they are global and some of them really genuinely are global, others are American, typically, with extremely large global operations. Where do they come in the college? Will they be prepared to cede power to a European lead regulator at the vital moment, or will they be wanting to revert to whoever it is who is the regulator in the US, the Federal Reserve Board or Comptroller of the Currency, et cetera? We have not even begun to tackle that, but this is, as I say, a G20 question and the G20 process is intending to draw this all together so that there should not be such splits, but, when it comes down to the hard question of who is bust and who has got the money, I am afraid nationalism is alive and well.

Q195 ***Lord Trimble:*** The same thing happens in other businesses as well. We see it in the car business where General Motors has decided to cut out of Saab, and we see it in the rationalisation of RBS where they are going to protect Scottish employees and cut the employment elsewhere.
Mr Bishop: Yes.

Q196 ***Lord Haskins:*** Am I not right in thinking that at the time of the Lehman Brothers crash there was a lot of debate about money sitting in London being repatriated to America, but did the British Government not somehow stop that from happening, or did it happen?
Mr Bishop: It may have stopped some, but it did happen.

Q197 ***Lord Haskins:*** Do they have powers to stop it or is it just shouting about it?
Mr Bishop: It turned out to have some powers under the anti-terrorism legislation in relation to Icelandic banks.
Lord Trimble: They might have had. In that case, Lord Haskins, the money was moved out. The £2 billion or million, whatever it was, was moved out of Lehman's accounts in London before it went belly up, so, at the moment when the bankruptcy occurred, there were no funds there, so whatever powers the administrators might have had here, they could not grasp it.
Lord Haskins: Which would suggest you need powers before the bankruptcy, which is impossible.

Q198 ***Chairman:*** It is a very interesting discussion, but—
Mr Bishop: It is fascinating. This is the central question of these highly charged moments over a weekend and on Friday night the authorities are informed that there is a problem, so what are they going to do about it? They have to have done it by the end of the weekend, by Monday morning. At that instant, do they have the legal power to appoint an administrator, send them in, shut down the computers and stop things happening? Does the administrator know how to do it? In these complicated organisations, is the person sitting there at the computer who has got the codes and the authorisation to make the transfer?

Q199 ***Lord Trimble:*** Just a few clicks and away it goes.
Mr Bishop: It is not like the old days when it was post a policeman at the port and stop the ship sailing and just sort it all out at your leisure.

Q200 ***Chairman:*** Howard Davies was reported in *The Financial Times* in January as saying that, without a single supervisory authority, at least for those banks who operate on a pan-European basis, there might be a break-up of the single market in the financial industry. Do you think that is overstating the situation?
Mr Bishop: That is the moment, the point we are at. For those limited number of genuinely pan-European firms where their systemic significance is for the whole of Europe, there has to be some way of regulating them with a European mandate, and we go to the CESRs and the CEBSs and so forth, but, if we are unable to do that, then they find themselves at this stage required by their host government to extend the available credit that they have got on balance sheet, the deposits that come in denominated in euros, for example, and where are the loans going to be made? Are they going to be made in the home State or uniformly corresponding to where the deposits have come from? If you do that, Central and Eastern Europe fall off the edge because they have few deposits and there is a capital transfer where, if we withdraw it, there will be problems, but this is crunch time.

Q201 ***Chairman:*** Does the UK's being outside of the eurozone have any significance in these discussions at all, or is it an irrelevance?
Mr Bishop: Speaking to a strong pro-European, that is a big question! It ought to have no relevance, but the decline in sterling over the past 15 months I would regard as being a competitive devaluation. There was a need for some, that is clear, but where we got to, particularly at the end of last year, that could only be seen as competitive devaluation. If other countries begin to react to that, and here we come back to protectionism, where will the pressure points come out? We could talk about cars and agriculture, et cetera, but, if there is seen to be something which is doing a lot of damage to the French car industry, will the French Government try and get us in some other way? So many of these things, when you are talking about payment systems and all the places to deposit credit default swaps and how you do that, depositories, et cetera, all the infrastructure of the financial system, they can push it to be within the eurozone and access to ECB facilities is only for the eurozone, whatever it may be, these are all pinpricks. They may look like debating points at the moment, but give it 10 years and then you will suddenly find that all the infrastructure has moved and we are offshore and really offshore and we have burnt our boats, as it were. The political theory of the Treaty is it that should not matter that we are not part of the eurozone. The politics in a world where we have had a competitive devaluation, I am afraid, over a period will count against us in one way or another.

Q202 ***Lord Haskins:*** You referred in your evidence to a current "rush of EU legislation", and this has come from various other witnesses as well. If you pick up the *Financial Times* today, you will see none other than Monsieur Trichet with a list of things which must be done, and everybody thinks that something must be done. You could argue of course that this is no time to be bolting the stable door because the horse has already gone, and it is very unlikely that the banks and others are going to misbehave in the near future in the way they have done in the last 10 years and, therefore, the case for urgent regulation does not appear, from some of the witnesses that we have heard, to be all that strong, and you have raised some very, very big issues which will not respond to a quick pulling of levers. Are you saying, therefore, that we should be saying that the EU should slow down in its zest for quick action?
Mr Bishop: Well, it is not just the EU. We are now in the G20 process and at the November meeting the G20 agreed, and obviously the UK is part of that and so is the EU, a list of 50 measures to be implemented by the middle of 2009, and I am sure in April we will get another 50-ish or something, so there is an international rush of which we are a part. In particular, I cited in my written evidence the question of deposit guarantee schemes, and clearly the Northern Rock problem here was something which started to remind everyone that depositors can rush off if they do not feel themselves guaranteed. We have now created a mechanism where we are going to offer €100,000 deposits maximum without any deduction, paid out within 20 days of the due period, or something like that. Now, what are we going to expect every citizen to do in the next 10 or 20 years? What is the highest deposit rate? I will have that, so 100,000 there or 99,000, et cetera. To use the stable door analogy, we have deliberately unlocked the stable door and shouted at the horse in 20 years' time to go and bolt, and it is absolutely extraordinary that, collectively, we have just opened this obvious moral hazard for a decade's time. I am told by some of my friends, and these are MEP friends, that it was not clear that the Council had quite understood exactly what they had agreed to, but it is more or less done now.

Q203 ***Lord Haskins:*** Can it be undone?
Mr Bishop: There is to be a review later in the year. I say this to everyone I see, that this is simply sowing the seeds, without a shadow of doubt, for a future disaster and it may take a decade.

Q204 ***Lord Haskins:*** This is only one example of the reaction that something must be done about bonuses, which I have sympathy with, but are these issues where you think the EU understand that they have got to move cautiously on, or the G20?

Mr Bishop: The remuneration questions are very interesting. There is this question of the EU as a political entity coming up and, when the EU starts deciding, as an entity, on how some of its citizens will be rewarded, it is actually a big statement of a political entity, so, out of this very specific point where everyone says, "That is wrong", with much wagging of fingers and so on, "and something must be done", we are on the way to creating a very interesting political situation, but, as I say, there is a rush, there is a lot being rushed through. To be fair, the Capital Requirements Directive, which is about to get passed, even in the middle of October and November Commission officials were making it absolutely clear that this is not the last word and now Commissioner McCreevy and the parliamentarians, for that matter, co-legislators, have been extremely clear, "Let's get this done and then we will come back and go through the whole question of how the financial system is to be operated". At the last ECOFIN meeting, they produced a paper of a key issues package to go to the Heads of Government, which says that in the summer, 8 July I think, there will be a Commission White Paper and that will start the ball rolling for a complete root-and-branch review which would include again coming back to the Capital Requirements Directive and to Basel 3, or 4 by then, and it will be completely reviewed.

Q205 ***Lord Trimble: My Lord*** Chairman, I am going off in a slightly different direction again, but it is something that Mr Bishop touched on earlier when he talked about the application of nought per cent risk to the debts of a State. In paragraph 10, you mentioned the much-discussed possibility that an EU Member State might consider defaulting on its public debt and then you say, "This is the time to amend banking regulations to ensure that the system is not fatally undermined by such an event".
Mr Bishop: Yes.

Q206 ***Lord Trimble:*** Could you just elaborate a little what it is you have in mind?
Mr Bishop: Going back to the eight per cent requirement of capital, unless it is a loan to a government, in which case there is no capital requirement, banks have an enormous incentive, therefore, to pay $\frac{1}{2}$ per cent on a deposit from the citizen, from the old lady, and buy a gilt, to use our local example, at two and three per cent, and there is no capital requirement against that, so this is a very nice profit machine, so at this stage, we have got a system which is designed to channel money preferentially into government debt. If a Member State looks as though it is getting into some difficulty, and let us operate in the eurozone for the moment, then, if they are offering a four per cent coupon on their bond and your deposit base is only half a per cent with no capital required, you know where the money is going to go. Then you come to the situation where that country does in fact default and a significant number of banks are now over-exposed to it, so, through that mechanism, it goes back to the other countries in the EU. I have written about this for 20 years actually, this problem, and I have always argued that, when you get a country going into the excessive deficit procedure, so the Finance Ministers are saying, "You're breaking the rules. We're requiring you to go back on the straight and narrow" and, if you get to the point where they are even sanctioning a country, then it makes absolutely no logical sense to then provide a mechanism to encourage your own banks to lend money to the worst credit available, but will Finance Ministers have the courage to say, "We're actually going to cut you off"? They could do this very early and they should be doing it now, or they should have done it a long time ago actually, but now is the time and, when people are being talked about as a default risk, various countries, they should know that, as they get closer to it, they are not going to be able to fund themselves through the banking system, so they capture the rest of the EU's bank capital and hold it hostage.

Q207 ***Chairman:*** What mechanism could stop that, by raising the requirement from zero to something, or what would be the mechanism you are suggesting at the European level?
Mr Bishop: At the point where the excessive deficit procedure has operated in sanctions, there is no question in my mind that the capital adequacy charge holding that government's debt should be eight per cent, in other words, the standard 100 per cent of the norm. There should not be a special dispensation because it is clearly risky and the Ministers have just decided so.

Q208 ***Lord Trimble:*** We have a situation at the moment where the norms are being exceeded, but no sanctions are being applied, so what do you suggest then would be triggered in the present situation we have where we have several countries, two countries at least, where the risk on their capital is over two per cent or the risk on their public debt is over two per cent?
Mr Bishop: The Commission has just initiated the excessive deficit procedures against, I think it is, four Member States and they will be reviewed by the Council in March, I think, next month, so very soon, so they will be an interesting test as to whether the Ministers of Finance, recognising that the debts are the problem, and of course there are temporary and exceptional provisions in the Treaty and the rules to allow a certain temporary overshoot, but, if it is clear

that a country is paying no attention to all this, will the Ministers say anything?

Q209 ***Baroness Northover:*** Which countries are these?
Mr Bishop: Well, they are usually referred to in slang terms as the "pigs", Portugal, Italy, Greece and Spain. They are the usual candidates.

Q210 ***Chairman:*** And of course the United Kingdom is in the exact same position, except it is outside of the eurozone, so can I ask you two questions. You say that this would apply to the UK, if in that situation—
Mr Bishop: Yes.

Q211 ***Chairman:***—and the markets would presumably apply the same rules, and you would impose an eight per cent capital requirement against that, so that would make the funding of UK debt considerably more expensive?
Mr Bishop: Yes. This is always sort of going backwards. The Government, if they had known that was coming, they should have set fiscal policy years ago when the amendment to the Stability and Growth Pact was signed by the then Chancellor and ratified at the Heads of Government Meeting by the then Prime Minister to bring the structural deficit steadily downwards. We should have done that and we did not.

Q212 ***Chairman:*** Could I refer you to paragraph 33 of your interesting written evidence in which you say the following: " . . . the central point should not be lost: in a crisis . . . the EU (and the eurozone in particular) proved itself able to take prompt decisions in a way that bears the hallmark of a single political entity. History may note this development more than the shortcomings of individual policies." Previous witnesses to the Committee have suggested that the European Union was unable to act effectively in response to the crisis, which appears to be different from your judgment, on balance. Would you like to comment on that?
Mr Bishop: Yes, and this is a central question. I do not want to disguise the fact that things have not gone as well as they should have done and I would have liked them to have done. Let us take a concrete example, the Irish Government's decision to guarantee deposits of Irish banks, which was done over a weekend. Very shortly afterwards, a matter of days, they changed that to include all banks operating in the Republic because that would have been seen as, yes, protectionism, splitting up the single market, et cetera, but the message sent was that individual countries should look after themselves and their own citizens first, and the rest of the EU took the position that that should not be done, the Treaty should be respected fully, and of course that was a big problem for the Government of Ireland, a big financial burden. That is an example where, when it came to it, the EU absolutely enforced the Treaty provisions and operated very quickly to make sure that things were not fragmented. Then I would highlight the approach of the G20, which I have mentioned, the November meeting. The eurozone, in particular, but our Prime Minister was there, were able to caucus beforehand and form a view as to what they wanted to do, what outcome they wanted, and they agreed, surprisingly quickly actually, on a long list of things to which, when you then look at the G20 communiqué, the rest of the world said, "Okay". Now, the US was hardly there because President Bush was not fully functioning, shall we say, and this may be different when we come round to the April G20, but I would find it quite difficult now for President Obama to backslide from that, but the central point is that the EU acted quickly together and influenced the national agenda, which is rolling on globally and down through the EU through the Financial Stability Forum, the FSF, through Basel, et cetera, so the EU acted as a single political entity. I would mention the actions on bankers' remuneration, and that has a lot of hallmarks of a single political entity when it can decide to do something about a particular group of citizens right the way across. Now, what happens in the end? The Commission has to come out with a communication, et cetera, on executive compensation and what happens in the end, I do not know, but the politicians, the political leaders, in the crunch rapidly took a decision which has great political implications, thin end of the wedge, et cetera, right the way across the EU, and those are the things which, I think, will be seen to last, whereas I have commented about the Credit Rating Agency Directive having this little flaw, deposit guarantees, boom, boom, boom, but there are some central elements here which came through in the crisis, they acted together, frayed at the edges, yes, not always, but the central thrust happened together and it is continuing. There is a meeting at the weekend, again pre-G20, and there is a communiqué there, "We will act together"; very important.

Q213 ***Baroness Northover:*** Where was the advice coming from that led to that approach?
Mr Bishop: It is simply the continuation of the commitment to a single market, that the time had come. To do anything other than that would have been a fragmenting of the single market, protectionism and so on.

Q214 ***Baroness Northover:*** What I was thinking was that the political leaders were no doubt debating matters themselves, but they also would be advised by advisers, and to have that kind of collective approach, I just wondered where the dominant advice was, as it were, coming from. Was that coming from within EU institutions? Where was it coming from, do you think, or was it from national institutions, saying, "This has got to happen"?

Mr Bishop: Obviously, I cannot answer on that particular point, but there is a generality here. In the 30 years that I have been involved with the European mission, I have always been extremely impressed by the depth of commitment by officials, private sector people, politicians, the real drive to create this "ever closer Union", to use the expression in the Treaty, and to make it happen in practice. I am just thinking of various committees I have been on, et cetera, and you talk to people over dinner after the committee meeting and you find out about what happened to their relatives in the War and so on, and they have an instinctive, emotional belief that Europe is a good thing and to see it fragment, fracture and dissipate would be a very bad thing, so they do not need to sit down and have a game plan. It is one of the paradoxes of Britain being semi-detached, that we have these debates and that the main countries there, in my view from the people I know and have dealt with over the years, they do not need to have a debate, they know what is right, they deeply believe what is right and they are going to go for it, and that has always been at every critical time. I could go through examples of was monetary union actually going to happen, was the Treaty going to get signed, when the German Government, Kohl's Government, realised that they had signed a Treaty that the people deeply disapproved of, so were they going to break up the ERM and so forth? No. There was that strong political view that it had got to be made to work and they would push it through, and it has happened again now and I have every expectation it will continue to happen in the future, which is why I think the break point here, when it is more or less Europe, I suspect, if we met again in six months or certainly in a year, we would have more Europe, but I cannot tell you exactly how it is going to happen at the moment.

Q215 ***Lord Haskins:*** The conclusion from that would be that, if the EU fails to get some degree of international regulation between the Member States, there is no chance of getting anything under the G20. On the other hand, if the EU succeeds within the structures of getting proper regulation, then you might have a chance of building something within the G20. Is it as stark as that?

Mr Bishop: It is already happening, and that was the message in the Washington November meeting of the G20 and the EU position carried the day. If you look at the comments from the weekend's Heads of Government meeting, and it is in the ECOFIN key issues for the summit in two weeks, the workstream in the EU and the G20 must go in parallel. If we succeed in creating a G20 framework which is in the image of what we, as the EU, are trying to do, our regulatory system, then for us commercially, and speaking for the City of London, as it were, this is a tremendous benefit. If the rest of the world moves to a system upon which we are based, we have a huge commercial advantage, in the same way as the Americans have had for the past half century or three-quarters of a century.

Q216 ***Lord Trimble:*** Just on your last point, we had evidence from someone who turned it round the other way and said that, with regard to the regulatory provisions that are coming in, the EU is adopting the ones which are emerging from Basel and Basel is a world-based operation, not an EU-based operation, so the convergence may be happening the other way round, but that is just a comment on the last point you made. With regard to earlier points you made, I am not disagreeing with you, that there is a very strong commitment to an ever closer Union amongst the political and administrative elite of many countries in Europe and the situation that you mentioned of President Kohl sticking to something even when he knew that his electorate were opposed to it, and it is something that we can see in other places at other times, but I was actually just going to do a little bit of nit-picking on your first example about what happened with regard to the guarantee offered all of a sudden by the Irish Government to some banks. There are all sorts of contradictions about that because of the rather curious structure of banking within Ireland and the British Isles as a whole in that initially, right from the very beginning, the Irish Government's guarantee applied to half the banks in Northern Ireland and there were some banks operating in Ireland, but headquartered elsewhere, which were left out of it, and some of them were European banks, but most of them were actually American banks. What happened subsequently, and this was within a very short time, generally other countries in Europe started to give similar guarantees, and the United Kingdom Government moved within a few weeks and had to do so, not for European reasons, but to stop the flood of money out of the United Kingdom into the Republic of Ireland, so the factor that led to the European countries moving towards a common position was not something to do with the European institutions, but just the way the market operated. It is very similar to the fact that you mentioned earlier with regard to government bonds issued which carried with them a two, three or four per cent coupon and you only needed $\frac{1}{2}$ per cent to pay your deposit and then you go to where the money, the profit on it goes. That is the way the market operated.

Mr Bishop: I agree that part of this was a rush to catch up, no question about it, you are absolutely right about it, but then it did force the thing which has happened which is that the Deposit Guarantee Scheme Directive has been passed by Parliament and Council, so the thing has been put together as a pan-European entity's response. If I can just go back to Basel and your comment there, the very interesting dynamics of who runs Basel, IOSCO, the International Association of Insurance Supervisors, et cetera, these bodies appear, they discuss, they are influenced by various individuals, by various officials, by various government positions, and they finish up with something which produces an international agreement which then flows down, but I think the EU plays to its full weight in these bodies and more, so, in that sense, the EU position is coming back into the EU having gone Basel, G20, Basel, EU, UK.

Lord Trimble: This may be a bit like beauty in that it may lie in the eye of the beholder!

Chairman: I have a feeling we could continue this discussion for a long time. Can I say how much I have enjoyed your evidence and we are very grateful to you. If there is anything you feel that we have missed out, I am sure you will let us know, but both your written and oral evidence have been valuable to us. Thank you very much indeed.

TUESDAY 3 MARCH 2009

Present		
Present	Browne of Madingley, L	Northover, B
	Cohen of Pimlico, B (Chairman)	Renton of Mount Harry, L
	Haskins, L	Steinberg, L
	Hooper, B	Trimble, L
	Jordan, L	Woolmer of Leeds, L

Examination of Witness

Witness: Mr Antonio Sáinz de Vicuña, European Central Bank, examined.

Q217 ***Chairman:*** Good morning, Mr Sáinz de Vicuña. First, let me thank you very much for coming to talk to us, it is very good of you, and we were lucky to catch you at the moment in England. You have already had a list of the questions in advance, and we are on the air, as of now. A transcript is being made of the whole proceedings, and you will get a copy of the transcript so that you can look at it and remove any infelicities. There are two ways of doing this. Either we can just start by working our way down the questions which you have already received, or you could start by making a general statement if you would prefer. What would you like to do?
Mr Sáinz de Vicuña: My Lord Chairman if you allow me to make a statement, I would like to start by saying thank you for the invitation, it is a great honour to be here today. Secondly, that of course, whilst I work within the management of the ECB, I do not represent the ECB, and therefore whatever I would say, it is my own personal views, without committing my superiors, who are the only decision-makers of the bank. This said, after I was invited to come here, we have received the Larosière report, which has introduced first a relatively lengthy explanation of the causes of the crisis, so on this probably you have a better reference than whatever I may say about it. We are in the process of digesting the Larosière report in what affects the ECB, and therefore we do not have yet conclusive concepts about exactly what they have in mind when they plan to vest to the ECB some tasks regarding the macro prudential supervision. With those preliminary remarks, then I am open to comment whatever you may wish to comment.

Q218 ***Chairman:*** Thank you very much. We are indeed hoping to see Mr de Larosière next week, and we are going to be talking to the ECB later in the month, so that we shall be working our way round these things. Thank you very much for coming to give us a preliminary stab at it. If I may start, does the financial crisis tell you that we need a single European financial supervisor, and if so, is such an organisation possible, and should it be established along the ESCB model of a European system of financial supervisors?
Mr Sáinz de Vicuña: The two questions which are embedded in this first question are whether it is necessary and whether it is possible. Necessary, I think there is a wide consensus that we are across the line that national supervision is not enough, so I share the views, which is the emerging consensus in fora, in academia, that national supervision now is not sufficient, and that it has shown the shortcomings in the recent crisis in many aspects. In spite of the fact that the networking organised by way of the Lamfalussy level 3 committees has been a good step, it has been clearly insufficient in the sharing of information, and in the making agreements between supervisors when a crisis arises. So clearly there is a need of an enhanced European supervisory arrangement. Of course there are two possible approaches, and the Larosière report has gone already into one of them. The other approach which the Larosière report addresses, but refuses, is the approach of creating a two tier kind of supervisory arrangement, namely to distinguish between small banks which are purely local, of little systemic relevance, and those banks that operate on a wide cross-border basis, which are systemically relevant. So this two tier approach of having a kind of European charter and having a national charter has been dismissed in the Larosière report, although in our view, it was a feasible approach. It could be the ECB but could it be otherwise, it is a matter of policy, but it would have made sense for big banks to have one single reporting structure, one single interlocutor for all supervisory arrangements for their multi-jurisdictional operation, instead of having to deal with plurality of national supervisors that then are asked to co-operate and to share information between themselves, in a very soft and vague manner, the current situation today. So this other approach has been rejected, and in our view it had some merit. The Bank, through the Banking Supervisory Committee, made the exercise of trying to ascertain the number of those banks that would be fitting within these characters of being cross-border in operation, systemically relevant as well, and the number is 45 banks. These 45 banks hold together

more than 70 per cent of the assets of the banking system in Europe, so by having a European single supervision to those some 45 banks, of course this should be objectivised by threshold, amounts of balance sheets and business and so on, it would have captured, I would say, the most important systemically relevant banking sector, and that would be an approach which as I said has been rejected in the Larosière report. So the other approach which is the one developed in the Larosière report is building upon the network of supervisors, so on the Lamfalussy level 3 committees. Of course, there is a lot of room for improvement. There, there is another question about the assessment of the Lamfalussy committees, question number 6, so I may refer to these later on, but basically the approach which has been taken by the Larosière report is to build on them by strengthening these committees, by in due time creating a kind of European, I cannot qualify it, because it is very vague in the report, but a central authority for the networking of these Lamfalussy committees. So all these evolutionary aspects are positive, but are I would say relatively modest in ambition. Of course perhaps it would have meant a quantum leap to go into the other direction of creating a newer structure for systemically relevant cross-border banks. The colleges of supervisors is also a very good thing, but still today it is a matter that either is developed further, or else it is still with a lot of shortcomings. The second part of the question is whether it is possible to create a European system of financial supervisors, and this is probably a legal question, because of course from a functional perspective, clearly it would be possible, but is it legally possible under the current treaties? This is indeed an issue. Firstly, because the creation of agencies has been very much the debate in the European Union in the last years, with a lot of doctoral writing about it and also Parliamentary discussions, and the current approach to the creation of agencies is a limitative one. It is structured in a Council regulation that was elaborated after such a discussion, based on Article 308, which basically adopts the view that agencies have to have very narrow discretion, they have to be with very executory tasks, but cannot have discretion because that belongs to the institutions as established in the treaties. Here, if we think about an authority to provide for prudential supervision, it is of essence that these authorities should have discretion, discretion to regulate, discretion to put sanctions, to intervene, I mean, all this requires judgment, and therefore, it entails discretion. So it is questionable whether with today's Treaty there is room to create a European supervisory agency, and this is perhaps one of the reasons why the Larosière report is very modest in ambition, because they understand that what can be done today is basically to reinforce the existing Lamfalussy committees. Prudential supervision is not or not yet a European Union competence, and as you know, the Community is governed by the principle of attributed competences, so if it is not attributed, it does not belong to the Community. It is difficult to argue that it belongs to the construction of the internal market, as the internal market competences are basically to abolish barriers, to approximate laws, to apply the principle of non-discrimination. But really to create a new agency with new powers is in my view across the line of what it is permissible under the internal market's legal basis. So what remains is 308. You know 308 is the article of the Treaty that provides for whenever something is necessary for attaining the Community objectives, the Council with unanimity and with the involvement of the Parliament and so on may adopt the necessary measures, the appropriate measures. But this Article 308, which of course opens a lot of doors, first it has been interpreted in a restrictive manner recently, after a period in the 1970s when it was used many times, I read a report where it says it has been used some 400 times, but after a court case in Denmark, reflection came in, and it was considered to be an article that requires a limitative interpretation. One of the provisions of this article is that it can be used whenever the Treaty does not provide for a basis for action, and here, we are confronted with Article 105.6, which is an article of the Treaty that provides a legal basis for a certain action regarding the creation of a supervisory arrangement in Europe. So the critical issue is here whether or not to use 105.6, which permits a supervisory arrangement by entrusting or conferring to the ECB tasks related to policies regarding prudential supervision with the exclusion, as you know, of insurance undertakings. So it is a very curious article, which was the result historically of negotiation in Maastricht between those who said that the Central Banks should have certain supervisory capacities and some who had the opposite view. We have to start with the wording of this article, which excludes insurance undertakings, but it is the only article in the Treaty that allows for this. So in my view, to create otherwise a new supervisory structure in Europe with some discretion and capacity to make rules, will require a treaty reform. This is perhaps regrettable, but I think it is the situation today, and the only other existing possibility is the use of 105.6, which means to vest to the ECB supervisory tasks. Again, this perhaps gives some explanation to the Larosière report, which one could see that he would have liked or the group would have liked to create a new committee vested with supervisory tasks, but because of the constraints of the Treaty, he says it has to be built as a committee of the ECB, and the construction of that committee within the ECB is not without problems, but this is the approach taken in the Larosière report.

Q219 ***Chairman:*** That is very useful. It is always useful to be reminded by a lawyer of what is and is not possible under the existing structure. Thank you for that. The other thing we are trying to get a handle on is how much all this matters—of course it matters, but is, for instance, Howard Davies right when he suggests that without a single financial supervisor, there may be a break-up of the single market and the financial industry.

Mr Sáinz de Vicuña: Well, one has to rely on the good sense of supervisors and, of course, of the ministers of finance, so I hope that it will not reach a total break-up, but the recent summit is already evidence that there is a concern about this. I think the States have intervened in the banking sector, let us say in an impressionistic mode, in a similar way, but when one goes into the detail, one finds all the differences of States' intervention in the banking sector. So for instance, four or five Member States, and I say four or five because in one of the cases it is not certain, have guaranteed interbank liabilities, and of course the ECB has argued very strongly that either it is done by all, or else the integrity of the money markets would be hampered, because in some cases you will have the State behind and in some other cases you will not. Of course because the interbank market, the money market is not working well, it is not yet noticeable, but of course, as soon as it will restart, the risk being different, it will have a different pricing. Therefore in some cases you will have banks lending to one another based on the state guarantee, and some cases not, and that will have an effect on prices. So I think it has a risk, it has a risk. In my view, the current approach, not only because there is national supervision, but because the States have entered into the markets very deeply, the risk of deterioration of the integrity of the market is a risk. Now the supervisors among themselves: I think there have been some examples of bad co-operation, and I can name the Fortis Bank case which has been notorious in the press, where basically the supervisors of Belgium and the Netherlands did not talk to one another, basically because they could not agree almost on anything, and the result of the policy actions taken on one and on the other side were absolutely different. So these are some examples, but overall, I would say the supervisors tend to co-operate and therefore I hope that they will not reach the limit of breaking the market.

Q220 ***Lord Steinberg:*** The role that the ECB should play in financial supervision, you have already talked a bit about, but what I would like to ask you is: would the United Kingdom be placed at a disadvantage if the ECB were to take a strong role in the financial supervision, given that the UK is not currently a member of the euro zone? Then, when you have answered that, I would like to come and talk about two articles, and maybe I will pass one of them to my colleague, Lord Renton, one of which appeared in The Economist and the other one which appeared in today's Daily Telegraph.

Mr Sáinz de Vicuña: We are in the scenario of using 105.6, so a Council decision with the assent of the Parliament basically vesting supervisory tasks to the ECB. Under the Larosière report, these tasks would be only macro prudential supervision. In our view, the use of 105.6 allows not only to vest tasks but also to organise the governance of such tasks, because the current governance of the ECB is a governance which is addressing the tasks currently vested by the Statute to the bank, so namely the monetary policy, payment systems, foreign reserves management, tasks which are enshrined in Article 3 of the Statute of the Central Bank. But this new task, macro prudential supervision, being a brand new task one could interpret 105.6 in the sense of not only giving the task but also saying, "I give you this task, but please organise the governance of this task in a manner which is conducive to the purpose of vesting to you the task". So we understand that it would be possible by a Council decision under 105.6 to say that this task should be dealt with by the ECB using the General Council, which is the third decision-making body that encompasses the 27 NCBs of the European Union. What is more questionable is whether it is possible to create a brand new body, like it is the proposal in the Larosière report, the European Systemic Risk Council, as a new body. This in my view may be seen as going beyond what the Statute would allow. But still I think it could be interpreted in this extensive way, to say if you give the task, you organise the governance. My view is: it is more prudent, and it would satisfy the ends of what is desired, to vest the task to the General Council of the ECB, which is a body that exists already; in the moment where the 27 Member States of the European Union will join the euro, it will be merged into the Governing Council, so it is a transitory decision-making body that will expire once the euro is the currency of all EU Member States, but that does not hamper this approach. So in my view, it is possible to grant this task to a body that also encompasses the United Kingdom. Even more, but this is absolutely a personal view, since one of the cons of vesting this task to the ECB is that it may have an effect on the monetary policy of the ECB, it is good not to have it in the Governing Council, it is good to have it in a different organ. Even more, it would be possible to think of the ECB establishing a branch, for instance, in London, where the General Council will have the supervisory meetings. So this is in my view totally feasible from a legal point of view.

Lord Steinberg: Thank you for that. Can I just go on, and then I will pass this article to you—

Chairman: Please explain what it says, Lord Steinberg.

Lord Steinberg: Thank you. This appears in this week's Economist, and it is headed, "The bill that could break up Europe", and it is talking about the weak countries in the East, and it says: "Indeed, collapse in the East would quickly raise questions about the future of the EU itself. It would destabilise the euro—for some euro members, such as Ireland and Greece, are not in much better shape than Eastern Europe." Now there are other comments, and I will pass it to you afterwards, but could you please comment on this particular part?

Q221 ***Chairman:*** Mr Sáinz de Vicuña, of course you were not given notice of this question, but we would be glad generally of your views on what is happening about the Eastern European countries; is there a systemic risk, because since they are also like us, outside the euro zone, it relates in a way to the UK's position, because while we may be stronger than some of the Eastern European countries, we are still not part of the euro zone, and not used to dealing with the ECB, so we would be very glad of your views.***Mr Sáinz de Vicuña:*** Regarding the Eastern Member States outside the euro zone, because it is a different situation than the cases of Slovenia and Slovakia, I think the problem there is that their economies are very much euroised, informally euroised, in the sense that the banking system is dominated by banks that have their head offices in the euro zone, and the main operations, the most relevant contracts are done in euros, because they rely more on the stability of the euro. The issue there is that in a situation where the money markets have squeezed themselves, this euro banking system has drawn the liquidity from those countries, and this has hampered the capacity to repay borrowings, and it has hampered also the capacity of the States themselves, the treasuries of these States to repay their euro borrowings. This is indeed a problem they are using the euro without having access to the source of the euro, and they would need then to borrow. The question is that now the markets do not lend the money, so the question is from where to borrow, and this is where the Community is taking a step in, and they are trying to give, under the provision in the Treaty that allows the Community to lend currency, the article says in particular, and I think it is 103, but I have the Treaty with me, it says it is only in cases of problems with the balance of payments, which is not specifically the case. 103 is the no bail-out clause. Well, I have lost the number now, but basically allows to give medium-term financing to those Member States that have a problem in the balance of payments. Here, although not being properly a balance of payment problem, it may be seen as not having access to the currency in which they have to repay their loans, and this facility is the one that has been used now with Hungary, and may be used with some Baltic States following current discussions. Now the problem of this article is it only applies to non-euro area Member States. If you mention Greece and if you mention Ireland, the Community cannot give financing to these euro area Member States, so this is one problem. The second problem is 103, the article I just mentioned, which is the no bail-out clause, which provides that no Member States and no Community body will assume the obligations of another Member State, and this no bail-out clause basically hinders the capacity for one Member State giving financial support to another one, to meet its obligations. Now we have taken a position, but of course it is arguable, that there are different ways of support, and if the support means lending, lending in itself is not assuming the liabilities of another Member State, lending is giving the means for them to comply with their obligations, but at the end, they are still debtors and therefore at a certain point in time they will repay. This capacity to lend, measuring the risks of non-repayment and taking appropriate precautions to ensure the repayment, would not be prohibited under Article 103 of the Treaty, the no bail-out clause. So lending in our view should be permissible. Guaranteeing the obligations, so if they would like to issue new bonds with the guarantee of another Member State, that in my view would cross the red line of assuming the responsibilities of the Member State. So in our view, there is still some possibility of manoeuvre regarding these euro area Member States if the need arises.

Q222 ***Lord Haskins:*** Just to follow up on that, really it is the IMF who have the capacity to deal with these crises, rather than the ECB, is that not the case?
Mr Sáinz de Vicuña: The IMF has, of course, the legal capacity to do it. The fact is that States can borrow from the IMF to the extent of their quotas, and therefore, there is a limitation implicit, so if the IMF would like to lend more, it will have to resource itself by way of agreements to borrow, which has been used in a couple of occasions in the past, meaning that they will have to borrow money from other States and then relend these monies, but that requires, of course, political agreement.

Q223 ***Lord Haskins:*** Is that not a more convenient way of doing it, than to let the large EU Member States lend money, put money up to the IMF, and then the IMF deal with the problem?
Mr Sáinz de Vicuña: That is feasible, because then the IMF is the one who lends.

Q224 ***Baroness Hooper:*** I would like to draw a distinction between supervision and regulation, and one of our previous witnesses, Lord Myners, our banking minister, told us that he was not convinced

that the ECB has the necessary skills in place to become a regulatory body. What is your view on that?
Mr Sáinz de Vicuña: The ECB is staffed by 1,300 professionals, and out of them, more or less half, so some 600 and something, are economists. Most of them are in the monetary policy side, but they are in the market operations side as well, so very operational kind of economists. The market operations department has also an analytical division, doing analysis of market developments. In addition to that, we have a small team of supervisors under a department which is called the directorate of financial stability, which basically provides the secretariat to the BSC, it provides also the observers in several Lamfalussy committees. This is a tiny department, 30 professionals, very good professionals, but still tiny. So the ECB itself has quite an important amount already of good qualified economists, but probably for the new tasks regarding supervision, it will have to increase and perhaps to build a department for that purpose. I think we have the grounds, in the number of staff which is qualified already, but still I think it will need to build this skill. How to build this skill probably is by building from the Eurosystem, and within the Eurosystem NCBs more or less half of them have supervisory competences, so it will be already a wealth of experience in those NCBs of which the ECB could draw. So in my view, the question of not having the skills is a question perhaps of having the appropriate staffing, which is feasible, we have a nucleus, it will have to be reinforced, but I think this is, I would say, not a problem. The problem is whether or not to vest into a body like the ECB this task, but not because it does not have the skills. I think we have a nucleus, we can develop these skills, building on the euro system wealth of expertise, so I think in that sense, we have the skills. Also central banks are very close to the stability issues, because at the end, their liquidity supply operation is very close to the stability of the markets, as the transmission mechanism is built on a certain structure of stability of the market, so it affects very closely the monetary policy, payment systems. The national central banks are lenders of last resort, and they do occasional emergency liquidity assistance operations. These operations are communicated and discussed by the Governing Council of the ECB, so at the end, I think we are already relatively close to that stability task.

Q225 ***Lord Renton of Mount Harry:*** Mr Sáinz de Vicuña, I would like to follow Lord Steinberg's example if I may, first a fairly detailed question, but then I would like you slightly to expand on that. Previous witnesses have told us that there cannot be any EU-wide supervisory body whilst banks are still recapitalised at Member State level, the point here being that, of course, the ECB can provide liquidity but as you yourself have just said, it cannot provide capital. Do you think there is any prospect of that being changed?
Mr Sáinz de Vicuña: We believe that the central banks should not be the ones recapitalising banks, that is certain, and we have taken the view that there is a prohibition in the Treaty on monetary financing. Basically solvency financing is a state task; if we would do that task, we would be breaching this prohibition. Because we believe this is a state task, not a central bank task, if we provide the capital, we would be replacing the State in making this kind of support. So central banks do liquidity support but not solvency support.

Q226 ***Lord Renton of Mount Harry:*** In that context, I have been reading the keynote address that Mr Trichet made at the Committee of European Securities Regulators on 23 February, and one does get the impression from that that Mr Trichet sees the ECB as the only possible saviour in this situation. Lord Steinberg has gone through the comments made about what is happening at the moment, the Daily Telegraph of today starts off: "So much for a compelling display of European unity. A disastrous summit in Brussels at the weekend laid bare what everyone already knew, the global economic crisis is threatening to tear apart both the Continent's single market and the peaceful transition to a prosperous European era . . . " You know the situation very well, you approach it as a lawyer. Putting that aside, what would you be suggesting should happen at the moment in the European Union regarding this trade problem?
Mr Sáinz de Vicuña: The danger to breach the internal market, you mean?

Q227 ***Lord Renton of Mount Harry:*** Yes, breach of the internal market, because individual countries are in danger of becoming protectionist and saying, "We are not going to want to be involved in what the ECB says, we will actually sort it out ourselves", and therefore a protectionist atmosphere will develop in the financial markets as it may in trade as well.
Mr Sáinz de Vicuña: Of course, I mean, to vest prudential tasks to the ECB requires unanimity, this is one of the constraints of Article 105.6, and therefore, if Member States do grant this task to the ECB, they will have to admit that the ECB performs this task for all. In that sense, I do not see that it would be a kind of protectionist attitude after the tasks are vested to the ECB. Now regarding support measures to the commercial banks, of course not having a common EU budget, and some Member States not willing to create a common fund for rescues of banks, clearly there is a risk that Member States, without the constraints of the state aid's policy of the Commission, which we may comment as

one question is referring to it, may have differences in the treatment of banks. In my view, the state aid's defence of the single market is possible but it has been used with relative prudence by the Commission. I may point to a couple of examples where clearly, the conditions put by the Commission's decisions allowing for state aid, so recapitalisations, for instance, have not been complied with. This is very difficult to monitor. Fortunately enough, in every decision, the Commission has said that in six months they will review what has been done with this permission, so there is a second chance: let us say that the Commission may revisit what has happened with this state aid.

Q228 ***Lord Jordan:*** I was going to ask that question on the state aid, and you have touched on it. You have already given examples of where the regulation has clearly been breached, most people think the regulations have been thrown out of the window with regard to the banking system, while in past years many manufacturing industries were allowed to go under because of the stringency of that rule. In the present circumstance, do the rules need further clarification or even alteration?
Mr Sáinz de Vicuña: I think the Commission has a wide discretion, so they have issued communications about how they plan to apply the Treaty provisions regarding state aids in their individual decisions, and they have been giving already almost 20 of them. They more or less apply the same criteria, basically no discrimination by reason of nationality. This is not respected clearly; for instance, behavioural rules, so that banks that get state support should not profit from the situation by marketing their products: this is not complied with and is, very difficult to monitor; that there would be a market price for guarantees over capital, and this is also arguable whether this is done, whether the banks benefitting from this support are paying what the market would ask for. I think the policy is learning by doing, and probably six months after the decisions are made, the Commission will have a thorough revisit of these things, and perhaps then it would require, which I think should have been asked from the very beginning, for an exit policy, that these measures should be temporary, and there should be commitments in that regard, because the risk clearly is there.

Q229 ***Lord Trimble:*** I think you have probably touched on the matter, but I just want to make sure I understand it correctly. You take the view that it would be possible, under Article 105.6, for macro prudential supervision to be given to the ECB, and you suggest that if that is the case, it is best done through the General Council of the ECB, rather than through some other body created as suggested in this report. I am just wondering what does that actually mean in practice, because 105.6 leaves out insurance, and has been mentioned earlier, the ECB could do something with regard to liquidity but it cannot do anything with regard to lending, so if there is some sort of macro prudential supervisory role given to the ECB, what does it actually do?
Mr Sáinz de Vicuña: This is one of the topics that we are internally brainstorming ourselves. So far, the contributions to financial stability by the ECB is the twice a year publishing financial stability report, which by the way already announced in the past that a crisis would be forthcoming, because there were some parameters which were seen as dangerous, but these stability reports are an ex post analysis of banking trends and evolution and so on, so it is not early warning, it does not provide for remedies. Already in the Larosière report, you may quess what they are at when they think of macro prudential supervision, and for this I think the Council decision that may activate 105.6 would have to flesh out what the tasks are for the ECB to do. I think the task should basically address the shortcomings which have been detected by the Larosière report in the past, as origins of the crisis, I think I had listed somewhere, allow me to find myself where I wrote it down. For instance, one of the causes, it says it is the loose monetary policy, low interest rates and ample liquidity, so to assess from a financial stability point of view monetary policy, I think this is a task for which, of course, the ECB is well placed. To assess the impact of global imbalances on financial instability on banks' businesses, which is also mentioned here as one of the causes of the asset bubbles. Of course, the ECB has been following very closely the global imbalances and discussing what would be the effect of these global imbalances, and now we see one of the consequences of this. I think for this the ECB is well placed. To assess also impacts of other external shocks that may come out of the problems in, I do not know, Mexico, Argentina, Russia, wherever. Of fiscal policies perhaps as well, as now it has been mentioned Greece and Ireland. The impact of new financial products, I think the ECB is well placed to understand what new financial products are about and what is the impact in financial stability. The financial stability aspect of accounting rules, and we have been active in one of the rules of the new accounting standards. What is the impact on financial stability for instance of keeping off-balance sheet some items, rather than on-balance sheet; the cyclicality or procyclicality of certain rules. The stability impact of taking short-term profits to the profit and loss account. There are several accounting rules related with financial stability, where the ECB is well placed to assess. To assess the regulatory structures of the Member States; I think what the IMF does in the national surveillances, the ECB could do it at the European level: to assess whether

the financial supervisory structure in one country is adequate or not adequate, according to the risks of that country. For instance, in the case of the Eastern European countries, do they have adequate supervision, can we trust them? This is the kind of thing where I think the ECB would be well placed to do an independent assessment, not an interested or biased assessment. The impact of financial markets on instability, the growth of the derivatives market, the evolution of the money markets, the shallow markets. The financial stability impact of legislation, this is also important: who does this? Is anyone today assessing the financial stability impact of netting laws, of insolvency laws, of company law on governance, on securitisation, on competition law and so on? So I think if you go through the list of causes to the crisis that the Larosière report contains, you can extract tasks that need to be done, so in that sense, I think it is a question of putting some brainstorming behind and think which body in Europe could do those tasks from a neutral independent perspective, and with expertise. And I think the ECB is well placed to have some of them.

Q230 ***Lord Trimble:*** I notice that in the matters that you are going through, you talk about assessing various matters such as low interest rates, build-up of asset price bubbles and things like that, but that is just a matter, if I understand it correctly, of warning about things or drawing attention to something. What would flow from that warning, if, for example, it was considered that the policy was resulting in a substantial asset price bubble forming in particular countries that the ECB could perhaps draw attention to and warn about it, but then the IMF did that anyway over the last few years, with regard to a number of cases, and no government changed its policy as a result of IMF warnings. Would they change their policy as a result of ECB warnings?
Mr Sáinz de Vicuña: Well, I mean, of course, the advisory capacity is already there, and if tasked to monitor this kind of things, the reporting is already an important part of the function. Now in our view, but as I said at the beginning, we are still brainstorming ourselves, so this is still work being done, the Larosière report in page 57 makes a kind of big summary in a chart of what should be the tasks. And here it says, I think it is a very important part: give direction on the macro prudential risks, and how to flesh out this "give directions" is the crucial part, because it could be binding directions, it could be just policy directions, so this is one part that needs to be thought of. In our view, if there is a wish to have an impact of the macro into the micro supervision, I think to flesh out this capacity to give direction is a crucial part of the task. There are other tasks which are not purely advisory, which is to participate in the level 3 committees on the Lamfalussy network, where so far we are only observers. To organise stress testing exercises which by nature are systemic, it has to be done not on one single institution but it has to be done across the several sectors, so to organise the stress testing I think if we detect a risk, we can make a stress testing of that risk, that would be also possible. The early warning system is perhaps one new terminology that we need to flesh out as well: what does it mean? In the report, it says we have to give the alarm to the EFC and to the ministers and so on, maybe that way. Then finally I would say the capacity to recommend changes in the regulatory framework, I think this is an important pre-emptive part. If we believe that a certain trend in the banking sector goes wrong, we have to recommend regulatory changes.

Q231 ***Lord Woolmer of Leeds:*** You have touched on a number of occasions on the Lamfalussy committees. Can we start by taking your assessment of their effectiveness to date, in particular, of course, in the turbulent last few months?
Mr Sáinz de Vicuña: I think that there are a lot of writings about the effectiveness of the Lamfalussy committees. My own personal assessment is based on the one which exists in Frankfurt, which is the insurance and occupational pensions committee: there are some dozen persons as permanent staff, and of course they are overworked, there is a constant flow of demands from them, and they cannot staff themselves better because they do not have a budget, because the Lamfalussy committees do not exist from a legal perspective, it is only a body, but in the case of the German committee, it is as a non-profit company, it is incorporated like a non-profit company under the German laws, subject to German tax, and without any kind of privileges and so on. Therefore, they get not the best professionals, these 12 persons that they have in their staff, are normally junior professionals. This is the reality, that these are committees are poorly staffed, that they get very big demands. I think they have improved a lot the situation in the sense that they have created a networking which is good. The second thing is that they decide still by consensus, and this is, of course, according to the minimum common denominator, which is not a good approach. I think we need to have clear leadership and clear decision-making, and this does not exist. Still, I mean, they meet once or twice a month, so it is a lot of one meeting and then back, so they keep still having the national mandates in mind, so they are not still with the European mandate. These are in my view the main shortcomings of the existing committees. In addition, they are only advisory, they do not have the capacity to take decisions, and to enact regulations, so at the end, they are still relatively soft bodies, governed by soft instruments, so basically, what we need at least in

the scope of banking is a clear pooling of supervisory data in a single shared database. This does not exist. Why does not exist? Because they could not agree on a single reporting, they could not agree on a single shared platform in which to place all this reporting, accessible to all. For this you require leadership, decision-making, budget, and these they do not have. So in my view, these Lamfalussy committees are of good intent, it is good to have them, but it is very much in default of what is needed.

Q232 ***Lord Woolmer of Leeds:*** That on the face of it is a fairly damning assessment of the effectiveness, I do not mean that in a personal sense, the professionals are doing their very best, but given the framework, it is a fairly critical view. Is your view that changes can realistically be made that will enable them to function much better, or does the whole question of Lamfalussy committees really need to be revisited and different structures put in place?
Mr Sáinz de Vicuña: I think their Secretariat has to have a European status, clearly it should be with the same status as a Commission body, to start with; I think their pay should be then improved, in order to gather the best, not the juniors. So these are practical things, but I think they are very important at the end. They need to have a minimum number of staff commensurate to the tasks that are being demanded from them, and only by having these structures I think then you can have once a month or twice a month a meeting of the national supervisors, otherwise I think it will always be relatively poor. I think it is possible, and the Larosière report points into that direction, to reinforce the staffing, to reinforce the status, to create them as agencies, and this will allow to have this European mandate and proper status, to recruit the best.

Q233 ***Lord Woolmer of Leeds:*** But in effect, for most of these Lamfalussy committees, there are a small number of very strong Member States in the financial service industries, and if these were much stronger effective committees, that would mean one of two things, would it not? The large strong financial centres would effectively dominate those, they would not allow decisions being taken by 27 Member States' representatives to determine things, and that means that a lot of the smaller states would actually feel pretty disenfranchised. This goes to the heart of the problem how do you have effective committees like this, how do you overcome that? Can the structure really be anything other than how you have described it to date? Do you see the problem?
Mr Sáinz de Vicuña: I see the problem. I have difficulties in admitting that in an internal market, there should be regulatory competition, which is the case today. I think these committees should be in a position to avoid that the competition is played in the regulatory side, so I think the level playing field is important to have good competition, and I see your point, which is "realpolitik", but at the end one could not say that a financial centre should escape from rules that should apply to all, one has to agree on rules that are applicable to all to ensure a level playing field when you want the banks to compete on fair terms. So how to achieve this is beyond my capacity to answer that.

Q234 ***Chairman:*** But at all events, you would probably say that the Lamfalussy committees are just not strong enough to stand up to the crisis? In a financial crisis, they are not a very effective instrument, as they stand?
Mr Sáinz de Vicuña: Yes, I think, first of all, they have allowed to persist a situation of differences in the regulatory framework in the different Member States, and therefore the several demands to have a single rulebook, have not been satisfied; and secondly, in crisis management, they have reacted with an instinct to protect their own folk. This is a flaw.

Q235 ***Baroness Northover:*** Perhaps in relation to what you described earlier of soft and vague co-ordination, I would like to ask you about the colleges of supervisors, you did also say that they were a good thing, but with many shortcomings. Can they provide an effective means of information sharing? Do these bodies need to be formalised within the legislation? How do you regard the suggestion that a formal European financial stability forum should be created? Generally, if you see them contributing, how far can they contribute given the problems of co-ordination that you have been describing?
Mr Sáinz de Vicuña: I think the colleges of supervisors now are going to be embedded in the legislation, and this is a good step. I think there are still shortcomings, the shortcomings are that there is no clear leadership, the lead supervisor is lead supervisor when there is no conflict, but where there is a conflict, the lead supervisor has little means to impose himself. Secondly, there are differences in the capacities of the supervisors that belong to the same colleges, so in one Member State, you will have a supervisor that has a strong capacity to sanction, to destitute board members and so on; in other Member States, the supervisor might have very weak means, and so on. So at the end, I think to work properly, you would have to have same level of powers in the supervisors that belong to the same colleges; and secondly, of course, to avoid the still significant differences in the implementation of directives in the Member States. Otherwise, I mean, there would be always conflicts in the colleges of supervisors. It is still an instrument that I think is useful, but which requires enhancement. Now the question about a

European forum on financial stability, if that means just the sitting together of the several supervisors of the different financial sectors, like the Financial Stability Forum, the global forum of the G10, I think it is always good, but I do not think it is necessary, because one of the Lamfalussy committees is the financial services policy committee, which basically puts together all the chairs of the different Lamfalussy committees, and which presently has the mandate to try to co-ordinate, to have a forward looking approach to the regulatory aspects of the financial markets, so I do not think it is strictly needed.

Q236 ***Baroness Northover:*** Do you think it is something of a sticking plaster, that it looks positive, but actually in a crisis it is going to be of no particular use, and therefore in some sense, it is somewhat misleading to keep focusing on this?
Mr Sáinz de Vicuña: I think so.

Q237 ***Lord Woolmer of Leeds:*** Where do you see the global college of supervisors, the colleges idea, fitting in? What is the Bank's view, what is your view about how this might be organised? Because clearly on a global level, the problem you describe is even bigger, and nobody is going to tell the Americans what to do if things come to a head, so what is your view about how at the global level colleges of supervisors might usefully develop, or do you think again that effectively as Lady Northover says, they look good on paper until they are really needed, and then they find it difficult to work? Globally, there has to be—
Mr Sáinz de Vicuña: I agree with you, probably it would not be easy to achieve but I think, I mean, the Americans you mention, if the New York market sees itself as a global market, they could not operate without co-ordination with the other supervisors. To me, that is clear, but of course, it affects them in many ways, like for instance the ringfencing: when there is an insolvency there, they protect just the local community. This is against the philosophy of being a global marketplace. If ever we achieve to have a global regulator, supervisor, the IMF being tasked or whatever institution being tasked, I think this coordination should be put in place at a global level. It cannot be that there are problems in Lehman and the supervisors in Europe are not even called to seek their views, to see what is the impact of the insolvency of Lehman in Europe, I think this is a not optimal situation. It has to be improved. I do not visualise yet how it should be improved. Perhaps it should be part of the dialogue; the dialogue between the European Union and the US is still with very poor results, so one has to give some more flesh to that, and I hope that this crisis may show the Americans that they have to be more co-operative in that regard.

Q238 ***Lord Browne of Madingley:*** I think you have answered the question I wanted to ask, Lord Woolmer has asked most of it, but if you go through what G20 is thinking about, and what Mr de Larosière has said, and what Mr Trichet has said about supporting global supervision, are there any other things you think that could be done?
Mr Sáinz de Vicuña: I think global markets require better structures of global regulation, I think it is a matter of discussion what is the best approach. I would say for one that the IMF, being an organisation of Member States, is the appropriate body to do that. The financial stability forum, the Basel Committee, these are fora of supervisors that meet together once in a while, they discuss things, they may set some benchmarks, but they do not have the machinery, they do not have the instruments to implement, to verify, to see how this is working in practice. So I think it requires an administration behind, and this they do not have, so in my view, if one needs to ensure that out of this crisis, there is a solid response, one should task this to a body that has this means, this administration, this global capacity to act, and for me, I only see this in the IMF, as a kind of complement of the current surveillance that the IMF does. I think it is a development that may come out of this crisis that they take this task to ensure that the financial systems comply with certain parameters, and that they are able to alert of shortcomings.

Q239 ***Lord Haskins:*** Your boss, President Trichet, recently made a speech listing the whole set of new regulations that need to be looked at urgently. Some of our witnesses have been slightly concerned about this, and I think the position would be, we are living through extraordinary times, we have to move very quickly on the banks, undoubtedly mistakes have been made, because these huge decisions have been made in the very short term, inevitably some of them will be got wrong, we are already seeing that that has happened. We are now having to move very rapidly on real economy issues. Again, mistakes have been made, but there has to be pressure. Something has to be done. When it comes to regulation, I am less sure that we need to move as quickly as maybe President Trichet and others think. Indeed, by moving quickly in this regulatory area, you will certainly end up with unintended consequences. The case for moving quickly surely is pretty weak. These banks, whatever they will do, they will not make those mistakes they have made in the past in the very near future, they may come back to them in five years' time, so is there not a case for a more measured approach toward regulatory reform than we are certainly hearing at the present time?
Mr Sáinz de Vicuña: I think you are right. Regulation, if we want it first to grasp all the aspects of the current crisis, needs to be not hurried, so it

needs to be well thought of. The fact is, I think the roadmap of the European Union was a very good list of measures to be taken, so this, I think, is a minimum that has to be done now. There are other measures which are still under discussion, like, for instance, regulating the hedge funds, or regulating—the credit rating agencies which is already on the table, now the question is, is it properly addressed? Does it not require more thought? Probably yes, probably yes. Now I think, the public is not so confident about the ratings, so to start ourselves, we are one of the biggest takers of collateral in Europe, and of course we now take the ratings with a certain distance, because we know that we cannot rely totally on them. So this requires a lot of thinking, but it cannot be improvised easily, that is sure. We need common sense clearly.
Lord Trimble: You mentioned a couple of bodies there which are referred to in Mr Trichet's speech, namely credit rating agencies, and I quite understand why you want to focus on them, because they clearly—even if it was just a misinterpretation of what they are doing, they have contributed to our problems, but the other one that you mentioned is hedge funds. That is rather puzzling, because as far as we can see, hedge funds had no significant role at all in the problems that we have. In fact, because of the way economies are contracting, hedge funds are contracting very significantly themselves, and I do not see how one can regard them as being at all significant in the present situation.

Q240 ***Chairman:*** What do you think about hedge funds?
Mr Sáinz de Vicuña: Well, I am not perhaps the best person to respond to this. The Larosière report already refers to them, I know for instance in the short selling policy they have been negative in this crisis. Also in the derivative trades, I think they may have been also part in the contributions to the crisis. Also the hedge funds trades being limited to professionals, I think in some cases they have gone beyond and they have addressed investments from the public, and this, I think, is also not a correct policy. I think you need transparency, you need to have the public understand the risks, all this requires being addressed. So as a lawyer, I find difficulties in cataloguing or classifying the hedge funds as a proper category to be addressed, because the hedge funds are not like banks. I mean, you have a proper statute for banks; hedge funds take diverse forms.

Q241 ***Lord Trimble:*** At the end of the day, they are just market traders who are managing funds.
Mr Sáinz de Vicuña: Yes, but they are systemically relevant, on this you would have to agree.

Q242 ***Lord Jordan:*** I just wanted to follow up on your answer to Lord Haskins. He argued for caution or talked about caution in regulations, but is it not equally true that it is only in crisis do politicians summon up the courage to take measures strong enough to deal with abuses of power, which is what we have been seeing, and then the moment the heat is off, they will be pressured not to take decisions by the same people who abused the power in the first place. So act now, act soon, while the crisis is still fresh in everyone's minds, surely that must be the way to deal with these matters?
Mr Sáinz de Vicuña: I do not have a clear answer to this. I think the momentum is now, to create the work that will lead to proper regulation, that is clear. To what extent can you leave things as they are without reacting: in some cases, probably you have to act very rapidly; in some cases you may think more, I do not know.
Chairman: Mr Sáinz de Vicuña, thank you very much indeed, you have been enormously helpful, we have taken a lot of your time, and it has been particularly useful, if I may say so, to have a lawyer to talk to us, because in designing new systems, we very often forget what there is in place, what is possible, and what is just not going to be possible to design and you have very usefully reminded us. Thank you very much indeed.

THURSDAY 5 MARCH 2009

Present	Cohen of Pimlico, B. (Chairman)	Northover, B.
	Haskins, L.	Renton of Mount Harry, L.
	Hooper, B.	Woolmer of Leeds, L.
	Jordan, L.	

Examination of Witnesses

Witnesses: Ms Sharon Bowles, Member of the European Parliament and Mr John Purvis, Member of the European Parliament, examined.

Q243 ***Chairman:*** Sharon and John, can I say welcome and thank you very much for coming to see us. You are, of course, on the record, Sue is taking a note of every word and we will provide you with a transcript in the usual way. This must be form very well known to you. Sharon, I believe you have to run at 12.30.
Ms Bowles: I have got another meeting at one but it is not a meeting that will fall down without me, so do not worry.

Q244 ***Chairman:*** Excellent. John, are you well-placed?
Mr Purvis: I understood it was 11.30 to 12.30.

Q245 ***Chairman:*** We are trying to get there for 12.30.
Mr Purvis: I have not got anything pressing except getting home.

Q246 ***Chairman:*** We overran somewhat because we were being told such useful things by the UKRep and ambassadorial teams. We are much exercised and what we are really brooding about, if I may witter for a second, is what is possible in the European context and who ought to be doing it. The Larosiére Report on the whole suggests keeping up the Lamfalussy Committees, but they do not have staff, although they are a committee, and in some ways we cannot quite see where the organisational structure lies in all of this. We are going to need to fix our minds on this as some sort of conclusion. Our Howard Davies takes the line that the case of the Icelandic banks supports the need to create a single European supervisory authority for pan-European banks if we are to avoid retreating from the concept of a Single Market. There is also his colleague, Lord Turner's direct contradiction where he does not see the possibility of supervision being exercised anywhere other than in nation states because they are the ones with the chequebook in the last resort. Can I ask you to start by telling us in random order whether you think Howard Davies is right in thinking that unless we fix this, unless we have a single authority, we are going to go backwards in Europe, people are going to retreat and go off and do other things. How do you feel about that?
Ms Bowles: I think that both are right in the sense that we do need something that is at the European level that is stronger than just the co-ordinating and advisory structure of the Level 3 Committees. By the same token, there is this problem that not only is the chequebook national but there is no treaty basis for banking supervision. It is specifically in the treaties that it is a national competence. If we had had the Constitutional Treaty with the passerelle clause there would have been a possibility to change that, but with the Lisbon Treaty that has gone there is no actual possibility to do, if you like, the day-to-day hands-on supervision via a European regulatory authority and that is the thing we have all been wrestling with, so how do you bring a European dimension into it. The Parliament had a report some time ago where we tried to strengthen what the Level 3 Committees could do, putting them in a kind of appeal role almost. There was quite a lot of commonality between the suggestions that collectively came forward from the Parliament's committee, although there are shades of view within it, and the sorts of things that de Larosiére is looking at. Having been busy on other things, and not having sat down and thought about this hugely, it would seem that there must be an opportunity, if you like, to get around or circumvent the problems of there not being a treaty basis if you say it is at the level when some kind of cross-border element comes in. If we have colleges, as de Larosiére suggests, then some beefed-up version or authority that is derived from the Level 3 Committees could play a role in being some kind of arbiter at the college and cross-border level. The crunch point will always come when you are looking at who has the final say over the capital, if the college does not agree about what the capital should be, and that is the area that I think is going to be very fought over. From the way discussions have gone in Council on, say, the Capital Requirements Directive and home/host control I cannot see that any Member State is going to give up having the last word on the capital vis-à-vis the banks in its territory. That was rock solid in Council. We have actually moved further away from

cooperation because we are having trouble on Solvency II. Even getting a mention that in the future there should be the group support mechanism where you can move an element of the solvency capital around between countries is running into great difficulties in Council. The UK likes that economic approach and I support it greatly. We are trying to make sure that we can at least keep the option there to have it in the future. If you see how this has developed during the financial crisis, it has been very sad that the first reaction of Member States and supervisors has been, "Let's hunker down in our Member States. Let's concentrate on the institutions", which is wrong, because it was the holes in-between and the way that they were connected up and elements of regulatory capture that took us into the situation that we are in.

Q247 ***Lord Renton of Mount Harry:*** I am sorry, "regulatory capture"?
Ms Bowles: This is where those making the regulations and those applying the regulations and the industry all get bought into the same psychological idea. There have been elements of that around. I have examined my own conscience in this regard—I am deviating from where we are at at the moment—and I think I have suffered a certain amount of supervisory capture in that I believed the FSA when they told me how good a lot of the things they were doing were.

Q248 ***Chairman:*** We have all done that.
Ms Bowles: If you like, that has been my greatest *mea culpa* that I could expand on at length, but not now.

Q249 ***Chairman:*** There is a question we are coming to on that generally. Can I finish my question before I ask Mr Purvis to come in? We are all wondering about the European Central Bank. They are a central bank and they have got lots of people, would it not be sensible to suggest that they had a greater part in this? Most of Europe, us excepted, on the whole kind of swings to the euro. We do not, but the Central European countries rather do. It seems a practical suggestion that, as Mr Trichet suggests, the European Central Bank should have a major part in all of this. If they did, would we somehow get squeezed out, left out?
Ms Bowles: There certainly is a role for the ECB and plenty of UK banks must have been grateful one way or another through subsidiaries to access the extra liquidity that they pumped into the system.

Q250 ***Chairman:*** True.
Ms Bowles: We were not isolated from the help that they gave. Certainly I think that the ECB can play a wider role and there is basis for that in the treaty, although quite where that leaves the UK I am not sure. Obviously we can join in on all kinds of things on a voluntary basis. It seems to me, if I play this technical, legalistic treaty line, the thing you should look to first is the network of the European Central Banks which, of course, includes the ECB. Then within that you can give the ECB, if you like, the "big cheese" role simply because it has got the staff and everything else. It seems to me if you proceed down that route through the network, including an enhanced role for the ECB, then there is a treaty base for it that would cover all countries. At the moment you require unanimity but with the Lisbon Treaty it is probably majority voting, although I am not sure. You do not then run the risk that in some way the UK can be isolated out of it. In stability terms I do not think anybody wants the UK not to be in on it, but there are certainly moves in some quarters to try to make sure that there is a certain huddling around eurozone to try and get institutions and regulation more centred on places other than London.

Q251 ***Chairman:*** Mr Purvis could I ask you to have a stab at all of that.
Mr Purvis: I would say Howard Davies is really envisaging the logical conclusion which may well be different from the political conclusion which will actually happen. I suppose we now have de Larosiére moving slightly in this direction but then backing off a bit because his group did not quite all come together. We now have Alistair Darling apparently saying he thinks there should be some sort of a European regulator or one that devises the regulations, apparently. I query that because who devises the regulations at the moment is the Commission, the Parliament and the Council of Ministers, but what this independent body is we remain to be elucidated on. I would now turn to what we have seen happening in the last few weeks and months because the Fortis case was a good case in point. We have been going down this idea of colleges of supervisors and home/host regulations and co-operation and co-ordination between national regulators and it is all going to work wonderfully well. We have been pressing this and my line has been, "Please, regulators, co-ordinate and co-operate. If you don't you are going to end up with a single regulator, that's what is going to happen". Still the big country ones, including the FSA, are arrogant and the little ones are scared stiff of the arrogance that they receive. It still remains to be seen whether they can co-operate and co-ordinate. The Fortis case was a disastrous example of it not working. This was the Benelux countries, would you believe it, Belgium, Holland and Luxembourg, who had been working together long before the EU was ever dreamt of and they could not keep together as regulators when the crisis arose and they all fell off in their own respective bits. We had a presentation in camera from Mr Prates

the other day and it was really demoralising, you might as well say the Single Market does not exist any more if that is the way we are going. My Lord Chairman, you mentioned the Single Market and to my mind that is the absolute essence of Europe and the future of Europe, and whatever we do in this area has to be consistent with making sure that the Single Market at the very least continues and prospers. Unless some dramatic change of attitude amongst the national regulators in terms of co-operation and co-ordination and respect for each other develops, and then maybe some sort of co-ordinating body, maybe at a European level, I think we will move to pressure for a single regulator because we will have more disasters like Fortis and the pressure will become impossible to resist. What sort of structure in the meantime would be ideal? You are always going to have the national regulators dealing with the local entities, that is obvious, they know the local scene, but as legislators we legislate the framework regulation and then we have the implementing process, which is the Lamfalussy process at the moment. As Sharon says, we have no legal basis for these Level 3 Committees, that is why they are only advisory committees to the Commission. Only the Commission has the treaty power to actually do anything. Incidentally, Alistair Darling excludes the Commission from his proposal completely, it is only the Council that is this independent body and the Commission is excluded, let alone the Parliament.
Ms Bowles: Our version had the Parliament in it.
Mr Purvis: Did it? Not in mine.
Ms Bowles: I mean the report we voted.
Mr Purvis: Absolutely. You could envisage a structure where the legislative bodies do the framework legislation and there is a rather more powerful Level 3 Committee. There is no way we are going to go through the treaty amendment process again, can you imagine, especially when it impinges on national sovereignty issues like this. The best we can contemplate is just a stronger Level 3 type of thing but still always advisory ultimately. The Commission will have to be the body that implements at the end of the day and the national regulators will deal with the bank on the street corner to make sure it is up to speed.

Q252 ***Lord Renton of Mount Harry:*** There is the point, of course, that many of the banks are multinational.
Mr Purvis: Right, and that is where we get these colleges of supervisors and the home/host regulators. That was where Fortis showed where the weakness is. Our Lithuanian colleague is constantly saying to us, "How can I go back to my constituents when all my banks are owned by Italians, Brits or Germans and the minute there is a crisis all the money is withdrawn back home and my poor little regulator has no say".

Q253 ***Chairman:*** It happened to us, of course.
Mr Purvis: It happened to us and it can happen on the other foot, exactly. The second point I raised was there is no reason in a Single Market why the biggest bank in the world should not be in the smallest country in Europe. Just like Ryanair is in a small country and is the biggest airline, why should the biggest bank not be in Lithuania if that were the case. We have to move to some form of mutual solidarity when the crisis arises. On a global basis I suppose that is the IMF and do we want an equivalent at the EU level or do we resort to the IMF? We are talking about countries now, not only banks.

Q254 ***Lord Haskins:*** This Fortis case fascinates me. Is this really the test case of all this? Presumably you have had them in to talk to them. Are all the lessons built into this saga? There is a spin-off with the RBS acquisition, and the RBS in a sense created the problem for Fortis, did they not?
Mr Purvis: Yes. It was ABN Amro because Fortis bought part of it, yes.

Q255 ***Lord Haskins:*** They say there was a complete failure to sort out a major banking situation of this sort. It is surprising in a sense that the consequences have not deteriorated even more than they have done.
Mr Purvis: There were some chauvinistic aspects because ABN Amro was a Dutch icon and, therefore, the Dutch said this was a good opportunity to get ABN Amro back in their camp.

Q256 ***Lord Haskins:*** It is so unlike the Dutch.
Mr Purvis: I know, but that is what happens when you get in a crisis, is it not, every man for himself. We have had a bit of that even at the British level, have we not? That is why I worry about the Single Market and will it cohere in these situations: British jobs for British workers and all this sort of stuff.

Q257 ***Baroness Hooper:*** The Commission has issued three separate sets of proposals to deal with this crisis, one of them dealing with credit rating agencies. We all know that a number of companies and banks relied on credit rating agencies in circumstances when maybe they should not have because, as we have been told, the credit rating agencies were really giving opinions and not guarantees that these were triple-A or whatever else they were saying. I wondered if your committee in the Parliament has looked at this particular aspect of the matter, whether the Commission's proposals look as if they could work in the future and whether this would cover the issue of quality of ratings.
Mr Purvis: You are right, undoubtedly the credit rating agencies did make some terrible mistakes. How could it be that there are 12 triple-A banks in the world but there are 30,000 triple-A securitisations?

Obviously there were conflicts of interest or something going on there. Nevertheless, they were just opinions and the investors should have used due diligence themselves. They had built up this reputation and people were misled accordingly. The proposals from the Commission, in my view, are completely unworkable. Maybe we need to have some regulation, but the sorts of proposals they are coming up with are very eurocentric and these are global companies, the big ones are not even European, but there are requirements that every opinion they make is vouched for by a European based entity or person. For example, if you have got the Tokyo Standard & Poor's person opining on Toyota or, let us say more importantly, some minor Japanese company, this has to be vouched for by somebody in Europe who takes responsibility for it. You are not allowed to invest in that company unless it has been dealt with by a European based assessor and it seems to me that on both fronts that is flawed. (a) The likelihood is that the assessment is not particularly added to by the person in Europe and (b) the exclusion of being allowed to invest in what you will is somewhat of an infringement of one's rights to invest where one will regardless. It is actually making rating agencies even more vital to the investment process. At the moment, if you want to disregard the rating agency you can go and invest in anything you like, but now you will be prevented from doing so.

Q258 ***Baroness Hooper:*** In all this, in the past the frenetic activity of the City and all these dealings in the City in my view have been exaggerated by the fact that with new technology the volume of transactions can be huge and the timing can be almost instant. It sounds to me as if the Commission's proposals are going to put so many delays on making decisions that maybe it will overcome the advantages of having new technology to speed everything up.
Mr Purvis: Yes, I agree, but you will not be allowed to invest if you suddenly want to in X, Y or Z company in Tokyo until this European second-guesser has vouched that.

Q259 ***Baroness Hooper:*** So it is a medium for delay in decisions?
Mr Purvis: It is a delay but I think it is an unnecessary bureaucratic addition and an infringement of one's freedoms. There are other aspects of it which are almost as strange. I think the basis of a lot of this eurocentricity that is beginning to develop out of the Commission is a reaction to what is going on in America where there is also an American-centric type of attitude developing and it is a macho battle developing between the two.

Q260 ***Lord Woolmer of Leeds:*** It is called protectionism, is it not?
Mr Purvis: It is yes, but it is also machismo as well.
Ms Bowles: Regulatory me too-ism.
Mr Purvis: Yes. As a committee we are going to America in a couple of weeks' time to meet with all the congressional people.

Q261 ***Baroness Hooper:*** Are you preparing a report on this?
Mr Purvis: Yes.

Q262 ***Baroness Hooper:*** When is it likely to be published?
Mr Purvis: We are indeed. It is in the legislative process. It is a legislative proposal, it is going through the Parliament at the moment, Mr Gauzés, the French EPP-ED co-ordinator is the rapporteur and we have all put in hundreds of amendments.

Q263 ***Baroness Hooper:*** So when is it likely to come out?
Mr Purvis: It should be voted probably during April in the committee.
Chairman: We understand this one will come out before our report and we are going to provide that committee with a letter saying where we are. This is one of the things we have got to conclude before we do the rest of the report.

Q264 ***Baroness Northover:*** Will it be approved, do you think? Will it go through?
Mr Purvis: The Parliament will approve something but it remains to be seen what. I hope it will be a very substantial amendment of the Commission proposal. I suspect if the EPP-ED and the Liberals agree on that then there will be a very substantial amendment to it.

Q265 ***Lord Haskins:*** Then it goes to the Council?
Mr Purvis: Then it goes to the Council. Well, the Council will be doing their common position. They are working on it at the moment on their common position. If it is going to be legislated during this mandate we have to reach a first reading agreement with the Council and we will be up against timetable problems because the last plenary is May.

Q266 ***Lord Haskins:*** Much too rushed.
Mr Purvis: Yes, but all of it is being rushed.
Ms Bowles: It will happen.

Q267 ***Chairman:*** Is it unkind to suggest that is not going to happen, that you are too close to a deadline?
Ms Bowles: No.

Q268 ***Chairman:*** In the UK Parliament I think I would be suggesting that it is not going to happen.

Mr Purvis: It might be pushed into touch and I think if I had my druthers it would be pushed into touch, but most of my colleagues who are standing for re-election feel they have to be doing something. That is why there probably will be a mad rush in the May plenary, which is the last plenary we have, to push these things through and say, "We've clobbered the rating agencies, aren't we good?"
Ms Bowles: The first trialogue is next week. Before the vote in committee there is an informal trialogue.

Q269 ***Baroness Hooper:*** What is a trialogue?
Mr Purvis: A trialogue is where the Parliament, the Council and the Commission meet to try and reconcile their differences.

Q270 ***Lord Woolmer of Leeds:*** From our discussions with the industry, not just the users of the service, credit rating agencies overwhelmingly perform a perfectly good job in relation to corporate debt and government debt and so on, but in the last few years it was on these enormously complex instruments where they failed completely, giving judgments on instruments they did not really understand and nor did anybody else.
Mr Purvis: Not only that, they were paid by the issuers for doing it.

Q271 ***Lord Woolmer of Leeds:*** Indeed. If you had somebody in Europe with this enormous duty of care, as it were, does anyone think they would have understood these complicated instruments any better than anybody else? There are two issues here. One is the general run-of-the-mill of what credit rating agencies did and nobody is saying they did a particularly bad job of that, it was the emergence of these complex instruments. What discussions have gone on in Parliament about this, the distinction between the kinds of assets we are talking about, their rating, and the feasibility of anyone rating those? What discussions have gone on about that?
Ms Bowles: There are quite a lot of problems here. I should say I am the rapporteur for the Legal Affairs Committee on this and in the main committee I have got 90 amendments in. Even if every single one of my amendments passed we still would not have solved the problem that John outlined vis-à-vis the small specialist rating in Japan, Canada or wherever. We can solve the Moody's S&P situation but nobody has yet found a solution to all of it. There are big dangers in the regulation that you could end up with unintended consequences of mechanisms to interfere in the ratings. Certainly some countries want to be able to do that. There are lots of people who want to be able to apply legal or other pressure to try and change ratings, so potentially it has problems there. That is one of the things I am trying to fix within my opinion in the Legal Affairs Committee. I take a slightly different view on rating agencies from some people in that I think they did understand the financial instruments but, of course, they are not organisations that do due diligence themselves and there is a slight conflict in the proposals: are they supposed to be doing that or are they not. I think the halfway house is they are supposed to expect their sources to be reliable although they are not doing due diligence themselves. The main problems on the securitisation were that there were flaws in the mathematics. They had correlation factors wrong and would make presumptions, for example, in lumping a load of mortgages together where you have a diversification that enables you to use a binomial expansion magic diversification of 15, but where from, mortgages are mortgages, they might all tend to move to the same kind of thing and to say historically the East Coast was different from the West Coast and rely on that kind of historical data is not sound. We could do everything that people are trying to do about conflict of interest but unless you have some better cross-checking on the mathematics you could go down the same track again. I am not saying that you have to interfere in the models of the rating agencies but it would be nice to have a little bit more academic oversight of the processes. I do not mean economic mathematicians, I mean mathematician mathematicians.

Q272 ***Chairman:*** Modelling mathematicians.
Ms Bowles: I am sorry, I have now done to you what I have been doing to the committee since the day I got there, I have been moaning about the maths. It is the case that there are lots of flaws all over the place in that kind of thing and you need to get them discussed more.
Mr Purvis: Transparency is the word, is it not?

Q273 ***Chairman:*** It is not transparency, it is understanding. I was sitting dazzled by this because this is a problem. One may consider oneself as well able as the next man to do due diligence on a proposition but if it has got mathematical assumptions in the middle of it, we need a mathematician here.
Ms Bowles: That is the point, it is the mathematical assumptions. Who said that this diversity was such that you could use these particular approximations? I think if you had thrown some of these open to a post-graduate class at Oxford or Cambridge in the maths department they would have torn it all to shreds.

Q274 ***Lord Haskins:*** It still comes back to corporate governance. You said earlier that these rating agencies give an opinion. They give an opinion to the boards of the banks and the banks then hide behind that, whereas at the end of the day they do not have to

accept the rating agency's opinion, they have to make their own judgment.
Ms Bowles: It is the risk officer thing there. We had a lunch debate the other day and we had the chief risk officer from one of the banks.

Q275 ***Lord Haskins:*** Of?
Ms Bowles: I am trying to think where he was from.

Q276 ***Lord Haskins:*** A big bank?
Ms Bowles: A big bank. Of course, there was all the fuss in the UK press at the time about the risk officer, the HBOS guy who said he was sacked, so I asked the question of our lunch speaker—I am trying to remember, it was a French bank, it was not Soc Gen, I cannot remember, and maybe we should not name him anyway, it might be diplomatic not to remember who he was—"What is the situation?" and he basically replied that if you disagreed with the rating that came from a credit rating agency you could well be on your way out, that this was an occupational hazard for risk officers.

Q277 ***Chairman:*** That is very interesting. Of course, there is a problem inside the banks that you are not allowed to disagree with the rating agency and, above all, there is regulatory reliance on what rating agencies say and that seems to me to compound the problem.
Mr Purvis: It is going to become even more so under the suggestions of the Commission. Whereas at the moment it is just an opinion, however mistaken, under what the Commission is proposing it is going to become almost enshrined in law and, furthermore, the Commission is almost going to take ultimate responsibility for these ratings because it has the right to intervene and say, "This rating is wrong" or "The model is wrong".
Ms Bowles: I think that will go.
Mr Purvis: That is in the proposal.
Ms Bowles: The proposal has all kinds of strange things, like if there is a small flaw somewhere in what you are doing all of a sudden the ratings cease to exist. Just imagine what that will suddenly do to the capital base of a load of banks if all of a sudden things that previously were triple-A became unrated. It cannot go through in that form.
Mr Purvis: It is the Commission that actually has the role of registering and de-registering and if it is de-registered then all its ratings for the last 10 or 20 years are invalid and they are no longer rated.

Q278 ***Baroness Hooper:*** Would it not be helpful to have guidance at least so that everybody was looking from the same point of view? Very often in our legislative process at home we say we are not going to put this into primary legislation but we will have guidance so people know how to interpret it.
Ms Bowles: We are just discussing what is in it.
Mr Purvis: Sharon is saying it is the Lamfalussy Committees but they cannot take any action, they are only advisory to the Commission.
Ms Bowles: It will be a regulatory authority in the Member State that is actually authorising them and de-authorising them.
Lord Haskins: At the end of the day, the management of this risk has to lie with the boards of the banks, it has to. If you take it away from them, what are the banks about?
Lord Renton of Mount Harry: I totally agree with you, Lord Haskins, the banks are entirely about making their own measurement of risk which may be different from that of another bank.

Q279 ***Chairman:*** We are trying to elucidate evidence from our witnesses, could we try again?
Ms Bowles: What is interesting, and you will want to come on to this when you do the Capital Requirements Directive, is that there are efforts on the other side being made to increase the amount of due diligence by banks, investors and others. The idea the Commission has is to try and reduce reliance on credit rating agencies but also at the same time to try and have some kind of quality of ratings. You may be able to improve the quality of the methodologies and the quality of the processes and either the elimination or greater transparency of where there are conflicts of interests so that, if you like, you have got a better idea of knowing what you are buying, but you cannot really go any further than that because, as you say, at the end of the day they are opinions and there is the overriding danger that by having them regulated you are telling people you have made them safe and the once bitten, twice shy deterrent to only looking at ratings is gone and instead they become even more fixated in people's minds.
Mr Purvis: My conclusion is that this is a classic example of the Dangerous Dogs Act.
Lord Haskins: Absolutely.

Q280 ***Chairman:*** It seems to me if this conclusion arrived at its logical point you would be making the regulator a credit rating agency fundamentally.
Mr Purvis: Yes.

Q281 ***Chairman:*** The regulator is responsible for credit ratings.
Mr Purvis: For registering and de-registering, for checking them, yes.
Chairman: It becomes very far from the original source of responsibility.

Q282 ***Baroness Northover:*** My question is whether, and if so how, hedge funds should be regulated at a European level?

Ms Bowles: Shall I go first on this because you have done a report on this in the past? I think this is quite interesting because we fought over this in committee quite a lot of the time and John and I have been on the same side of those debates.
Mr Purvis: You are really talking to two of the—
Ms Bowles: Maybe this is one area where I have also suffered a little bit of supervisory capture, as I term it, because I firmly took the stance that in London hedge fund managers are regulated and, if you like, every bit that you could get at does have some supervisory oversight. You cannot get at the fund when the money is offshore, so that is a problem, so you regulate those bits that are on your territory. Where perhaps it was not as strong as it might have been was in how the FSA was checking the counterparty exposures and risks, which we were assured in various sessions that certainly for the largest risks those were looked at. Maybe that needs to be strengthened. It is interesting that de Larosiére is basically saying that everybody should do the kinds of things that were going on in London but, again, in an enhanced way, getting at the counterparty risk. The problem is everybody who has been demanding this the whole time has always reckoned the big problems were going to come from the hedge funds and the leverage in the hedge funds and that was very much the populist line, that it was pretty difficult to swim against, but now everybody has discovered the banks were more highly leveraged than the hedge funds which are now down to about one or less but people are still loving to hate them. Frankly, I think it took the attention off what were the true hotspots by going on about hedge funds and private equity. The assumption was always that the banks were on the safe side.

Q283 ***Chairman:*** Yes, absolutely.
Ms Bowles: These kinds of thoughts even came into contracts like the ISDA contracts if you think about it, the presumption was that the bank was always going to exist so you could cancel from the bank side but you could not cancel from the hedge fund side and when they cancelled from the hedge fund side suddenly their money went into the general pot. This was what happened when Lehman's went under. Maybe more people ought to be paying attention to what is going on in contracts and what role lawyers are playing in allowing what seemed to me to be unbalanced contracts. There is a whole new area of things that have added to problems. If you think, "I want to get my money back so I'll cancel my arrangement with my counterparty and I'll have my money back", you would think that was a standard thing you would be allowed to do, not that you forfeited your money or it just went into the general pot, but that was what happened.

Lord Renton of Mount Harry: The main worry about the hedge funds was the fact that they were driving demand down excessively at a time which was putting bank shares at risk because of the position of the hedge funds and it was not so much about the machinery of the hedge funds, which have existed forever. I was Leader on the London Metal Exchange for years and we shorted metal all the time. It was the fact that the extent of it was putting, if you like, Barclays at risk because their share price became intolerable in effect.

Q284 ***Lord Haskins:*** Alongside Robert Peston. They were the two guilty characters, hedge funds and Robert Peston.
Ms Bowles: That was late in the day. We have had the argument over should you regulate hedge funds that has been rumbling on for donkey's years.

Q285 ***Lord Renton of Mount Harry:*** It all may happen again. It is not over.
Ms Bowles: Your question really is not should you regulate hedge funds but should you regulate short selling. They are not the only people doing it, there is a certain car manufacturer in Germany that has indulged itself.

Q286 ***Lord Renton of Mount Harry:*** Absolutely, I quite agree. A hedge fund hopefully can go long up rather than short down.
Ms Bowles: There must be elements of short selling or when it is done to excess that possibly can become market abuse. The Commission has said it is going to look again at the Market Abuse Directive and possibly they can do that there.

Q287 ***Lord Haskins:*** How can you regulate them?
Ms Bowles: I do not know is the answer.

Q288 ***Chairman:*** For the purposes of this session we have had a very sensible answer that hedge funds are not where the problem turned out to be, the systemic problems turned out to be in the banks.
Mr Purvis: Yes, but there is still persecution going on against hedge funds and, as Sharon was saying, it goes back much further than this. On the one hand, among our centre right friends, it goes back to the locust issue and their activism as shareholders in certain companies. The same with private equity insofar as they are lumped with private equity even if they are quite different animals because they were trying to maximise the return for their shareholders from companies and that often involved reducing the number of workers in a factory or perhaps even closing down a factory, so they became denominated as locusts in Germany in particular, and our centre right friends in Germany had that behind them. The left has it behind them for the same reasons, so there

is a bit of an amalgam of interest in those areas. They are all seen as very London.

Q289 ***Chairman:*** Yes, London locusts.
Mr Purvis: As Sharon also said, they are regulated insofar as they can be regulated both by the managers being regulated and the prime brokers being regulated in the UK, but in the US they are not and this is why we have had all these problems with Madoff and the investment banks in New York. They were not regulated until just very recently when they have been pushed to become real banks instead of investment banks and the hedge fund managers were not regulated. The SEC tried to put through registration which was knocked out by the Supreme Court, so some were registered but they certainly were not properly regulated. As far as what sort of regulation there should be, I would refer you to my report of 2002 or 2003, whenever it was, on hedge funds which was proposing a light-handed form of regulation to try and encourage them to come onshore because at the moment they are all offshore. Part of their reason for that is the regulatory consideration and the other, of course, is tax. If they were going to move into the retail market, if retail customers were going to quite reasonably want to get the same benefits that fat cats get by using hedging techniques then they would probably be tempted to go into these areas. Therefore, there should be some form of regulation for onshore hedge funds, but I think it should be relatively light. UCITS, of course, are the daily bread of the investment business and highly successful but there is a discussion about whether there should also be a similar regime for alternative investment-type products, real estate investment and so forth, with a passport to operate on a European-wide basis in the Single Market, which at the moment there is not. They have to register in every individual Member State.

Q290 ***Chairman:*** Yes, we have touched on this one.
Ms Bowles: I have got one reservation that goes on from that. If you go into the retail area then one often ends up looking for safety through funds of funds.
Mr Purvis: Which are very expensive.
Ms Bowles: Not only are they very expensive, but when you start looking again and talking about market trends and due diligence the information at fund of funds level you are going to get is very dated. I perceive that potentially there can be risks in that and I am not sure they are necessarily being looked at. That is all I would say on that at the moment.
Chairman: That is most helpful. The next thing we have to face, as it were, is the Capital Requirements Directive.

Q291 ***Lord Renton of Mount Harry:*** We have touched on it already, but I wonder what you think about it, particularly the requirement for the retention of risk in securitisation transactions. Do you think that the changes made in the Council working groups have reduced the risks that financial institutions might go outside the EU in order to escape the restrictions imposed by the Directive?
Mr Purvis: This is essentially an update of the CRD1 or Basel II and is going through as a matter of course anyway. Basel II has probably been found slightly wanting in this, although it was only half implemented when the crisis blew up. In the unfortunate circumstances in which it has arisen, it is understandable why there is a move to tighten everything, a Dangerous Dogs Act sort of approach, but I do query greatly this retention idea. In fact, we have an amendment in to have an option for a warranty. I have tried to get the industry to come up with what I would call traceability, rather like we have for cattle or sheep going back from your hamburger to your cow, to trace back to the origin and hold the originator to task if it was misrepresented at some point. In a way, the retention idea is a way to make the originator feel a continuing responsibility in his back pocket for this. It seemed to me the industry were unable to come up with a very adequate form of traceability, unfortunately, so we have put in this thing about a warranty, that the originator must give an absolute warranty on what he is originating.

Q292 ***Lord Renton of Mount Harry:*** As to its content.
Mr Purvis: As to what he is saying it is worth and is. He can be held to task on that warranty if subsequently it is found not to be up to scratch, but he does not then have to hold five per cent back. At the moment the rapporteur is supporting that as an alternative. It is five per cent retention, not more. Some would like it to be 10, 20, even 40 per cent, but the current proposal of Othmar Karas, who is the rapporteur, is five per cent or the warranty. I hope that will survive.
Ms Bowles: The socialists are not so keen on the warranty.

Q293 ***Lord Renton of Mount Harry:*** Why?
*M*s Bowles: Because there is a lot of pressure from socialists and Germans, it is a bit of an unholy alliance. I have to exclude the Labour Party from this because it is one of many issues where they do not seem to be in line with their group. They pressed for the very high retention factor. I do not know whether they actually want to kill securitisation off completely or not. I think a lot of this is just electioneering, it plays very well in the popular press because ordinary people do not really understand that we need good

securitisation back again and if we do not then they are going to feel it in their pockets with a credit card crunch, which is already starting. The state of play is the compromise as proposed by Mr Karas, which includes John's warranty alternative and on the retention side has got a lot of amendments in that are better than the ones that are the state of play in the Council, most of which I have to say are mine, in particular doing away with what we call the death penalty clauses where the penalties put in by the Commission are so great—

Q294 ***Chairman:*** Public hanging!
Ms Bowles: —that the risk to issuers of doing securitisation is too great, and the risk to investors of buying it is too great if some little bit of due diligence falls out. However, collectively between what the Council and Parliament propose those problems will be solved. I think it will be a five per cent retention. I suspect that we may have a hard time in the trialogues defending the warranty alternative, but for my own part I think it is quite a good idea to have that indication of flexibility so that if we end up coming back to revisit this again people may have had better thoughts about how to make some more commonality of interest. The one thing I am fighting for at the moment that I have not yet got in and was not got in at Council is to get some exemption for corporate securitisations.

Q295 ***Chairman:*** They are fairly straightforward and traceable.
Ms Bowles: And the companies have still got an interest in the ongoing business, it is not as if it is completely disassociated, as was the problem with other securitisations. It will be much improved and I am hopeful that the end result will be such that it is workable and when securitisation markets do reopen it does not inhibit or force people to be elsewhere. I would point out that there was an extraterritoriality in this as well in that investors in this country have to have the promise of retention irrespective of where that securitisation is done, so the temptation, therefore, is to not have your fund on European soil so you can escape it altogether.

Q296 ***Chairman:*** That is probably a key point. Would that difficulty be avoided with a warranty?
Mr Purvis: At least the retention problem.

Q297 ***Chairman:*** If they had to give a warranty, they would not feel they must move somewhere else rather than do that?
Mr Purvis: I would not have thought they would be too concerned. If they are honest and reputable people I do not see why they should worry about giving a warranty if what they are saying is the truth and disclosing what they see as the good or bad points of whatever it is they are issuing. It should at least make it easier. There might be a problem if it is an American securitisation and it does not have a warranty then are you entitled to invest in it. It might make it more difficult for European investors to have a range of securitised products to invest in. Again, that becomes a slightly protectionist issue as well. I would just like to stress how vitally important securitisation is to the recovery of the economy. Mortgages, car loans and credit card loans are the three major areas of securitisation and what do we have problems in, mortgages, car loans and very soon credit card risk. That is why the car industry is in the dumps, because people cannot get the funding to buy a car, so now we have to pile all this money into car companies to keep them afloat. Why do we have mortgage people having to be bailed out of their houses, because of—

Q298 ***Chairman:*** Lack of securitisation and the ability to securitise.
Mr Purvis: It is a critically important issue and I just cannot understand why both the Member State governments and the Commission are so determined to make it difficult to get securitisation starting again. I just cannot understand it.

Q299 ***Lord Renton of Mount Harry:*** That is a very interesting point. Why are the Commission determined?
Mr Purvis: I do not know. Actually, I have an inkling and it is just pressure from media, Member State governments, the left-wing. We have had terrific pressure and poor McCreevy gets torn to shreds every time he appears in the committee or the Parliament by the left and by other people as well, I have to say. Barroso has been so pushed around at Council meetings that he has told McCreevy, "You've damn well got to do something". That is my supposition, maybe it should not be recorded, I do not know. There is a huge amount of political-cum- Dangerous Dogs Act type pressure which is forcing it to happen.

Q300 ***Chairman:*** Are we still in the "punish bankers, make me safe" mode?
Mr Purvis: Seen to be doing something.

Q301 ***Chairman:*** Seen to be doing something at great risk to the future of securitisation.
Mr Purvis: Yes, that is my conclusion.
Ms Bowles: It is very difficult because every time you have interviews the very same people who would normally want to say Europe should not be interfering in this are the first in the queue asking what is Europe doing about it. It is not just MEPs who want to be re-elected, and some people make this part of their political platform, there are also people within the Commission whose jobs and future

positions depend upon how they are perceived and how Member States perceive them. I am afraid it all comes at a very unfortunate time.

Chairman: That is extremely interesting. I know that we are keeping you beyond your time, but what I would just like is for Lord Jordan to ask the key question.

Lord Jordan: This is a rounding up question. I was going to ask do current EU treaties and procedures allow an efficient and effective response to a crisis situation? From all we have heard and seen already clearly the sheer size of the present crisis shows that they are not. I would like to project forward and ask if the London Summit in April were to come up with any radical policies requiring treaty changes, and that is not certain, would the divergences that exist in Council, Commission and Parliament be able to enable those changes and in the case of the Council would they be more or less directed by the political power that the major multinational banks wield when pursuing their desire for regulation avoidance havens which they have found to a large extent in London for a few years? It was when the people who were running the system discovered that by abusing the Anglo-Saxon system they could make such major personal financial advantage. There was nothing wrong with the system, it was the way it was abused. If there were radical changes, can the present set-up handle them?

Q302 ***Chairman:*** Or even if there were not? Is the present set-up workable and, if not, what do we need to do? Discuss.

Mr Purvis: I think our previous evidence through this has shown, frankly, it probably is not at the moment. I do not think it is necessarily the fault of the EU institutions that it is not, it is that there has not been a willingness on the part of all the people of the European Union yet, let alone the nation states, to consider themselves as a mutual solidarity pact of some sort. We have seen it writ large in the last few meetings that have been organised between the various heads of state and government because they all say, "We're wonderfully European and going to co-ordinate all our things, but you go and do what you want and you do what you want" and they all go off and do their own things and they are looking after their own and usually that means a retrenchment to their Member States to the disadvantage of other Member States. This is writ even larger on a global scale, I suspect. Funnily enough, I would put a couple of notes in. I would put mutual support and solidarity because the whole thing has to move from being co-ordination to being more of a system of mutual support. Whether this is global or European, the obvious institution on a global scale is the IMF and there might be a European equivalent potentially. It is not necessarily that you have got to say it has got €500 billion or dollars, whatever, to its resources, it is that no matter what happens we will stand together to support anyone in trouble. It has moved from banks now to countries. We have it at the European level with Hungary and Latvia, potentially Ireland and Iceland, who knows who else it might be, but when it gets bigger can we say that no matter what happens we will stand behind you, our neighbour. If we were prepared to say that I would very strongly suspect that no guarantee would ever be taken up because the short sellers, or whoever out there, would know the support would be available. It is not that it is the actual amount of money, it is the commitment.

Q303 ***Chairman:*** It is the fact.

Mr Purvis: I would like to think in my dying days of the European Parliament that we could move from this idea of let us co-ordinate things to building a genuine mutual support organisation. It is vitally important politically for the East European and Central European countries. I know they do not like to be lumped together, and rightly so, but a lot of them are still adolescents in the economic development game and adolescents are tender beings and might need that mutual support, but also old-aged pensioners are rather tender animals and it might be some of the bigger, older countries may need some of this support in due course if things get any worse. I do think that is something I would like to aspire towards.

Ms Bowles: There is a lot in what John has said that might be the only way that one can do it in that if you look at the present crisis there were various warnings. Nobody knew exactly how it was going to happen, and of course some people were saying it was all going to be the fault of hedge funds and so on, but there were warnings of various different natures out there, including some from the ECB. Who was going to stop the party? What government or supervisor was going to intervene and say, "You can't do that and the country's growth is going to be reduced as a consequence"? In order to take action that did not competitively damage, if you like, the first to move, because the first to move would be the one that took the hit of the lowering of the growth, how do you do it? You would have to do it on some kind of international basis and, to me, that looks as if it is hard enough within the EU, as we well know, never mind when you go to the international level. We may build more European early warning systems but what on earth is going to be the intervention system, when it says—

Q304 ***Chairman:*** "Stop doing that".

Ms Bowles: Yes. By the way, we have got our Lisbon Agenda which says you have got to have growth but what is the intervention mechanism? If somebody can invent one, fine, but I cannot think what it is yet.

Mr Purvis: The IMF.
Ms Bowles: Yes, but that is afterwards, not before. We have got the early warning systems, we have got the bail-out systems developing for when the worst happens, but what do you put in the middle that is interventionist that stops you getting to the bail-out system. Possibly the only thing that you have got is if the bail-out systems and mutual support are strong enough that in some way it acts almost like a nuclear deterrent to abuse. As Mr Purvis says, the short sellers will know it will not work in the end, so there is no point in doing it. That is an argument for putting the bail-out mechanisms, mutual support mechanisms maybe, into place that might extend beyond the comfort zone of national sovereignty and things like that. I cannot see how you can design, if you like, the glove that grasps this interventionist nettle when, as I said, it would stop growth.

Q305 ***Chairman:*** I would like to be allowed one final shot at this. We are all still looking for the institution, if you like, to whom we can adhere, through whom our mutual support can be expressed. Mr Purvis, do you think it is the IMF? Is it outside Europe? Is it either something we have not invented or is it the IMF?
Mr Purvis: I think on a global scale it is something of that sort and, yes, the IMF is probably the obvious body. Failing that, it could be that maybe one has to do it on a regional scale as well if that is not adequate and maybe there should be something roughly equivalent, a fail stop, and the IMF is the backstop, or they work together. Yes, I think you could have it at different levels. Obviously you could have it at the Member State level to deal with small things and then you move out to the regional level and then to the global level. It is desirable that we do have that sort of cascading facility. As Ms Bowles said, there is a sort of policeman role as well as a rescue role. Maybe that is where we come back to this European single regulator concept that at the very least he holds up his hand and says, "You are doing bad things you ought not to be".

Q306 ***Lord Haskins:*** Or this bond that was floated by the Germans last week for the Irish . . .
Mr Purvis: We have had the eurobond issue and that is another whole thing. The subsidiarity camp does not like the idea very much but there are some arguments that maybe eurobond's time is coming.
Lord Haskins: Yes, I think so.
Chairman: We could go on, but I know you have other things to do and you have been very generous with your time. It remains for me to thank you both very much for coming, particularly since you are right in the thick of all this and it is real, frontline expert opinion that we have been given. Thank you.

THURSDAY 5 MARCH 2009

Present	Cohen of Pimlico, B (Chairman)	Northover, B
	Haskins, L	Renton of Mount Harry, L
	Hooper, B	Woolmer of Leeds, L
	Jordan, L	

Examination of Witness

Witness: Mr Robert Priester, European Banking Federation, examined.

Q307 ***Chairman:*** I should start by thanking you very much for coming to talk to us. You are on the record. You have a shorthand writer sitting next to you who is taking down every word. We do give you a transcript so that any infelicities can be removed or at least discussed. I believe you have had a set of questions from us already.
Mr Priester: I have indeed, yes.

Q308 ***Chairman:*** We propose to work our way down them unless you would like to start by making a preliminary statement.
Mr Priester: Only to thank this Committee for the opportunity for the European Banking Federation to express its views on these important issues. I am happy to proceed along the lines of the questions you have put to us.

Q309 ***Chairman:*** Thank you very much. In which case I will start. I will remind you that our Howard Davies believes that the case of the Icelandic banks supports the need to create a single European supervisory authority for pan-European banks if we are to avoid a retreat from the whole concept of the Single Market. Do you agree with him, or does the EBF?
Mr Priester: That is the clarification, thank you. I am here first and foremost to represent the positions of our member associations which include the BBA and other national banking associations.

Q310 ***Lord Haskins:*** All within the European Union?
Mr Priester: The European Union and EFTA, 31 countries in all. The EU, the European Economic Area and Switzerland.

Q311 ***Lord Haskins:*** Not Iceland?
Mr Priester: Iceland is included in the EEA. Yes, Iceland is one of our members. This is a very difficult question and I would say in the way you have phrased it, the response that can be given is one that is more ideological than perhaps one that is more politically realistic or viable. This is a debate that has been going on within the European Banking Federation and its constituent members over the last two years with varying degrees of intensity. I must disappoint you by pointing out that it is very difficult to achieve consensus across the broad membership, there are very different views. The way the question has been phrased here, when I see reference to a single European supervisory authority, you will find some members are supportive of this. Pan-European banks, I understood to mean an indication towards possibly, a two-tier structured supervisory system with domestic banks remaining under the current arrangements of domestic supervisors and those cross-border banks subject to a single authority, looking at them exclusively. Amongst our members we have those that are interested and supportive of this idea, but I would say, the common view that all EBF members are supportive of, is towards a single framework. If you ask me what that framework should look like then it becomes a lot more difficult and a bit foggier. We have this longer term objective to arrive at a single framework and there are different concepts, different models, that are being supported amongst our membership but none to this day stands out as a majority view. What we have done at the European Banking Federation level is to try and arrive at a more pragmatic approach, a more short-term approach given the current framework, current constellation of supervisory arrangements, and what can be done to improve that in particular for the banks that are operating across borders in different Member States. What we have been looking for here is to avail ourselves of the existing structures and promote and support the use of colleges of supervisors. Colleges of supervisors were already in use before in some cases but it was always on a voluntary basis. We have been pushing and supporting the European Commission to enshrine the colleges concept in a mandatory form in the current Capital Requirements Directive which is under review, which would mean that all cross-border banks would have to consider putting together a college of supervisors. The colleges of supervisors on their own are not considered the final or best solution, we think these colleges are a ways and means to get the supervisors to work more closely together, to foster more trust and confidence amongst them. In order for these colleges to be able to make a difference in the way cross-border banks are

supervised, the EBF has been pushing for what is commonly known as the lead supervisor concept whereby you would have the supervisory authority of the mother company bank that would be in charge of the college, would preside over the college, and only in those instances where the college is unable to come to a consensual view on how to implement the supervisory principles and practices across the entire group, would we want the home supervisor to have the capacity to arrive at a decision. How it does that, is perhaps something to be left to the colleges, but from the point of view of a banking group in different European jurisdictions what matters is that the bank as a whole understands what is expected of it in terms of supervisory reporting, supervising duties, how on-site inspections, *et cetera*, will take place, and we would want this to be co-ordinated within the college in those cases where there is no consensus within the college with a capacity to arrive at a decision so that there is a clear outcome and a clear approach for the bank to respect. That is only one half of our preferred solution in the short-term. The other half would be the strengthening of the Committee of European Banking Supervisors, which is a Level 3 Committee which has been created to foster greater convergence between the supervisory rules as they are put into practice across Member States. We think that the CEBS has been under-utilised so far and we would wish to see it given a greater role in banking supervision for cross-border banks in Europe. At the same time, we also think it would have an additional role to play when creating different colleges for different banking groups. There is a variable geometry in terms of the composition of these colleges with different banking groups having different presences in various European countries, so the colleges will tend to have different compositions and will arrive at different supervisory conclusions or practices. The idea to counteract this vertical silo effect is for the CEBS to be a more horizontal body above these colleges to ensure there is convergence across Europe in the way the various colleges interpret their duties and apply them in practice. In a sense, it will be a mediation role also for the CEBS to ensure that we end up with a single approach and a single understanding across all members and different banking groups. We are also very keen to have national discretions disappear from legislation and the implementation variations of European Directives and the interpretations that very often result in further fragmentation in the regulatory landscape compared with what was intended in the European directives at level one. As a whole, this is what we in the EBF would like to see in the near future and that should gradually evolve towards a framework that is more single and would encompass all the banks in Europe rather than perhaps a two-tier system.

Q312 ***Chairman:*** Do you see a role for the European Central Bank in this lot? Previous witnesses have suggested that the European Central Bank is the best positioned to undertake macro-prudential supervision. Despite the fact that not all of us are in the eurozone, do you see a role for the ECB?
Mr Priester: We do, but, as you suggest, my Lord Chairman, more on the macro-prudential side. In terms of what I described a moment ago, I think this is much more focused at the institutional micro-prudential side. Certainly for the macro-prudential side, getting the central banks involved makes a great deal of sense and is something we are promoting or supporting. Whether it needs to be the European Central Bank as such, I suppose so, but at the same time I do not think it needs to be the ECB, it would be more appropriate to have the European system of central banks, which would include non-eurozone countries, to participate in this macro-prudential financial stability oversight capacity or role.

Q313 ***Chairman:*** You do not see the ECB really as representing anybody except the eurozone countries?
Mr Priester: The ECB represents the eurozone countries obviously and first and foremost is an institution that has been tasked with monetary policy considerations, so there is discussion about whether giving it supervisory duties in addition is perhaps a conflict with its primary mandate and, therefore, is the ECB the appropriate institution for that. I must say the ECB stepped forward earlier this year with its interest in this area and because in the past the institutional and structural discussions about supervision within the EBF were quite difficult we have not really taken on board for or against a stronger role for an institution like the ECB in banking supervision. We have no particular opinion as to the ECB as such having a role in supervision.

Q314 ***Chairman:*** Is it fair to say that the EBF has been concentrating its mind less on the stability side than on the general how you look after a bank side?
Mr Priester: Yes.

Q315 ***Lord Haskins:*** You talk about pan-European banks, but how many banks are in that group? What market share have they got?
Mr Priester: At the last count we had about 40 banks that were in more than three Member States.

Q316 ***Lord Haskins:*** That was the test, more than three Member States?
Mr Priester: Yes. They would represent about 60–70% of the total assets of the industry in Europe. This is the sort of magical figure that is very often cited by the European Commission, 40–45 big pan-European banks. One of our member organisationsfrom Italy has done an overview of the

banking industry and has looked at every country, mapped out the banks in those countries and their affiliations to groups and there we found that the concept of colleges for pan-European banks as enshrined in the CRD proposals now would lead to 139 colleges. In essence, you have 139 banks that are operating cross-border, either through a branch or a subsidiary.

Q317 ***Lord Haskins:*** That is an administrative challenge in itself.
Mr Priester: It is. Some of these colleges will not be very important. The real big challenges will be for the 40–45 big pan-European banks that are not only in Europe but also global. There is that extra dimension of having organised the colleges in the European dimension—how can the global dimension be accommodated. This is not negligible, it is an important aspect. We have been focusing principally on the European aspect because there are ways and means of anchoring some of this with more legal instruments whereas at the international level, for the time being, it is partly standard-setting on a voluntary basis.

Q318 ***Lord Haskins:*** So the big American banks are not a member of your Federation?
Mr Priester: They are, insofar as they have subsidiaries based in Europe.

Q319 ***Lord Haskins:*** You treat them the same as any other European bank?
Mr Priester: They are a member of our organisation just as European originated banks are.

Q320 ***Lord Haskins:*** Would they attract their own individual college?
Mr Priester: They would be part of a college in Europe certainly. For the American banks, it is a big problem because the mother company is based in the US, so very often the true home supervisor would be outside Europe whereas in Europe you would have the principal subsidiary in London or Frankfurt and it would be organised in Europe around that but what happens if you get contrary messages from the head office in the US.

Q321 ***Lord Haskins:*** That was the question I was going to ask. In Lehman Brothers we had the question about money being withdrawn overnight from London. In a European context, would the colleges have anything to say about that? This has happened with the Austrian banks and Eastern Europe. Would you have any view on that?
Mr Priester: We do. Part of the problem around banking supervision or financial prudential supervision, which can include other sectors as well, is its complexity. What I described earlier on in terms of colleges and strengthening of the Level 3 Committees—CEBS, is an essential step to go through, but unless you can underpin this development with more concrete arrangements and agreements amongst Member States in terms of burden sharing, it will remain a relatively ideological concept because, as we often see today, the authority to supervise is still anchored very much in the national context. The institutions have been given the capacity to go cross-border but the supervisory structures are still very much in a national context and that needs to be improved. In order to give the capacity and confidence to national supervisors that they can entrust their colleagues in a neighbouring country with supervision of particular aspects, or of a branch or that subsidiary, there needs to be an understanding among the supervisory authorities. For instance, if things go wrong how do we act and share out the ultimate burden that may result from a bank failure. And the taxpayer, if he has to step in, how much is coming from my taxpayers and how much from yours. This is a very difficult question to tackle. It will depend also on the differences between the colleges, the banks, the presence in the relevant countries, how important they are compared to the rest of the sector, how important they are to the economy. There will have to be a little bit of negotiation and case-by-case clarification amongst supervisors on what happens in case things go wrong. Without this sort of underpinning of burden sharing, which has already started to an extent in its articulation through the Memorandum of Understanding, but without drawing it all the way to the end and saying, "In case something goes wrong I am liable for so much and you will pick up the remainder", it is going to be difficult to bring to life the cross-border colleges in a true sense.
Baroness Hooper: My question was really on the global banks and their supervision, but maybe I can just ask did your Federation have a view on the British Government's action in freezing the assets of the Icelandic bank in the UK and how would that sort of activity fit into this?

Q322 ***Chairman:*** How does that fit into the scheme?
Mr Priester: With your permission, I must say that we have such an amount of legislative initiatives taking place at the European level and increasingly at the global level that for us to follow and to an extent intervene in some national situations that occur, is the exception rather than the rule.

Q323 ***Baroness Hooper:*** Very diplomatic.
Mr Priester: All these crisis management efforts that we have seen across Europe in different Member States tend to happen at very short notice. The European Banking Federation is just too far removed from the actual coalface to be of any immediate

application and we have steered our resources and energies in a slightly different direction. What we did have to face and come up with was a request from our Icelandic colleagues to see to what extent, within the EBF, there would be interest and preparedness to help them with their plight. Although we were not able to do very much, we did try and support them and also the BBA was amongst the leading organisations in trying to support their colleagues. As to the overall problem, we kept out of that.

Q324 ***Lord Woolmer of Leeds:*** We have been skirting around the issue of home/host country responsibility, have we not?
Mr Priester: Yes.

Q325 ***Lord Woolmer of Leeds:*** As I understand it, you are basically in favour of a home country approach. Professor Goodhart in his evidence to the Committee said that he felt there probably ought to be more reliance on host country supervision in practice. I would like to ask you two or three questions about that. If the home country principle was replaced by the host country principle, do you think that would pose long-term problems for the internal financial market?
Mr Priester: Yes. From my perspective as a representative of the European Banking Federation, that would be an unmitigated disaster. Forgive my bluntness. If you look at the development of the Single Market and the construction of an integrated financial services market it has been firmly anchored in the home country control principle where you have the home supervisor that does the duty of scrutinising whether somebody is able to have a licence and conduct the ongoing business. Home country control and mutual recognition is the basis upon which the internal market has been built and, with the Financial Services Action Plan, has been given an acceleration in terms of creating an integrated financial services market. We view the proposals in the current review of the Capital Requirements Directive with some reticence where there is now scope for Member States, when they have branches in their countries, to have a role in determining that those branches are significant branches and would thereby need to be included in the college structure. Legally speaking, that is not entirely sound; a branch does not have legal personality and is part of the mother group. In those circumstances we would say there is no real need for a host supervisor to have greater grip on a branch. We live in the real world, we understand there are sensitivities around that and very often branches of larger groups do tend to react, to an extent, to the host supervisor that would like to have a little bit more understanding of what is happening in that particular branch. There are practical solutions to this, but as a fundamental principle we certainly think that we should keep on this path of home country control, mutual recognition and find mechanisms through which the supervisors can gain greater confidence and knowledge of each other, trust and underpin it ultimately also with burden sharing arrangements so that the conflicts of interest which currently still abound between home and host countries diminish or even disappear.

Q326 ***Lord Woolmer of Leeds:*** There are a number of practical examples where the home country principle as opposed to host has posed problems. With Iceland, after all, home country appeared not to be very strong in that case. Then you have got German and Austrian banks that are operating in Eastern Europe where those countries are very vulnerable under the home country principle. I have two questions for you. First of all, in practical terms when crises arise is it not the case that countries are very pragmatic, they will either abandon the home country principle because they want to tackle the problem in their own country or they are all in favour of the home country principle because that looks after their interests? How do you respond to the practical problems that have arisen as opposed to the theory that it is very good for the internal market but when it comes to a crisis it has not proved a very good principle, people do not act upon it?
Mr Priester: It is a dilemma. Overcoming it would perhaps be easier, certainly in the difficulties that currently exist between home/host and the suspicions of some Member States *vis-à-vis* others, by a more radical overhaul of supervisory arrangements by creating a single separate structure. Whether that is politically achievable today, I doubt it. That was also the line, as I indicated before, that the EBF as a whole took. Apart from the difficulty of aligning your members on such a solution, I am not entirely clear that politically it would be the most astute solution right now or politically feasible. Why is a single supervisor perhaps more palatable, because it is a little bit more in line with the European construction that adhering to European institutions is a little bit easier than putting your faith in the hands of your neighbouring colleagues in a Member State. I would agree with you that this is a difficult dilemma and a more palatable solution may well be to create a single supervisor, but in the days we are living in today it is not necessarily going to achieve the political backing of Member States and it is not something that Mr de Larosiére, who has been looking at this with a number of other eminent experts, has come forward with. I think he too has seen that there is a need for practicality and political realism. We have to take this evolution step-by-step and burden sharing is something that would need greater attention.

Q327 ***Chairman:*** A witness this morning said that the Central European banks were very worried about not having host country supervision—most of the banks in their countries are branches, of course, of bigger European or global banks—because they were worried about a situation where the money just vanished one day, as we have had experience of in the United Kingdom. With the Lehman Brothers branch the money just vanished overnight. Is it just too difficult for the EBF as a whole to address?
Mr Priester: Thinking about?

Q328 ***Chairman:*** About the problem of what you do about money vanishing from, say, a not very well endowed Central European country.
Mr Priester: One distinction I would want to make is with the concrete example you have given it is, shall we say, a relationship from the EU with the US and there is no supranational context that governs that. It will be more difficult to find solutions to that relationship.
Chairman: I am also thinking if a European bank, let us say an Austrian or a German bank, withdrew its funds rather sharply from its branch in Hungary or Latvia.

Q329 ***Lord Woolmer of Leeds:*** It will simply stop lending.
Mr Priester: Yes. That is also one of the problems. We think the colleges of supervisors are still something that would have the capacity to bring the supervisors closer together. We have also been asking for arrangements to be considered at the highest possible level, globally ideally but also at the European level, to have better liquidity risk management systems. Currently, what we see is a number of Member States having different demands in terms of liquidity of the bank and this makes it difficult for a pan-European group to use liquidity across borders. If the supervisors can get their heads around a more common approach and also a common reporting format it would help them to understand where the demands within the group are within different countries and they would be able to discuss these pressures as they arise. Whether this is enough to stop a particular country from saying, “Let’s close up shop” or “Let’s pull the funds out” remains to be seen, but we do need to be able to have the supervisors working more closely together to overcome some of these problems before they arise rather than having to deal with them once it is too late.

Q330 ***Baroness Hooper:*** The Commission’s proposals seek to give credit rating agencies more authority, more independence and so on, and it would be interesting to hear your views on their proposals, but I would like to ask whether you as a trade organisation were consulted by the Commission when they were producing their proposals.
Mr Priester: If I can answer the latter half of your question first. With the difficulties of the financial crisis, better regulation, which we had come to appreciate greatly as a trade body, became less of a priority. One of our concerns over the credit rating agencies was the speed at which the legislative proposal was put together and once it was put together there was a consultation but not necessarily what we would consider to be under the better regulation principles. We have misgivings over that but we also understand the political pressures and where this came from. Looking at the actual substance of the proposal for regulation, we have been positioning ourselves on this, and the need for a regulatory regime around credit rating agencies we have take as a given, and looking at some of the aspects in more detail. There are a few concerns in general that we have with the proposal. One would be the scope, and where originally the regulation of credit rating agencies had been defined for regulatory purposes, there is now uncertainty in debate between the Council and especially the European Parliament. We think it is very important to keep the focus on why credit rating agencies should be regulated at present because it marks a distinction between credit rating agencies and work that otherwise is being done by financial analysts, where does it start and where does it stop. If you want to touch upon the activities of credit rating agencies, that would be very important. Also, we are a little concerned about the way in which the extra-territoriality principle is applied. We still live in a global world and what happens if, as an investor, you come across an investment opportunity outside of the EU and you want to buy it as a resident of the EU, it is not with an affiliated credit rating agency registered or recognised in the EU, is the credit rating agency outside the EU then obliged to register or is the investor at fault for having invested. There are still some issues that need to be addressed. One key concern which has not been given a lot of attention, but which we think is an important factor from the point of view of banks, is that insofar as rating agencies are being used for the evaluation of particular financial instruments, the regulation currently foresees a sanction whereby you would withdraw the rating or the registration of that firm. With investors, banks included, that have already used rates for their internal risk management processes, withdrawing a rate that has been attributed causes great problems. This is the sort of technical concern that we are trying to get across but it is lost in the bigger picture of whether credit rating agencies should be regulated, how to overcome the conflicts of interest and should the methodology be touched on or not. This is an important element to

keep in the back of everybody's mind, not least because very often you find in other regulatory pieces references to the use of ratings. For example, in the asset management world, sometimes if an instrument drops below a particular pre-defined rate determined by the regulators in the rules then all of a sudden you have a market movement as a result of that. The rating agencies have a role to play but it needs to be understood what that role is and how the regulation may affect that.

Q331 ***Baroness Hooper:*** Would you say that the criticism which has been made that in the past financial institutions and, indeed, regulators relied too much on the rating agencies and were not doing their own due diligence which they ought to have been doing is something which these new proposals will reinforce?
Mr Priester: I am not sure. The difficulties that the financial services world is currently experiencing would have taught everybody that doing your own homework pays and there are perhaps no shortcuts to that. We are also a little concerned over the credit rating agencies' regulatory proposals in the sense that what we believe that probably the better way to go is to give less prominence to rates and rating results, thereby stimulating everybody to do their own homework. If you regulate it you are putting it on a special pedestal and I am not entirely convinced that is the appropriate way to go.

Q332 ***Lord Haskins:*** The same witness that Lord Woolmer mentioned who I think you did not agree with, and you may not agree with this suggestion either, suggested that the banks are getting too big and over the last 20 years, banks having been 25 years ago distinctive as retail or insurance, have become conglomerates at a time when conglomeration has been going out of fashion elsewhere in the economy. The argument is that these conglomerates (a) are not very efficient, (b) necessarily are anti-competitive, and (c), most important of all, hard to regulate. No doubt you agree with that 100%!
Mr Priester: You make it very difficult for me to disagree, but if you would indulge me I will have a stab at it. There is definitely some truth in that. I would also remind you all of the comments I made earlier on. With the European market integration that has been fostered by the Financial Services Action Plan that heads of state have underpinned and supported with the Lisbon Agenda making Europe the most advanced economic area by next year—

Q333 ***Lord Haskins:*** There is some way to go.
Mr Priester: Indeed. What I think you will find is that on the economic operators' side you will see the very impressive development of operators, institutions, banks, credit firms, becoming bigger in an integrated market and reorganising themselves as groups beyond national borders. I would argue that unfortunately, the supervisors have not been able to keep pace with that development and are still predominantly stuck in a fragmented national framework and from that point of view it is very difficult to supervise these bigger entities. Many of the sources of these comments come from the United States. The United States has an even more fragmented supervisory landscape than Europe. For example, in the insurance field there is no federal authority: 51 states, 51 supervisors. In that sense, Europe is already progressing and is a step ahead of the US. Also, the Glass-Steagall Act, separation of activities, was far from ideal as we have now witnessed to our chagrin. I think it is important that the supervisory community finds ways and means of improving its efficiency and effectiveness. Again, my mantra is the colleges, et cetera. We are also calling for better resourced supervisors, something that may well be worth considering in terms of delegating supervisory tasks between supervisors for pan-European groups that would allow you to create centres of excellence, that derivatives experts are perhaps all based with the FSA in London and they take charge of supervising derivative activities of the groups on behalf of other supervisors. Right now everybody is doing it in their national fiefdoms and they have to bring the expertise to the table and that is difficult, whereas if you find an arrangement amongst supervisors where you have certain centres of excellence and they take charge of supervising group activities and have arrangements between them, that may well be a solution to allow the supervisory community to keep pace with the innovative capacity of the industry.

Q334 ***Lord Haskins:*** Do you not think there are pressures within the markets, certainly within the British banks at the moment, to de-conglomerate because they have got to and, therefore, they are trying to sell off their insurance branches and their investment banking branches? Maybe they are doing it because they are unprofitable, but when they have done it it is going to be a much less complicated regulatory world to deal with than at the present time.
Mr Priester: I am not entirely sure that is true.

Q335 ***Lord Haskins:*** The line between retail banking and investment banking has got quite clouded over the years.
Mr Priester: Investment banking is all about the products, the financial markets and retail banking is how you bring that to the individual customer and there are different bank models, et cetera. I am not really in a position to start analysing or discussing

that. What we have seen from a European level is that there are initiatives that have already taken place to try and overcome this. The MFID—Markets in Financial Instruments Directive—is putting in place the capacity for banks to be active on financial markets, the investment banking side, et cetera, but at the same time it is putting in place quite strict requirements in terms of retail consumer protection, best execution, suitability, know your customer in terms of what the investment profile is. I believe that the regulatory framework in principle is there, it is perhaps the way of applying it that leaves something to be desired.

Q336 ***Lord Haskins:*** You do not think that the reason why it appears the Spanish and Italian banks have suffered less from this meltdown is because of the structural points that I am referring to?
Mr Priester: No, I do not think so. The Spanish banks may have suffered less partly because their supervisors were quite conservative in what they were prepared to allow the banks to look into. With the current crisis that we are experiencing, one of the areas that is being looked at most intensively now is the dynamic provisioning, allowing banks to put more money aside in good times and to dip into this when times are harsh. The Spanish supervisor found a way of forcing its banks to do that even though under IFRS it is not straightforward. This is now a model that is being looked at, but in part I think that is why Spanish banks are perhaps a little bit less fragile than some of the banks in other parts of Europe. The supervisory regime has a definite role to play.

Q337 ***Baroness Hooper:*** You said originally that the Federation included Switzerland?
Mr Priester: Yes.
Baroness Hooper: What is the position of the Swiss banks in all of this because, after all, they have such a reputation, or had?

Q338 ***Chairman:*** And they have UBS.
Mr Priester: I have to be mindful that this is being minuted. I would say that our Swiss colleagues have been a little bit less vocal than you might expect otherwise. Having said that, that is not entirely fair either because Switzerland—

Q339 ***Baroness Hooper:*** They could be affected.
Mr Priester: They are affected. The European Banking Federation is essentially a trade body here in Brussels trying to effect the regulatory developments as they come about. The EU laws do not apply to Switzerland *ipso facto*, so Switzerland follows what is happening at the European level but does not really comment on it that directly from the Swiss point of view. Obviously UBS is in Luxembourg, London and Germany, so from that point of view they keep an interest in what is happening, but then the messages would reach us via the respective national associations of those countries, and would not necessarily be something that the Swiss Banking Association brings to the table. We certainly take on board comments from Credit Suisse and UBS, but with their current predicament this is less regulatory policy and not that close to the EBF and we tend to stay out of that.
Baroness Hooper: It is certainly outside our remit, but it is interesting.
Chairman: I am conscious that we are, as always, running out of time and I am particularly concerned that Lord Jordan and Lord Renton should get to ask their questions.

Q340 ***Lord Jordan:*** You have already commented on some of the forms of supervision. Does your organisation agree with Mr Wymeersch, Chair of the Committee of European Securities Regulators, and Mr de Larosiére that the Lamfalussy Committees should have an enhanced role in supervision? If they do agree, what new powers do you think those committees need to be effective?
Mr Priester: On the first part of your question, we have wholeheartedly been pushing for that strengthening of CEBS, as I mentioned earlier, but it is also something that we wish to see applied to CESR even though the roles are slightly different, CEBS is more prudential supervision and CESR is more market oriented, so it is conduct of business and market integrity. In our view, they both have a greater role to play. Insofar as we are affected by it with insurance and banking conglomerates, we are also interested in seeing CEIOPS, the Insurance Committee, strengthened. In terms of what types of powers it should have to be more effective, first of all it should have greater resources. Without more resources dedicated to these institutions or these committees, because that is what they currently still are, it will be very difficult for them to do more. In the recent difficult times with reactions that are perhaps a little bit more nationalistic in origin, these committees have very little capacity to intervene and co-ordinate, which we think is essential, for example in the short selling reactions from UK and Ireland which then spread all over Europe but when you looked at the measures, they were quite different from one country to the next. It would have been preferable had they been co-ordinated beforehand through an entity. They need more resources. They have already moved in that direction and they should have the capacity to come to decisions by Qualified Majority Voting so you do not have endless debates until you come to consensus or the consensus forces you to drop down in the scope or intensity of the measure that you are considering. We also think that

it is very important that national supervisors have in their own mandates at home, a reference to the work that they should be doing at a European level because right now the accountability for national supervisors is principally towards their national institutions but nothing towards something like CESR, CEBS or CEIOPS. We think it is very important that this is enshrined at a national level so that you can indeed call on people to come together, to come to decisions and to stick to those decisions once they are back in their home countries.

Q341 ***Lord Renton of Mount Harry:*** Mr Priester, I get the feeling that you and the Banking Federation are really feeling your way very carefully as to how much should still be done at Member State level and how much at the European level, which I totally understand, but obviously the problems that we are all facing at the moment mean there is a greater push for things to be done at a bigger level which we will probably see more of after 2 April and the meetings of G20. In that context you will know that Jacques de Larosiére on 20 February suggested in his report that a European Systemic Risk Council should be formed for macro-supervision and a European System of Financial Supervisors for micro-supervision. I hesitate to say exactly where you draw the line between micro and macro, but in principle what do you think about that?

Mr Priester: We are very supportive of the proposals of Jacques de Larosiére for the creation of this Risk Council and also the European System of Financial Supervisors. If you have the time or the inclination it is something that the European Banking Federation put forward as one of its ideas towards improving the supervisory capacity in Europe. There is general consensus that what we have seen to date, in terms of macro-economic supervision, was perhaps under-valued and under-rated. There have been warnings from different entities, central banks, the ECB, academics who have produced analyses, but they have not ever really led to concrete results amongst the supervisory community or ministries of finance. It is important that there is this body that picks up on these signals, that analyses the information that is fed through the individual supervisors so the micro-prudential information and reporting requirements that exist need to be pooled. The aggregate information is then exchanged with the macro-prudential supervisor, the Risk Council, together with figures from monetary policy considerations that central banks are keeping anyhow, and you get a bigger picture of where potentially certain risks are building up and where greater attention may well be required from the political world or from the supervisors across Europe or across the globe. One other thing is, we feel that macro-prudential has been very much focused on the banking industry, a little bit less on asset management, insurance, private equity and hedge funds, but they are all players, they have a role in the financial services framework. I do not think hedge funds were the cause of the current crisis but they probably had an impact and a role in financial stability, which right now is not being picked up by anybody in a concerted fashion. We think that this European Risk Council would certainly be something that would complement what has not really functioned so far.

Q342 ***Lord Renton of Mount Harry:*** To me, as someone who worked in the City for many years, I get the horrible feeling that all that is being suggested is terribly complicated and you have all of these different committees reporting, macro and micro, but by the time they come to report things are likely to have gone bad because it takes too long. On that basis I have a certain amount of doubt. Can I ask what you think about the remarks made recently by Lord Turner, who is the Chairman of our Financial Services Authority, which is the body that comes between the Bank of England and the Treasury. He said very firmly that he thought an EU-wide financial supervisor, which we have been talking about, is impossible whilst banks are still bailed out at Member State level.

Mr Priester: I would agree with that in the sense that in the absence of an EU level fund or EU level taxpayer it will be difficult to overcome the current absence of burden sharing and when things go wrong, and right now we have seen it very clearly in the last couple of months, it is a national reflex to step in and support banks or bail-out and save banks. Within the EBF, we have had some discussion over whether an EU fund for the bail-out of banks would be helpful, a common EU deposit guarantee scheme, the current "bad bank" proposals, but at the risk of disappointing you, I would say that we have not been able to come to a consensual view. The way in which the different markets across Europe have been constructed traditionally and culturally in their approach to the banking industry, the financial services industry, is so different that to come to a common view and come up with not just a high level agreement that it would be nice to have an EU fund but then also to look at how this is to be funded, shared out, who contributes, et cetera, we usually do not get past the first hurdle and consider more detail, the nitty-gritty of it. This is still something which is very complicated at the European level and in that sense Lord Turner is quite right. At the same time, I also urge you to remember what I said before, that we need to move to burden sharing arrangements to start the process evolving towards what could ultimately become a European single supervisory authority with a fund to support it.

Q343 ***Lord Renton of Mount Harry:*** If I may suggest, I think that is a very honest answer, but in a way the burden sharing, the mutual sharing, is a step forward because you cannot see an EU solution yet.
Mr Priester: Yes.

Q344 ***Chairman:*** If I may ask a supplementary question. You are speaking in terms of country funding in some way, unsubscribed by government.
Mr Priester: Yes.

Q345 ***Chairman:*** My natural inclination in this and other fields runs to do we get the industry to subscribe to a common fund? Has the EBF talked about a scheme where a bank puts up, I do not know, 1% of something every year as a mutual assurance?
Mr Priester: No.

Q346 ***Lord Renton of Mount Harry:*** I was actually saying that at the moment in talking of mutual funds and so forth this is a step forward whilst you really wonder whether there is an EU solution with EU money coming forward to increase capital and I think you said that is true, we are not at that stage yet, hence we are thinking about a mutual role.
Mr Priester: Yes. That has not been a topic of discussion at the European Banking Federation. It needs to be borne in mind that in all Member States there are currently deposit guarantee schemes which tend to be funded by the industry. This is something which is also on the table at the European level for review, improvement, enhancement. We are focusing on that and we have had a first bite at the cherry with the increasing of the levels of protection which was perhaps overdue and have not caused any problems. The next steps are going to be much more difficult, and here I allude to what I was saying before in terms of different organisations and traditions in Member States. In some countries, these funds are funded ex-ante and some post and, therefore, to find a common fund, a common concept that would apply to everybody at a European level, is fraught with a lot of difficulties in terms of political discussions and capacities for Member States to agree. Last but not least, there is also consideration to be given to the fact that at the moment we are living today in the political reality and there is no desire whatsoever to open the treaty to allow for solutions and you would need treaty revision to create entities that could accommodate EU solutions in whatever shape or form. There is no real appetite to open that debate right now. Having closed that door we are looking at what can be done with the existing legal constellation and in that sense, political realism wins the day and an evolutionary approach is preferred.

Q347 ***Lord Renton of Mount Harry:*** But there is perhaps appetite from the European Central Bank to open up the question of treaty changes?
Mr Priester: The European Central Bank believes that in its mandate it already has a provision that would allow it to do more than it is currently doing and I think that is correct. I can get the lawyers to ascertain that but I do not think that is a point of debate. The ECB has a mandate for the eurozone, and the UK is a very significant player in the EU for financial services, so it is not a very complete fit. That is one of the considerations now which puts some reserve around giving the ECB the role it is volunteering for.

Q348 ***Chairman:*** To me it follows logically that you can only ultimately have supervision where the money raising power lies and my inclination is to try and move the money raising power out of the nation states. Since the treaty does not permit us to move it into a group of nation states I was, I suppose, beginning to hunt for a "private sector" banking solution, a kind of banking bail-out fund administered by banks, but this is not something as yet on our radar?
Mr Priester: No.

Q349 ***Lord Jordan:*** With the serious consequences of the present crisis, might that lead to a willingness to reopen the treaty in order to find solutions? I understand what you are saying about the treaty, no-one wants to go near it because it is already in enough trouble, but as the consequences begin to bear down on the whole of Europe might that not create a willingness to go back to open the treaty to look for longer term solutions?
Mr Priester: That cannot be excluded. For the immediate future, so to speak, until the Lisbon Treaty has been revised and supported by all Member States nobody is going to be tinkering with opening it or adding to it. If Ireland has another bite at the cherry later this year, at the earliest next year, I am not sure there is going to be much political appetite to relaunch it.

Q350 ***Baroness Northover:*** This is a general question. I realise you have a major problem because you are speaking on behalf of all of these disparate organisations in different countries, but what is coming through as far as I am concerned, and I may be wrong about this, is that you are welcoming things that would, as it were, assist banks, that is to say if you have got a European system of warning on risk that is really helpful because any business would benefit from some free advice as to what is happening which might threaten a business and when it comes to supervision it would be very helpful if there were similar things in various countries because then you have got a level playing field as you compete with each other, so that is something you welcome. When it comes to actually stopping banks from doing certain things in certain countries so that, for example, if you are in another country away from where the home headquarters is based and you do not want to be forced to do X because that might undermine you back at home, that is when it becomes problematic. I find myself thinking if this cannot be adequately addressed on an EU basis, what hope have we possibly got of reaching something on a global basis. It may be that the banks are resisting and resisting, and maybe that is fair enough and your position is to make sure nothing happens that might damage them in terms of what they might wish to be able to do, but I find myself somewhat less than encouraged by what they have come forward with as expressed by you.

Mr Priester: I can understand that. The challenges before society and countries and then last but not least the banks are formidable. The challenges that we have been looking at principally are perhaps more in the European context. I understand your point about the international context, that needs to be taken on board and certainly it is something that we as banks in Europe have been pushing for because the bigger banks that we also represent are present across the globe. They would like to see rules that are as closely aligned as possible across the globe. That makes their life easier, I accept that, and that is what I am here to do in Europe and increasingly outside of Europe. It is not entirely fair to overlook the fact that by having more aligned rules you are getting a clearer picture in the supervisory community of what a group is up to, if I follow your insinuation, and that is an important element to take on board. The EBF, yes, we are there to defend the interests of the industry but sometimes we also have to defend their interests against their immediate interests. I am sorry if it is not currently very transparent that we are trying to come up with solutions that bite the banks, but we are looking into these and, again, bridging the 27 jurisdictions of the EU and the 31 members that we have in areas such as remuneration policy for directors and officers we are trying to distil across our membership principles that should be adhered to. In agreeing on those principles, what we would like to see in future is a degree of co-regulation rather than self-regulation or regulation, so that you have industry solutions that are devised by entities such as ourselves and that would be capable of finding the endorsement of the supervisory community and the supervisory community would have the capacity for policing some of these principles. As a trade body, certainly at the European level, we have no policing community over our member banks. What we are trying to identify is areas where these ideas of co-regulation would be of mutual interest both to us as a banking sector representative and for the supervisory community to have a little bit more grip over what individual banks can or should be doing. We have been pushing some of these proposals in the past, they are not necessarily related to the crisis, and there is a code of conduct for pre-contractual information on mortgages where there is a standardised format for what information must be given to a retail client when he is interested in a mortgage, et cetera. These are concepts that have been put forward by the industry that are followed largely by banks throughout Europe, but as such we have no capacity to finger an individual bank and say, "Hey, why aren't you following our code?" To overcome some of these difficulties in industry self-regulation we are trying to investigate where we can combine forces with the supervisory authorities.

Chairman: If you can bear with us for just five minutes more, Lord Woolmer, could you ask your question?

Q351 ***Lord Woolmer of Leeds:*** Certainly. There have been a lot of bank bail-outs across Europe.

Mr Priester: Yes.

Q352 ***Lord Woolmer of Leeds:*** Do you think that there is a danger that those bail-outs under pressure, at great speed often, may potentially distort the market, both within a particular Member State and across Europe? If your answer is positive on that, do you think that State Aid rules at some point will need to be rethought in relation to state bail-outs and their consequences?

Mr Priester: Yes and no. Yes to the first question. State Aids, as they have been applied, have a distorting capacity for competition and that has been seen already in some instances. Certainly those banks in August/September of last year that got state support were immediately more attractive for retail investors, depositors, and we saw some movement away from certain banks towards others. It is absolutely clear that State Aids have a distorting capacity. We have had a discussion about that within the EBF and, although everybody is clear and in agreement about its distorting capacities, we also understand in the current circumstances of the industry, we have very little choice but to prefer stability concerns over individual institutional competition points. To come to your second question in terms of whether, that being the case, State Aid rules need to be overhauled, my short answer is no. I think the proof will be in the eating of the pudding. The European Commission has applied the State Aid rules that are enshrined in the treaty, they have applied them at very short notice and they have been quite able, in novel territory, short notices, usually over the weekends, at getting an assessment of the individual State Aid requests and proposals under control. In several instances, they have imposed conditions on the State Aid. The rules are there. The competition authorities here in Brussels at the European level, have done a good job in applying those, but it remains to be seen to what extent the conditions that have been laid down for individual State Aid measures will be abided by in the coming months. There is a review clause enshrined in many of the State Aid approvals that six months down the line there has to be an assessment of to what extent the particular conditions for each particular aid package have been respected. If they have not been respected and the Commission does not take the necessary strong action, then I would be more favourable towards your suggestion that perhaps State Aid rules need to be revised, but for the time being the framework is there, it is being applied and we need to see it will be followed through further down the line.

Q353 ***Lord Woolmer of Leeds:*** In part the banking industry in some respects is a bit like the automobile industry in that part of the bail-outs is because there is excess capacity. The bail-outs in some cases have enabled some institutional banks to survive that probably ought to have gone to the wall but because of the impact in particular countries they are being kept going.
Mr Priester: Yes.

Q354 ***Lord Woolmer of Leeds:*** Like all bail-outs, the problem always is what is the exit strategy and how do you get out of this. Ultimately you have got excess capacity and you have kept some of the most inefficient going in the short run. There must be some of your members who are solid, who have not been bailed out, who must look at these others and think, "In the long run this cannot be right, we have been very good, very efficient, and billions are going to these to keep them going". I do not ask you for the conclusions that may be reached, but is there any internal discussion on those kinds of issues?
Mr Priester: Yes.
Lord Woolmer of Leeds: I am not talking about short-term, like deposits flowing and so on, that is a short-term issue, but in the long-term excess capacity has been kept going in some of the more inefficient units.
Chairman: We probably own some of them.

Q355 ***Lord Woolmer of Leeds:*** Indeed. That sounds a ruthless thing to say but if you were looking at any other industry that is what you would say.
Mr Priester: I suppose you would expect it of me but I would argue that the banking business is not quite like making cars. The banks have a very important role to play as intermediaries between savings and investment and we have to collect the savings throughout society and then reallocate them. We are always going to be short of cash. We need a certain degree of trust to keep in business. I am not saying there has not been any over-indulgence or over-exuberance in the banking industry, that is a fair point, but not all the banks in Europe are actually dipping into State Aids.

Q356 ***Lord Woolmer of Leeds:*** That is my point.
Mr Priester: Some of the conditions attached to State Aid make it very unattractive. Those banks that can afford to stay out of State Aid because they have been more conservative, prudent, astute in their risk management capacity, their investment opportunities, are staying out of that. I think you will see in the investment markets, once it calms down a little bit more, some slightly more rational behaviour will give preference to those banks that are on top of their business, know their stuff and have weathered the storm without necessarily having to fall back on the lender of last resort, State Aid.
Chairman: On that wonderfully optimistic conclusion we must come to an end. Thank you very much for coming, Mr Priester, it has been most useful. We are very grateful to you for giving us rather more time than you thought you would have to. Thank you.

Examination of Witnesses

Witnesses: Mr Patrick Pearson and Mr David Wright, DG Internal Market and Services, European Commission, examined.

Q357 *Chairman:* Thank you very much for coming, it is very nice to see you both. I am sure you have given evidence to these sorts of committees before. We are taking a full transcript and you will get a look at that before it finds its way into the back of our report in case any infelicities need to be sorted out on either side. Would you like us to start or is there some opening statement either of you would like to make?
Mr Wright: Let me just say one or two words about what is on our mind and then tackle your questions which are absolutely pertinent and very actual. Clearly we have a number of big subjects right now and one of them is the future of European supervision and regulation which has been triggered by the report of Jacques de Larosiére and we have this whole area of how do we maintain fair competition in the internal market. I think the current level of bank guarantees provided by governments to European banks is something like €2.2 trillion and we have had another €400 billion or so of direct bank capitalisation and, of course, there is more to come probably. That just gives you an indication of how enormous this issue is. At the same time we have a deteriorating economic situation. We are very worried about the fact that governments seem to be somewhat blocked about the valuation of assets, which we think is holding back some of the policy responses. We have, of course, and this is something very important to London, to move forward in the global sense as well and through the G20 process and we are working very hard with the various committees to ensure that policy development in Europe is as much in sync with the emerging G20 agenda as well. You can blame many people for many things here, but my view the origin of this crisis started primarily in the United States with very poor regulation in the mortgage markets, unsuitable monetary policy etc; but contagion happened and our financial institutions were foolish enough to purchase some of this appalling paper. We have not got as much as the US. We do not have a clear view of how much, but I think it is quite indicative that in our political discussions three Member States are asking for a great deal of flexibility in the way they go further with the support for the banks, and those three countries are the UK, the Netherlands and Germany. I do not think the Italians, the Spanish, the Nordics and the other Member States bought a lot of this US toxic paper. They are now being much more affected by the deteriorating economic situation in Eastern Europe or in the Baltic countries. The sub-prime was concentrated primarily in quite a few countries.

Q358 *Chairman:* Thank you very much. My impression also is that the sub-prime comes from America and the, as it were, honestly done but rather over-extended banking comes from us, that we all lent too much to Eastern Europe.
Mr Wright: Yes.

Q359 *Chairman:* Or more than was sensible in the circumstances. We have had several witnesses to this Committee who have argued that an expanded system of colleges of supervisors will improve the regulation of cross-border EU financial institutions. What we cannot quite sort out in our minds is how close we are to organising the differences in approach between supervisors who come from completely different banking traditions. Is this a sensible idea or is it just something that people are writing down on bits of paper?
Mr Wright: First of all, I think it is a sensible idea and it is an idea that we have encoded in our amendments to our capital rules which should be agreed in the next month or so, so this will become a legal obligation for the big cross-border groups in the European Union. It is a good idea because it brings together on a frequent basis the key supervisors for the big cross-border institutions and it is through that that you can develop a supervisory culture, communal thinking, transparency and so forth. As a tool I think it is a good tool and it is a tool which should be replicated. The G20 is talking about replicating that idea at global level as well. The problem with it is who should be inside the colleges. That is the first problem. The second problem is if we do not have some basic framework of supervisory standards everyone will act differently. That is why you see, for example, the de Larosiére group suggesting that there needs to be a definition of supervisory standards at the European level which would give guidance and a framework by which those colleges should act. For example, by hooking up the micro-prudential side to the macro-prudential side it will also allow the colleges to identify and put their finger on issues that were identified as creating risk in the system. One of the failures in the global system, if I may say so the UK system and European system, is there has been no link up between the macro-prudential side of supervision with the micro-prudential side of supervision. Risks were not identified and action did not follow. This issue is exactly what de Larosiére is addressing. One of the ways that action can follow is through those colleges and good standards of supervision being determined at European level. We like this approach. It is not problem-free but we think there is some added value here.
Mr Pearson: Could I perhaps add a few things to that? You asked for a definition of "good" and I can give you one. The way that bank regulators, and I belong to that community, would look at that is "good" means and equals "no surprises". Can colleges help?

Yes. Have we had experience of colleges? Yes, in some cases for more than a decade at Barclays, ING, and ABN Amro when it still existed. Why were they set up before we even required them to exist? It was because the regulators did not want surprises, they wanted to know what was going on in the different jurisdictions in which these groups worked. What do we want these colleges to do? We want them to be mandatory, exchange information and regulators to interact with each other around the table as we are interacting now and, as you say, not sending pieces of paper to each other that are misunderstood or incomplete, but around the table, talk, discuss with each other very clear issues. I can tell you that last month there was a college of ING. The UK, the Spaniards, the Americans and the Germans took their places in that college of regulators with the ING-board members and there were some very, very frank and open discussions—very frank—ranging from remuneration policies to the business policy of the group to very specific business challenges the group is facing in individual jurisdictions. I agree with David, colleges are not a panacea. You cannot rely on colleges to set our supervisory system straight, you need colleges and a lot more, but they will be very, very important. There is one new and important element to this: colleges are also involving new member countries much more. You mentioned Romania, Bulgaria, Poland, Hungary, the Czech Republic and the Baltics. These regulators have very, very clear concerns that we are not used to dealing with in the old Member States. The colleges are a very good arena for the new member countries to make their concerns clear but also to understand how the group itself is functioning. My final point is: colleges are about single firms, individual firms, but what you need is the same approach for each firm and across firms in these colleges otherwise you will have a disparate approach to how regulators talk to each other and look at issues.

Q360 ***Lord Haskins:*** Could you give us a bit of a flavour of the meetings of colleges? How many would have been present at that ING meeting, 10, 15, 20 regulators?
Mr Pearson: There was a meeting of the ABN Amro college three years ago set in Aruba or Curacao for obvious reasons, to be sure that everybody would come, and there were 76 people.

Q361 ***Lord Haskins:*** Seventy-six?
Mr Pearson: That is the point that David is making, how do you make these colleges function efficiently. What you do with 76 people is you make sure that you have "core" colleges, that is to say the most affected jurisdictions, and in this case of ABN Amro there was Holland, the United States of America, Belgium and the United Kingdom at separate meetings, but you made it quite possible for all the interested regulators to know what was going on with the core group as a whole.
Baroness Northover: But they did not find out what was happening in the core group. They had 76 people focusing on this.

Q362 ***Chairman:*** If they were that good, why are we in this mess?
Mr Pearson: That is why I used the example of ABN Amro, that was when the going was still good.

Q363 ***Lord Haskins:*** Are there examples of this process having been successful in the past where potential dangers were picked up through this process and headed off?
Mr Wright: I think what we had here was a system, and Lord Turner was saying the same thing the other day, that was very much focused on micro-supervision firm-by-firm and not looking across markets and the macro economy as a whole and identifying the risks from there, so we had a partial supervisory system. It is difficult to say today that there have been great successes of the colleges. I stand to be corrected on that, but I think in a joined-up system they could play a very important role. The other problem is this: as Patrick was saying, if you come from a small country, particularly the new Eastern European countries, where your banking system is primarily owned by other countries—I was in the Czech Republic on Tuesday and 95% of its banking system is owned by foreign banks. You might well want to be in the college of HSBC, let us say; even if you might be a blip frankly of the business in terms of importance to HSBC, that could be 50% of the Czech economy. The participation here is not simple and that is why we need some good participation rules and proper information flow. If that works then I think we see benefits here. We need standards as well. We cannot just do this where everybody does it their own way because it would be a shambles.

Q364 ***Lord Haskins:*** So will you have to lay down the standards then?
Mr Wright: That is the view of the de Larosiere Group, for example, who would say you have to lay down some clear standards here and if there is a risk warning from the macro-prudential side those supervisors and those colleges have got to act mandatorily.

Q365 ***Lord Woolmer of Leeds:*** What rules could you set out that would protect Slovakia, Poland or Hungary in those circumstances? As you put it, they are a blip in HSBC. What rule could you have that would protect such an economy and what would be the problems of having such a rule? Are you saying

that there would be a rule that would in some way ensure that every single Member State that had an interest would have its interest protected, and who would protect them?
Mr Wright: There are a number of things there. First of all, what you want is a system that is strong on prevention, identifies risk and deals with it at an early stage. That is the first point. The second point is that we have in Europe and are moving towards a harmonised set of rules on deposit guarantees. That is very important, it was not the case before and we saw what happened when a Member State took a blatantly discriminatory measure and money started to flow between accounts from one country to another on the basis that they were insuring their own banks and not foreign subsidiaries, which was illegal but they changed it afterwards. The third element, and this is the most difficult part, in a formal sense is burden sharing rules. Here, of course, we spent a long time trying to work out and from the Commission's side pressing very hard for some real clarity about exactly what happens if a home country goes belly-up with 15 branches and subsidiaries all around the European Union. We did not make a lot of progress. Again, that is why de Larosiére said that simply is not good enough. Another part of the supervisory toolbox is not waiting until the home country bank goes belly-up but to act earlier, so through early intervention mechanisms, through having rules on the transferability of assets, having rules on winding up and bankruptcy law. Today all of that is missing so we have a lot of work to do here. At the end of the day you have to put in place a set of safeguards that are legally binding and deposit guarantees is one thing. If you have got a big bank, the deposit guarantee system, if it is pre-funded, is not going to be able to deal with the deposit base of, for example, Deutsche Bank or HSBC. The deposit base of Deutsche Bank is about 400 billion and no pre-funded scheme is going to deal with that, so governments would have to be involved. This is really a very complex area and we realise we have a long way to go. By the way, what is true in the European Union is true globally as well. I do not know whether you want to add anything to that, Patrick?
Mr Pearson: A couple of small points. On the practicalities of what a college is about, a college is about single firms and what the regulators have discussed with the board of managers until now are the business policies and business direction of the bank. I will give you an example of a real life bank—but I will not tell you which country it was operating in—in former Eastern Europe. The former Eastern European country I am talking about in March last year explained that they had raised in the college the problem of potential foreign exchange exposures because a lot of the customers of that bank, with its headquarters in the Netherlands, were financing their mortgages through foreign exchange rate deals, so the mortgages in the Eastern European country were not in zloty or forint or whatever, they were in dollars and euros. That regulator in the college said, "There is a potential problem here because there is the potential that our local currency will basically go belly-up and you will have a problem in your local branch subsidiary in this former Eastern European country. How are you going to solve this?" That problem was not discussed: it was off the table because the operations of that huge bank in Eastern Europe, as David said, were a blip on its balance sheet and completely, totally unimportant. We are now facing that situation in three of the former Eastern European countries with six of our banks and it is not a problem for one of the banks, it is a problem for that former Eastern Europe country as a whole. This is where micro-economics and micro-supervision on an individual firm need to be teamed up with a macro-prudential view of what the risks are that the banking sector is being confronted with, and that is where we hope, as de Larosiére has said, you have to team up micro-supervision at the level of the colleges of firms with macro-prudential oversight.

Q366 ***Lord Renton of Mount Harry:*** I find it very hard to see how you are going to manage micro-supervision even with these colleges. The detail that the bank gets into in its lending policy is huge and very varied. I do not see how you can find the number of people with intelligence and knowledge to do the micro-supervision on this basis that you are talking about.
Mr Wright: Let us be clear about one thing and, again, I am harking back to de Larosiére because, if you like, that is the blueprint that is on the table at the moment. De Larosiére is not saying that the supervision of the banks should be handled at European level; it is saying that the standards should be defined at European level. It is saying that in a college, if there is a major disagreement between the FSA and, let us say, a Czech regulator that there is a method of resolving those disputes. So the actual supervision of the firms in the UK case will remain with London and the FSA would be responsible for the day-to-day supervision of HSBC, Barclays, *et cetera*, no change there, but de Larosiére is saying we are going to build a capacity at European level to ensure consistency of practice, high level standards, dispute settlement mechanisms, obligations to take into account major risks that are identified through the macro-prudential function. Actually it is a hybrid system. It is a strong co-ordinating centre on the policy side at European level with day-to-day supervision at the national level. You are absolutely right in what you say. I will give you an example from Spain because I know the Spanish banks very well. There are about 30 full-time central bank inspectors

inside the Banco Santander bank. To say you are going to move all of that to the European level is a huge bet, frankly, and the view from de Larosiére is that it is too early to do that. The second big problem is if you do that at European level, if you move the big institutions to some being supervised at European level, who is going to pay the bill when there is trouble. So, in short, is an EU-wide financial supervisor in the sense that I describe it, ie supervising on a day-to-day basis the bank, possible while banks are still bailed out at Member State level? My answer is it is impossible. That is the reason why de Larosiére said we should not go that far, because it would require a much higher level of political integration in the European Union. Remember what I said at the beginning, we have talked about two to three trillion euros so far in one form or another being guaranteed to recapitalise the European banks and that is the sort of financial capacity you are going to have at European level if you move all the supervision. I cannot see supervision being given the responsibility at European level and national Member States just picking up the bills, that is not going to happen and it should not happen. If you like, we have a hub and spoke system, that is the idea and that is where if the European Union is going to move forward it is going to move forward on that basis.

Mr Pearson: Just to pick up on your question, it is not about how many regulators we have, we have enough regulators, more than enough, it is about who regulates. De Larosiére has not suggested that regulation of individual firms should take place at the European level, that is not the question: it is how you regulate. What de Larosiére has brought to the table, and this is something that is also being picked up in the UK, is a wider, more holistic view of the risks that firms are running, not the very myopic view of the business model of the bank but what are the wider risks that bank would be running on the wholesale markets; what is its liquidity exposure; what are the monetary implications that are taking place in certain parts of its business operations that could affect its earnings capacity; what is the information the regulators need to have a better view of the risks that individual firms are running. These are issues that we have not looked at and these are issues that have emerged over the past 18 months. The UK has been at the forefront of the regulatory reform programme and the FSA has very clearly pinpointed the fact that we need a much wider and different view of regulation, not more regulators, not regulation at European level, that is not the question: it is how regulation is effected for individual firms.

Q367 ***Chairman:*** This sounds fine, but can I unpick your example of the substantial bank that just treated its exposure in Eastern Europe and the problems raised by the Eastern European bank as something they could spend ten minutes on at the end of a long Friday. I am not quite sure I see how you stop them doing that.

Mr Wright: In my example if you were in the seat of the Eastern European country and you were really concerned that, let us say, the capitalisation of the bank was in trouble and through the college maybe you were picking up signals, what could you do? At the moment it is very difficult to do anything. What de Larosiére is saying is there would be a binding mediation process whereby that Eastern European country could go to this process and say, "I am very concerned about this FSA issue. We totally disagree about the level of capitalisation" or whatever the matter is, "and I want a binding decision taken at European level on this particular matter". This is one way you could deal with that.

Q368 ***Chairman:*** You can, as it were, appeal outside your own owners?

Mr Wright: Absolutely. However, from the letter of the Chancellor of the Exchequer yesterday, the UK, at this stage anyway, is indicating it does not agree with this. It has made some very interesting proposals but has said on the supervisory side that it wants the European level to stay out of that type of issue, in which case you have to ask how the interests of the smaller countries will be guaranteed. They will be guaranteed to some extent. They could always appeal to the Commission. We could take an infringement case against the UK—I am just giving an example—for not applying the rules properly but by that time 50% of the Estonian economy could have gone down the tube. We have to have a system in place here that can resolve these types of disputes much more quickly. Another safeguard here is that, again, de Larosiére suggests that the people who work on the future European Systemic Risk Council side and the people who work in the new European authority could also be in those colleges helping, listening, smelling trouble.

Chairman: That must be the answer.

Q369 ***Lord Renton of Mount Harry:*** I totally see what you are after and why you want to do it, but banks have been getting into trouble since Barings in the 19th century and it seems to me it is almost in the nature of banks, because they are always manoeuvring risks against their competitors, to get into trouble. You say you have got enough supervisors, and it is a question of what they do but it still seems to me you are saying you can do an immense body of detailed work and manage it and I find it very difficult to see how.

Mr Wright: Where perhaps we have a misunderstanding is that we are not doing the day-to-day detailed work.

Q370 ***Lord Renton of Mount Harry:*** No, I appreciate that.
Mr Wright: That is being done by the FSA or the BAFIN or whoever it is. What we are saying is we must have a dispute settlement to resolve disputes, we must have rules to guarantee proper discipline in the colleges, we must have risk warnings that have to be taken into account and acted on: it is not "Come back next week for a cup of tea", it is action and it has to be mandated. Those are the sorts of things we see at European level. Again, to make your point, to move supervision of the big banks to the European level is just not possible at the moment, and this is the view of de Larosiére. I think the Commission was indicating yesterday in its position that it has preliminarily taken on this and that it is more or less signalling it agrees with that. We have got a hub and spoke system here with strong co-ordination at the centre; supervision on a day-by-day basis of HSBC, say, and the big institutions will remain at national level. By the way, we have got 8,500 banks, so how on earth could you move all that supervision. There is another problem here, which is a political problem, which is that a strong cadre of banks in the European Union, particularly the smaller banks, the sparkassen, the mutual banks, and they are not insignificant and have a lot of influence, do not want to see two tiers of supervision in which they would feel, "There's a nice set of rules for the big boys and big girls which will give them an advantage on a cross-border basis and we will be stuck with the local supervisors and be disadvantaged markets". There is also an issue here of equitable treatment and ensuring that the same standards are applied to everybody in a fair way. For all those reasons we are saying that day-to-day supervision, the technical details of supervision on a day-by-day basis, stay with the Member States.

Q371 ***Lord Jordan:*** De Larosiére has also said that he thinks the Lamfalussy Committees should have an enhanced role in the wider supervisory structures. As we understand how they operate at the moment they would not be effective. In your view, what would it take in terms of resources and additional powers to make them effective?
Mr Wright: You are quite right. At the moment the so-called Lamfalussy Committees, the three committees, are advisory committees to the European Commission, so they advise us on our rules, on the technical aspects of clearing and settlement, banks or whatever it is, but they cannot take any decisions. The question, and this is at the heart of the de Larosiére view, is should they be able to take binding decisions at the European level. Well, de Larosiére makes it very clear, he says they should have powers in certain areas, but not widely across the whole ballpark, to be able to have swathes of power to overrule left, right and centre, no. What he is saying is what I have just described, being able to put forward standards for supervision, standards to be able to mediate disputes, to be able to interpret technical rules. If you take the capital rules, for example, they are extremely complex. If you take our rules on UCITS, which are the investment funds, they are very complex things. Somebody will come along one day and say, "Can I put this product into a UCIT?" and I would have thought that was a technical issue and could be resolved by giving an interpretive power to the Level 3 Committees. That is what de Larosiére is saying. Does it make sense from the Commission's point of view? Yes, it does. Some people think the Commission is a huge army. We have—
Mr Pearson: Sixteen people on banking regulation.
Mr Wright: How on earth could we do that technical work? Sometimes we have to but we pay our supervisors to be supervisors, we give them authority to supervise. Give them the authority and make them accountable. If we give any limited powers to these new authorities they would have to be accountable.

Q372 ***Lord Woolmer of Leeds:*** Who to?
Mr Wright: Accountable to the Parliament, the Council of Ministers and the Commission. We do think there is a strong case. Let me just give you two or three examples very quickly. Look at the shambles we had on short selling. Everybody went all over the place in a crisis and the traders did not know what set of rules applied in which market, that is a good example. In a crisis you would have thought it made sense at the European level to have a decision taken by, in this case, the securities authority, "Here are the short selling rules and we are all going to apply them as from nine o'clock tomorrow". That is one example and deposit guarantees is another. I do not know how many were triggered after the Irish made their changes to deposit guarantees. I think we had 17 almost domino-like changes to deposit guarantee schemes because everybody had to move up.
Mr Pearson: Within 72 hours.
Mr Wright: This does not create confidence in a crisis situation, it does the exact opposite, it creates even more uncertainty. Those are the sorts of things we are talking about. I will repeat, we are not talking about day-to-day supervision of institutions. For many years I represented the Commission in the Securities Level 3 Committee and I remember once we were discussing some very sensible principles for clearing and settlement, which is the infrastructure of the financial markets, and everybody agreed except the German delegate and that was it. So instead of having a system whereby we could have taken decisions by qualified majority, if necessary, we lost approximately three years in terms of installing some very sensible, practical, technical standards. If we cannot do a plan like de Larosiére is projecting, the

only way of doing it is through European law and I can tell you that is slow, very slow. In the type of crisis we have had, slowness is not an asset.

Mr Pearson: Can I give you one very important example as to why de Larosiére is absolutely right, just to take a very, very topical issue, and that is remuneration of bonuses and pay. The standard that we promulgate, the 16 people who work on banking regulation in the Commission, 16 people including secretaries, says bank regulators can over and above the technical capital requirements require extra capital from banks to meet risks that are not specified. What the UK has done is very sensible. They have said, "We have identified a risk that is not related to any portfolio of mortgage lending or credits due to corporates, and it is the risk that the business profile can be affected negatively because of the remuneration standards and the bonuses policy of the bank itself. We in the FSA are going to require extra capital in the bank because we think the risk of bonuses is short-term and could aggravate the solvency of the bank". We discussed that between all European regulators yesterday in Prague and there was almost unanimous agreement that the way the European rules are phrased allows this, with one exception: Germany. Germany says, "We interpret that rule at European level differently. We will not allow extra capital be required from German banks on the basis of that legal principle". This is a good example. Twenty-six European regulators agree on something and one important European regulator is against. That is something that de Larosiére has addressed and he has said this is unacceptable, these committees should be able to implement and agree on the application of these standards quickly, through qualified majority you cannot have one Member State blocking an important issue.

Q373 ***Lord Jordan:*** The reforms that you have talked about sound quite necessary and sensible, but are they all capable of being implemented without treaty revision?

Mr Wright: That is a very interesting question. We are going to be spending—are spending—a lot of time now looking—

Q374 ***Lord Jordan:*** With your lawyers!

Mr Wright: With our lawyers. We kept them away from de Larosiére by the way as much as possible. The big issue here is the issue of can you delegate under the treaties what we call horizontal rulemaking power: is that allowed, can the Commission delegate that away? There is an ancient judgment from 1956 called the Meroni judgment and basically it prohibited this. Now we are seeing much more creativity in various agencies. We have seen techniques used to test the limits of that. The legal and political question is can we draw on the experience of other agencies and is there a degree of both political willingness and legal flexibility to allow this. I am not sure all of it will be able to be accomplished under the treaty, but we think most of it can. That is not a definitive answer because we are still looking at that. If I may say so, what is clear is that if we are to move forward toward these sensible reforms if anybody who wants to go further than that and change the treaty I think there is no chance of doing that. If we are to move forward we have got to find a solution within the current treaty. I think the majority of Member States are on that page, frankly. Again, if you want to go towards ambitious pan-European institutions, which is not what the Commission has said because yesterday the Commission supported the de Larosiére approach, we have to find as much flexibility as we can under the treaty. Governments for some will argue about these legal competence issues.

Q375 ***Chairman:*** Can I unpick a specific de Larosiére recommendation. Recommendation 22 says that authorities in the European System of Financial Supervisors, would have competences for legally binding mediation between national supervisors.

Mr Wright: Yes.

Q376 ***Chairman:*** How would that take place? Are we convinced there is a legal basis for doing that or is this one of the problem areas?

Mr Wright: Yes, we have probably got more legal certainty there than we have on some of these horizontal interpretative questions. Let us be clear about who these authorities are, because the authorities are not us. The "authorities" is the Committee of European Securities Regulators—CESR—transformed into an authority, which we will call the European Securities Authority, who would have those powers. We are an observer in those committees. A very important point here is that those committees, rightly in my view, stress the importance of independence. These are independent supervisors and they should not be influenced by the Commission, finance ministries or anybody else. We pay a lot of attention to that. We give our views, but if we are going to give them powers then they take their decisions. Of course, if they take decisions which are blatantly in contradiction with the basic framework rules or against the treaty then we will not accept that, but they are not going to do that. We think binding mediation can work and in the legal sense it is probably easier to do that than perhaps some of the other areas, but we will see.

Chairman: We are sticking on this area because we have not had much evidence before on it and it is particularly important.

Lord Haskins: I wanted to come back to what Lord Renton said about Barings and banks failing. Banks have always failed and by the nature of markets you have to have failures. What I am worried about now is we are trying to produce a world where a bank will never fail again. Lord Turner talked to us about systemic failure, that there was a systemic failure in the system that was to do with the securitised debt coming out of America. If you could control that systemic failure then you would have got to the nub of the problem.
Chairman: That would be what "good" looks like.

Q377 ***Lord Haskins:*** The worry I have is if you try to cover every hole through regulation you first of all end up with nobody managing the banks and taking responsibility away from the banks. Let us be clear, the responsibility for this is that the boards of the banks went along with practices that they should never have gone along with. If we try to regulate our way out of that problem we might as well nationalise the banks and hope for the best.
Mr Wright: Lord Haskins, I fully agree with what you say, the banks and the management of the banks are fully responsible for what happened. In the end you can say they are the primary culprits. We are not trying to design a system where there are no failures but we are trying to design a system which if there are failures can be managed efficiently. We are trying to strengthen the prevention in the system, both from strong macro-prudential analysis and, if necessary, risk warnings through techniques such as I indicated earlier, so that when colleges see trouble brewing up action can be taken. If all that fails then we have got to have in place mechanisms for winding up quickly. We think there are some good things in the American system: they can wind up banks quickly over the weekend, and in particular that system works well for smaller banks. We have got to have early intervention mechanisms, tools across the European Union which allow us to deal with the sorts of situations you are talking about. At the end of the day, if it is a big institution with multiple branches and subsidiaries, if we do not have mechanisms for dealing with burden sharing then sooner or later there is going to be a massive problem. In a way we have been quite fortunate.

Q378 ***Lord Haskins:*** Are some of these banks just too big in the sense that in the American system they hoped that other banks would absorb the less successful banks? On Barings again, Nathan Rothschild got them together on a Saturday afternoon and they shared out the pain amongst themselves and on they went and that was the history even in the 1930s. Now it seems impossible, we are having banking failures and state bail-outs of an unprecedented nature in history.
Mr Wright: Intellectually you make a very good point. After all, what is going to happen when we move out of this crisis, and we will one day, the banks that are left, market concentration is going to be higher than it is today. This is why you see references in the de Larosiére Report to "too big to manage, too big to fail, too big to supervise".
Mr Pearson: "Too big to save".

Q379 ***Lord Haskins:*** Too many conglomerates as well, too broad.
Mr Wright: Exactly. I think serious policymakers have got to come to grips with if we are going to allow these huge institutions then we have to set up the sorts of reforms that we have been talking about otherwise the risks in the system, the risks and the contagion, the feedback through the real economy is just too high.

Q380 ***Lord Haskins:*** It is simpler to break them up.
Mr Wright: If we are going to have big institutions we have got to have very strong systems in place to deal with them. Not to crush them and over-bureaucratise them and remove innovation, no, but to have very good prevention systems.

Q381 ***Lord Haskins:*** Your competition authority colleagues could deal with this by breaking them up saying, "You're too big".
Mr Wright: As you know, when there are State Aids there are conditions for State Aids and in the current climate our competition authorities have a huge job to try to keep basic order and fair competition across the European Union, but increasingly they are turning their attention to the fact, particularly if a situation gets worse, of what are the rules going to be and how are we going to exit, and sooner or later should some banks be wound up and removed. Absolutely this is part of competition policy, it is, but we are in a systemically very delicate situation at the moment and the first thing is to stabilise financial markets.
Chairman: Lady Hooper, would you like to ask about the credit rating agencies and if we have got time we will come back to Lady Northover's question.

Q382 ***Baroness Hooper:*** Basically, credit rating agencies have played an historic role in this crisis and, rightly or wrongly, institutions and regulators have perhaps not done their own due diligence adequately and relied on the ratings. I realise that the proposals from the Commission are intended to overcome that, but will it not put European-based organisations at a disadvantage in terms of global finance if they have to subscribe to these rules where others do not?
Mr Wright: That is a very good question. Let me say, first of all, my Commissioner, Commissioner McCreevy, and we agree very much with the premise

that there have been massive failures in this crisis, and prior to this crisis, by the credit rating agencies. The fact of the matter is surely the quality of their work and the massive conflicts of interest in this industry have resulted in very serious problems that in our view needed regulation. We had standards from IOSCO which manifestly failed to do the job and, of course, the major ones are US corporations and you have to say that the US regulation, or lack of it, also failed. That is why we have moved forward at the European level. On the specific point you raised about European institutions only being allowed to trade instruments rated within the EU: first of all the negotiation process on this Directive is still unfinished and it is a point that has been consistently raised. Secondly, on the Council's side they have agreed on an endorsement mechanism so that would solve a lot of the problem. We are also thinking here about whether we need some equivalence provision whereby if the standards in, let us say, the US or Japan were good enough we could simply accept the ratings from those jurisdictions. All this is still in flux. I would not be as concerned as perhaps we might have been a few months ago. The conflicts of interest here, the lack of disclosure, the governance failures, the incestuous way many of them have operated over the years, allowing firms to just traipse around, and firms have told me this, from one to the other until they got the rating for the securitised product that they wanted, we really cannot accept that. In de Larosiére, and please excuse me for referring to that again, he raises a much more fundamental question which is should we have ratings at the heart of the Basel process and do we not need to think about alternative investor models. Again, you can have conflicts building up on the investor side. It is a tricky issue. We are trying to improve standards and I believe that before the Parliament breaks at the end of April we will have an agreement and I hope it will deal with the problem you raised, and it was a very fair one to raise. Clearly nobody wants to choke off European firms from any business, but what we want is much higher standards.

Q383 ***Baroness Hooper:*** In any event, do you think that by regulation you can actually affect the quality of credit rating agencies?
Mr Wright: Yes, I do, I think it will help. I think it will help because, do not forget, if there were consistent manifest failures of an agency, let us take an example in the future, then the supervisors could simply say, "You are not doing business in the European Union", so you would have a real sanction here which you do not have at the moment. To be fair to the credit rating agencies they have tried to move forward to deal with some of these huge conflicts they have, but we think they have to go further and they have to have boards, which was Lord Haskins' point earlier, which really understand this business. It is no good putting people on the boards of these companies who simply have not got a clue of how models work and function. It reminds me very much of the issue with auditors a few years ago. You need to have some safeguards. Many people are thinking even longer term about the whole future of this rating industry in financial markets and encouraging the buying side, if you like, to do their own due diligence.

Q384 ***Baroness Hooper:*** By making it mandatory to have a rating which, after all, has only been a statement of opinion and, therefore, the company looking to the rating should have done its own due diligence, I would have thought makes them less likely to do their own due diligence. The onus is more on the ratings agency than it was.
Mr Wright: Yes, except that in our amendments to the Capital Requirements Directive we have now put provisions, and Patrick may say a word on that, which put obligations on both issuers and investors to do their due diligence and if they do not do it they can be hit with capital charges.
Mr Pearson: I have two points on ratings. First, there is a lot of misunderstanding: the capital requirements for banks do not say that if you subscribe to a rating agency you are disculpated from carrying out your own due diligence, that is not the regulatory environment, but, unfortunately, that is the way in which a lot of investors and banks have interpreted it in the past, so that has been rectified. The second point is on securitisation. We are not against securitisation, we are in favour of securitisation, it has been a very good source of funding and liquidity for the markets and it has to continue, but what we are against is the excesses of securitisation and Europe's taxpayers are paying the bill for the excesses of securitisation. The excesses of securitisation have to do with the incentive structure, that is "pass the buck", I have an asset, I securitise it and the problem is with the investor. That is the excess and we have seen that with sub-prime mortgages in the United States of America and are paying the bill for sub-prime mortgages in Tallahassee, Oslo, Amsterdam, Portugal, right down to Greece. That is the excess and the point we are trying to address is incentive structures. What is wrong in requiring anybody who wants to securitise assets to retain part of the risk? Is that bad? No. Is that what some of the more serious investment firms on this planet have done as basic practice? Yes. There are many examples of successful securitisations in which some of the big investment firms have maintained 10% of the risk on their balance sheets. The markets require that, the securitising firm always felt it to be good business practice to give comfort to the investors, so that is good and there is nothing bad about that. Remember the Commission started at 10% retention and we were

hammered by the market. We moved down to 5% retention in our proposal and now all of a sudden the European Parliament, national jurisdictions and a lot of regulators say this makes a lot of sense and there is a lot of support for that, more support than we would believe in the markets. You have a very specific question relating to the proposal by Othmar Karas MEP, do you want me to talk about that or later? Unfortunately that proposal no longer lives. What Othmar Karas did was say, "Okay, I don't mind this retention but instead of 5%, let's not define that, let's just require the originator of a securitisation to retain a net economic interest", but he did not define what that would be. When we looked at that the Commission said, "This is really very sympathetic but we are not going to be able to check how this has been implemented in 27 Member States" and that is what I am paid to do. If this rule is passed into law I have to check the 27 Member States and actually make sure there is a net economic interest retained by an originator. My Commissioner and I explained to Mr Karas even if we thought it was a good idea we could not check how 27 countries implement that in practice.

Q385 ***Chairman:*** Does that also apply to the proposal that is floating around for making everybody give a warranty?
Mr Pearson: That is by Mr Purvis MEP, that is correct. I can tell you that on the proposals that will be voted on in the Parliament on Monday Mr Karas has changed his own amendment, he now agrees that it will not fly and will not work and agrees that the 5% has to be retained, that is the latest.

Q386 ***Chairman:*** What think you to the warranty proposal?
Mr Pearson: The warranty proposal is also in the Parliament's proposal and we do not like it. The Commission will advise the Parliament not to adopt that.

Q387 ***Chairman:*** Why?
Mr Pearson: That is what Mr Purvis asked me!

Q388 ***Chairman:*** We met it for the first time this morning and it sounded an interesting alternative. Please tell us why it does not seem to be so to you.
Mr Pearson: Because it does not solve the problem. Where does the warranty come from? Is the warranty hedged? Is the warranty placed somewhere else in the financial markets? We have serious misgivings about the warranty proposal because we do not think it is tight enough or rigorous enough. It is an incentive for anybody giving a warranty to make sure that the warranty in the end will not have to be paid by himself, he will make sure that some other financial—

Q389 ***Baroness Northover:*** Where does it come from?
Mr Pearson: Where does what come from?

Q390 ***Baroness Northover:*** This idea.
Mr Pearson: Mr Purvis from the European Parliament.

Q391 ***Baroness Northover:*** When you said you know where it comes from—
Mr Pearson: Mr Purvis has spoken to a lot of people in the sector who thought it could be a good idea to make the securitisation retention more workable, more flexible in practice. We agree it makes it flexible in practice; it makes it so flexible that we do not like it because it undermines the entire 5% retention concept.

Q392 ***Lord Woolmer of Leeds:*** Can I ask a couple of things about the proposals on securitisation and capital requirements. The Commission is confident that it is workable and it will not be a restraint on funding through this particular source, but how will that fit into a global regulatory environment? This will apply to institutions in the EU that are originators but how will that apply to somebody going offshore and originating it in the States, the Middle East or Far East? How will that competitively place our institutions?
Mr Pearson: There are two sides to the coin, Lord Woolmer. The first is it will require any European bank investing in securitisation to exercise due diligence. That means if Barclays, Royal Bank of Scotland wants to invest in a US securitisation it has to make sure that the US originator retains at least 5%, so there is an indirect impact. There is an increased due diligence requirement for European banks to make sure that they know what they are investing in, what the underlying assets are, that they have a regular monitoring of the performance of those assets and make sure that the originator retains some form of interest, and our proposal is 5%.

Q393 ***Chairman:*** Can I just stop you because I want to read this into the record. The proposal would not just involve a European originator hanging on to 5% of the security, it would involve anybody who wanted to invest anywhere in the world.
Mr Pearson: A European bank.

Q394 ***Chairman:*** A European bank wanting to invest anywhere in the world must ensure that the original instigator retains 5%.
Mr Pearson: And that the European bank exercises due diligence, that it knows what it is investing in and it needs to demonstrate to the regulator, so Barclays would need to demonstrate to the FSA, that if it invests significantly in securitisations originating in

the United States not only that the US originator retains an interest but also that Barclays knows exactly what that securitisation entails, what the underlying assets are, the full due diligence. This might not be so much of a problem for Barclays but, believe me, this has been a problem for a lot of other banks in Europe which have been investing in this style without exercising due diligence.

Q395 ***Lord Woolmer of Leeds:*** How would that apply to an American bank that had a base in London or in Frankfurt?
Mr Pearson: An American bank that is based in London is licensed under UK law and is a UK bank, it is absolutely fully applicable.

Q396 ***Lord Woolmer of Leeds:*** But if they did it through New York, the American rules being different, do you see any possibility for regulatory arbitrage on that?
Mr Pearson: The 5% retention idea has been picked up by the Group of 30, the G30, and they recommended this as a sensible approach emanating from the European Union. It is being discussed in the G10 Basel Committee.

Q397 ***Lord Haskins:*** Will it come up in April at the G20?
Mr Wright: The G30 is a group of experts on financial markets, so it is not political. It was chaired by Paul Volcker, de Larosiére was on it, Callum McCarthy was on it, and they came out with a report at Christmas time saying that this retention idea was a good way forward.

Q398 ***Lord Woolmer of Leeds:*** Will it be acted upon? The Commission's intention is that Europe goes ahead and we hope that the Americans will too.
Mr Pearson: That is right, it is on the table.
Lord Woolmer of Leeds: And they are saying the right words.

Q399 ***Lord Haskins:*** And you can regulate it effectively.
Mr Pearson: We can regulate it within Europe. We can require any bank investing in securitisations outside of Europe to demonstrate to the European regulator that full due diligence has been exercised, and we will require a European bank to demonstrate that an American or Argentinean originator retains 5%. That is not difficult, that is in the prospectuses and you can very easily pick that up.

Q400 ***Lord Renton of Mount Harry:*** Could you give me a definition of securitisation?
Mr Pearson: The long or the short one?

Q401 ***Lord Renton of Mount Harry:*** The one that you think applies to this 5%.
Mr Pearson: I can actually direct you straight to the legislation, the Capital Requirements Directive, and show you the article 4 that defines securitisation. That article has been transposed in UK legislation verbatim and in 26 other legislations.
Mr Wright: When you think about this generally, we have securitised markets that are basically dormant and, by the way, that is very serious because we have a huge hole in the provision of credit.

Q402 ***Lord Renton of Mount Harry:*** I would be very interested to know the precise definition.
Mr Wright: We can give you a precise definition which is used in our directives.
Chairman: We have a note on securitisation already.

Q403 ***Baroness Northover:*** Lord Woolmer asked you whether you thought that the Americans might accept this and I wondered if you could perhaps answer that.
Mr Wright: Today I cannot give you a forecast whether the US will adopt the same rule as us or not. You can look at this in two ways. You can say if the Europeans adopt a good incentive here which provides a certain degree of reassurance for investors we have a better chance of reviving the securitised markets than if they do not. On the other hand, you can argue this is going to drive the securitisation business offshore back to the United States. I do not think that is right. I do not think the world is going to move in that direction because my view is the financial markets are going to move much more into a commoditised and safe direction. All governments throughout the world are saying that we must have proper incentives, whether they are in securitisation, in remuneration or in credit rating agencies. Governments are simply not going to take the risks any more for what most people would say are mis-incentives in the system.

Q404 ***Lord Jordan:*** Will this proposal be discussed in April?
Mr Wright: This particular proposal is being discussed right now.

Q405 ***Lord Jordan:*** I mean at the April meeting.
Mr Wright: You mean the G20. Certainly it is an issue that is on the table. I am not sure I have the latest drafting on that. Patrick, do you know where we are on that? It is certainly being discussed, yes, it is.
Mr Pearson: What the G20 does is form only broad recommendations.

Q406 ***Lord Jordan:*** That is going to be one powerful meeting. Whether it does anything is another matter.
Mr Wright: We are working extremely hard on the G20 process and in many ways there has been some welcome convergence of thinking at the global community level, but let us remember something about the G20, that you are not going to get down to a level of granularity which will guarantee you that when the London Summit is finished everybody goes away and adopts the same measures. That is the first problem. The second problem is there are no institutions. If I was in favour of the G20 what I would be saying is you can only deliver global convergence of standards if you have a strong Europe and a strong United States, because a strong Europe, the sort of Europe we have been talking about with strong supervision standards, *et cetera*, macro-prudential, de Larosiére, that is a stronger Europe and a stronger United States is 80% of the world's capital market. Both of those jurisdictions have legal powers, the G20 has no legal powers, and you are not going to deliver global convergence unless you have a strong Europe and a strong US.

Q407 ***Chairman:*** Can we ask you about one institution which does have powers but which may or may not be suitable, and that is the European Central Bank. Mr Trichet has very much set out his willingness to help, he has got staff, he is a bank, and personally I think he has got a case.
Mr Pearson: To do what though?

Q408 ***Chairman:*** It looks like he could do something. He has got the staff, the people.
Mr Wright: To do the micro-supervision?

Q409 ***Chairman:*** Yes.
Mr Wright: I am sorry to keep referring back to my Bible here, but the European Central Bank has roughly 1,000 staff, or of that order.
Baroness Hooper: 1,300.

Q410 ***Chairman:*** It is more than 16, if one can put it that way.
Mr Wright: We took evidence in that committee, as you are taking evidence, from a wide group of people at European level. The unanimous view around the table in every case was not to give the European Central Bank the role of directly supervising financial institutions for many reasons: its independence; the fact it does not have a mandate to cover insurance; the fact that many people would worry if you brought that into the scope of the current European Central Bank you would deflect it away from its primary monetary policy role; and moral hazard as well. I was quite surprised by that. The arguments are set out in the de Larosiére Report. I come back to the point if you want the European Central Bank to supervise the major institutions in Europe it is going to have to have an enormous credit line in which to help to bail them out in the circumstances we have got now backed up by governments. Who is going to do that? The answer is nobody. That is why the practical steps forward, the Jean Monnet approach, if you like, to European integration is the one that de Larosiére has favoured here.

Q411 ***Lord Haskins:*** My question is a general one. The last six months has been an extraordinary time for the world and clearly everybody had to act like hell to deal with the banks overnight and big decisions were made, many of which were wrong. Clearly with the declining economies action had to be taken quickly, which again was wrong. When you come to regulation, I can see the attractions of moving quickly because public opinion of the banks means they are ready for change because of the crisis but I can also see some serious unattractive elements jumping into complex areas which we have to live with for a long, long time. Are we going too quickly at this or are you satisfied with the pace at which you are doing this? What I am hearing frightens the wits out of me that there are going to be a lot of mistakes made in the process.
Mr Wright: We have a series of disciplines which are called Better Regulation, we try very hard to abide by them, and we have done. That means looking at impacts, consulting widely, and we have done that. You should never make regulation in a hurry, I agree with that, however we have had incidents, and I am thinking about changes to the accounting rules, for example, which converged with US practice, which allowed a degree of more flexibility about how banks could deal with some of the securitised paper in an accounting framework, in other words to move it from the trading book where it had to be mark-to-market to the banking book where it could be depreciated over a longer period of time. We did that very fast and we think it helped. It was a convergent measure. I agree with you about the need to take care. Obviously we have huge amounts of consultation through our Member States and we actually have a pretty open process in Europe. Sometimes people think it is not but I would challenge anybody to compare the way we prepare our regulation with how the United States does it. I think we are more open and have more checks and balances in our systems in many ways than the US system.

Q412 ***Lord Haskins:*** I agree, but the dust has to settle a bit. We still do not really know what we are regulating against. The horse has bolted from the stable, these guys are not going to misbehave in the next few months or years, they will get back to it in five or ten years' time. The risk is the other way around, they are going to become so risk-averse they

are not going to trade and that is sort of what is happening.
Mr Wright: You are right and that is why I think we have got to be extremely attentive to whatever we do, we do not choke off innovation, as I said earlier. There are a number of issues here. We have been talking about crisis management. We have not talked so much about pro-cyclicality but it is clear that the system we have invented here does have some worrying pro-cyclical elements which in any case require fixing both on the accounting side and on providing capital buffers, what is sometimes called dynamic provisioning, for banks in the future. There is a series of sensible steps we can take and I think most people would agree that the manifest conflicts of interest in credit rating agencies had to be dealt with. We have not gone over the top. I agree you should not do it in a hurry but, on the other hand, at the same time you have to reassure the public interest, and that is what our job is, that we are building a much safer system for the future which for a while will be much more cautious and much more commoditised, and that in itself is a problem because who is going to provide the necessary credits for our economy. Therefore, we must get these securitised markets revived and if you want to get them revived it seems to us you are going to need transparency, due diligence, proper credit rating and some proper incentives for this system, and that is what we are trying to do here.
Mr Pearson: Could I give two examples to underpin this. There have been two areas where Europe has acted very, very rapidly: "SIVs" and "contingent liquidity lines". We changed the European rules very quickly through a fast-track procedure last year but we only did that after full agreement in the G10 Basel Committee when the Americans, the Japanese and the Canadians said they would take exactly the same measures. These were two technical areas that banks were using to circumvent higher capital requirements and we closed down that avenue very quickly but only after full international agreement. We do that but only with international accord. There are other examples of issues that are much, much longer term where we need to go through longer legislative processes where we need interaction at the G20 and G10 levels: remuneration, trading book, pro-cyclical capital buffers, building them up. These are things that take more time and where we act quickly we do that responsibly.

Q413 ***Chairman:*** I know you probably had to go a few minutes ago. Thank you very much for coming. If we may, we may ask you for some supplements on various points. We are drafting the report and you know how it is that when you draft a report it is then that you find what you lack.
Mr Wright: I have just been drafting one called the de Larosiére Report, so I have a lot of sympathy.
Mr Pearson: He regrets it!

Q414 ***Chairman:*** There are very strict rules about not speaking beyond the evidence, so if we do not have evidence of something which we kind of know has to be there we have to go back and ask.
Mr Wright: Can I Just make a final point here. Sometimes in London I think there is a strong feeling that Europe has been a handicap with all these rules and regulations. There is no evidence at all over the last ten years that the London market has suffered from a set of internal market rules which, by the way, have been projected into the global market through having the global standard for investment funds and so forth. For us, if the UK seizes this opportunity to strengthen supervision and regulation in Europe, and let us just talk about supervision, I think it benefits the UK enormously because the UK has the biggest capital market in Europe and the most important ingredient of any economy or, indeed, any big capital market is financial stability and that is not something the UK can manage on its own, it requires co-operation. It requires co-operation in Europe and globally. You cannot deliver the global without the European. The decisions that are coming up here on whether and how we move forward, I think the UK has an absolutely critical role in shaping this otherwise it will be shaped by it. The Chancellor's letter is extremely encouraging, but we have to go through all the details and so forth. What we are trying to do here is not create bureaucracy and difficulties for London, we are trying to create a more stable set of rules which will give us a better chance of maintaining financial stability, which is the most important thing for all of us.
Chairman: Thank you very much for coming. It was very good of you to stay.

FRIDAY 6 MARCH 2009

Present	Cohen of Pimlico, B (Chairman)	Northover, B
	Haskins, L	Renton of Mount Harry, L
	Hooper, B	Woolmer of Leeds, L
	Jordan, L	

Memorandum by the European Commission

(1) Current Commission Proposals

1. The current crisis in financial markets has been influenced by several factors. Initial weaknesses in one market were compounded by a prevalence of complex products, especially linked to securitised loans, significant reliance and exposures between financial institutions, weaknesses in deposit guarantee arrangements, insufficient internal controls at credit rating agencies. The Commission's current legislative proposals aim to address these vulnerabilities, in part through improvements in prudential regulation. However, it must be noted that prudential regulation is intended to incentivise firms to err on the side of caution, but it cannot, by itself, deal with the global imbalances in economies at the very heart of the crisis.

2. The complexity of structured products has led to a lack of transparency and understanding, which caused havoc across the entire financial system. The Commission proposal to amend the Capital Requirements Directive (CRD) aims to increase discipline for those originating and sponsoring securitisation instruments. It also requires investors in such products to conduct thorough due diligence, based on adequate information about the securitisation. The Commission's proposals cover all products that have the economic substance of a securitisation, so as to prevent arbitrage opportunities.

3. The Commission's proposals on the CRD "large exposure" regime (single name concentration risk) will encourage financial institutions to diversify their exposures. In particular, reinforcing limits on inter-bank lending reduces the risk of contagion effects moving across the financial system.

4. The amendments to the Deposit Guarantee Schemes Directive aim to ensure a fully effective protection of depositors, which is an essential accompaniment to strong prudential rules in ensuring financial stability. The EU Council and Parliament have supported the Commission's proposal to increase coverage to 100,000 Euros. However, the Commission's proposal to reduce the pay-out period from three months to three days did not meet with sufficient support, and the EU Council and Parliament subsequently agreed to a pay-out period from four to six weeks. The Commission is of the view that further progress is still necessary, and will address this in a report to the EU Council and Parliament by the end of 2009.

5. Over the last decade, credit rating agencies (CRAs) have increasingly influenced banks' and other investor's behaviour, investment decisions and risk appetite. It is commonly agreed that credit rating agencies contributed significantly to recent market turmoil by underestimating the credit risk of structured credit products and by failing to adapt the ratings promptly when market conditions worsened. The Commission's CRA proposal aims to ensure that CRAs avoid conflicts of interest, act in a transparent manner and remain vigilant on the quality of their ratings and their rating methodology. The Commission's proposal further provides for a supervisory regime which requires CRAs to register and ensures efficient enforcement of the rules. The Commission strongly believes that the regulation on CRAs will contribute to increase the integrity of the rating business and the quality of ratings thereby restoring market confidence and making a repetition of a similar crisis in future less probable.

(2) Further Legislative Opportunities

6. The Commission believes that the current financial crisis has shown that there is a need to re-consider the supervisory and regulatory framework for financial institutions, and bring forward further legislative proposals where change is necessary, in particular to ensure confidence in financial markets.

7. Because prudential regulation will not prevent all bank failures, it is crucial for the EU to be equipped with robust crisis management and resolution arrangements. This involves developing a coherent set of rules aimed at dealing with failing banks at an early stage—to ensure confidence, financial stability and the continuity of

banking services. Closely following the recent developments in the UK banking sector, the Commission is currently working on devising the contours of what needs to be done at the EU level to efficiently deal with the failure of cross-border banks and banking groups. We plan to issue a White Paper in June 2009, which will, in particular, address insolvency law issues that may prevent the use of crisis management tools in a cross-border context. The recent financial turmoil has shown that crises may materialise within a matter of hours or days, and that any actions would be influenced by the specific circumstances and a risk assessment of each firm. In that respect, the Commission believes that a system based on "hard" triggers, expressed in terms of liquidity or solvency, may not necessarily prove effective.

8. Alongside current developments in other international fora, the Commission concurs that the issue of procyclicality in the financial system needs to be addressed. This requires a comprehensive approach which identifies the part played by all relevant factors in generating procyclicality. Accurate identification of such factors (including executive remuneration and accounting rules) will enable us to tackle the issue in the most effective manner. The Commission is committed to submitting a report on the impact of the current capital requirements rules on the economic cycle to the European Parliament and the Council by the end of 2009.

9. The financial crisis highlighted the need to improve the functioning of OTC derivatives markets, and in particular the credit default swaps market. This is necessary in order to reduce the risk and improve the resilience and transparency of these markets. A frequently mentioned possible solution to achieve these objectives is the introduction of central counterparty (CCP) clearing in these markets. For example, in its recent report the Group of Thirty concludes that "CCP mechanisms should be encouraged, if need be with regulatory capital requirements that bear more heavily on instruments that are not cleared through a CCP." The Commission intends to analyse this and other issues in a broad review of the derivatives markets (both OTC and on-exchange) during the course of 2009.

(3) EU Supervisory Reform

10. The crisis has brought into sharp relief the weaknesses of the present arrangements, eg, significant coordination problems and conflicts of interest between Member States. This is why the de Larosière Group has been asked to make recommendations to the Commission on how to strengthen European supervisory arrangements. By the end of February, the Group should bring forward concrete proposals which will contribute to greater financial stability and help maximise protection for depositors, policy-holders and investors. The Commission's first reaction to the de Larosière recommendations will be incorporated in a Communication which is foreseen for early March, in time for the Spring European Council. An extensive discussion will take place later this year.

11. The Commission is fully committed to improving the functioning of the EU supervisory structure. If financial integration is to be efficient in terms of safeguarding systemic stability as well as in delivering lower costs and increased competition, it is essential to accelerate the ongoing reform of supervision. The Commission proposal on colleges of supervisors will strengthen practical cooperation and coordination arrangements between home and host authorities, and should form an important element of any supervisory architecture. Reinforced EU co-operation mechanisms would address concerns raised by some that group supervision will result in the supervisors of larger countries becoming more powerful to the detriment of supervisory bodies of smaller Member States.

12. The Commission believes that the current home/host country divide with regard to supervision and crisis management in the EU has reached its legal limits. Recent events have demonstrated that, should a crisis arise, banking groups in fact constitute a collection of separate, national legal entities. This means that any further attempts to improve the efficiency of group supervision (such as group-wide capital add-ons, in the banking sector) must overcome differences in national insolvency laws and crisis resolution frameworks. In the absence of any EU-wide crisis resolution framework, ring-fencing of assets in different legal entities within a cross-border group is made both legitimate and necessary by the need to protect the interests of national creditors and depositors, even if it is to the detriment of the survival of the group and the broader general interest. The Commission is of the strong opinion that further developments in terms of supervisory architecture need to be coupled by renewed efforts to strengthen EU crisis management and resolution arrangements for cross-border banking groups and banks. Such a crisis resolution framework will be key to further consolidating the EU Internal Market, by increasing confidence in the home-host supervision arrangements for branches, and ensuring its smooth functioning in stressed situations.

13. The Commission is of the view that building an EU framework for supervision requires giving further consideration to the creation of pan EU-mechanisms, the use of private resources, and the use of Deposit Guarantee Schemes' funds. A report and any necessary legislative proposals in this area will be presented by the Commission at the end of this year.

(4) Working Practices

14. As to the effectiveness of current working practices, it must be noted that EU institutions have proved extremely efficient in adopting timely responses to the crisis where needed. For example, the proposal on Deposit Guarantee Schemes to increase the minimum coverage level was proposed and adopted, with retroactive effect, within two months.

15. Nevertheless, any regulatory response to the crisis needs to be devised carefully and with proper opportunity for reflection. Key to Commission's better regulation agenda is the commitment that all interested stakeholders shall have sufficient time to express views and opinions through extensive public consultation, as well as inter-institutional dialogues. The Commission has mainly based its work on the ECOFIN 9th October 2007 roadmap. Because a global crisis needs global responses, further regulatory initiatives would need to be coordinated in the G20 or G10 context.

16. The Commission is reviewing its financial services policies and may make further announcements in time for the March European Council.

(5) Global Supervisory Reform

17. The financial crisis has clearly demonstrated that micro-prudential supervision would need to be complemented by a stronger macro-prudential assessment. The Commission believes that the role of IMF should be strongly reinforced to further assess macro economic risks and systemic vulnerabilities in close cooperation with the FSF. This includes establishing an ongoing early warning system to prevent the building up of excessive risks in the financial system, the creation of global financial risk maps and a global credit register to assess global, cross-border and domestic exposures. A European capacity will also be needed.

9 February 2009

Examination of Witness

Witness: Mr Martin Power, Head of Cabinet for Charlie McCreevy, Commissioner for Internal Market and Services, European Commission, examined.

Q415 ***Chairman:*** Thank you very much for coming. As you know, we take a transcript and you will get a copy of it.
Mr Power: Thank you.

Q416 ***Chairman:*** You have seen the questions and against that background would you like us to start asking them or would you rather make an opening statement, it is as you wish?
Mr Power: I am quite happy because not knowing what you have already familiarised yourself with and what your aims are I would prefer to respond to your questions and would be happy to develop beyond that as you want.

Q417 ***Chairman:*** Let me give you a tiny bit of background about where we think we have got to. We are boiling towards producing a report but it has been somewhat checked by the receipt of the de Larosiére report, which we welcome, we are glad to have it because it has got a plan for the future rather than just a set of things that are going into directives. We are always asking about plans for supervision, plans for collective responsibility, but we have been able to focus it better in relation to the de Larosiére report. Against that background can I start by asking you will the changes to the Capital Requirements Directive made in the Council, in particular reducing the scope of the retention requirement for securitisation transactions, reduce the success of the Directive in creating a prudential regime for financial institutions? Along with that, do you expect further changes? We are rather assuming it is stuck at 5%.
Mr Power: Yes.

Q418 ***Chairman:*** As a secondary issue, how does the Commission plan to address the issue of pro-cyclicality?
Mr Power: Let me say that in respect of the Capital Requirements Directive I would expect we would get agreement on this in first reading. There is still a certain amount of work to do over the next couple of weeks between Parliament, Council and the Commission to try to narrow down the range of options that the Parliament is currently considering. The Parliament still has a number of amendments that are going in all directions at this stage, but from our appreciation of where it will go I think we will end up with something that will keep the retention formula. What we are endeavouring to do is make sure that the retention is a retention of something real, not something that is quite meaningless at the end of the day. This is extraordinarily technically complex because of the way securitised products are structured and because of the way rewards are also structured to the originator of the product. It is not impossible that you could end up with five, 10% retention criteria that would mean nothing. That is

where the technical people are trying to work through to understand how best to do this so there is a meaningful retention. Of course, the lobbies on both sides are working their way through the Parliament as is normal in this kind of a process. I am fairly confident we will end up with this. Mr McCreevy would not object if it came out at 10%, to be quite honest with you. His original idea was 10% in some of the early drafts we floated and he rowed back to 5% because people said this was too heavy. From that point of view he is quite agnostic whether it ends up at five or 10%, but he said it has to be a meaningful amount and that is where the work will have to concentrate in the time ahead. This is not the end of the story in respect of capital requirements because later this year we will be bringing forward further amendments to the Capital Requirements Directive because the work is ongoing in Basel and elsewhere on certain aspects that have become evident as a result of the crisis. This is in relation to the trading book where traditionally the assets held on a trading book get a lower capital requirement than if they are held on the banking book. That is going to be addressed because it has been found out that risks on the trading book are just as acute as risks on the banking book.

Q419 ***Lord Renton of Mount Harry:*** Could you just explain that to us, lower capital requirement on the trading assets. What does that actually mean?
Mr Power: At present there is an assumption that assets held on the trading book will only be there for a short period of time, ergo you could have a much lighter regime for assets held on a trading book than you would on a banking book that you were holding for a longer period of time. A lot of the so-called toxic assets or problematic assets that are currently on banks' books were found on the trading book when this crisis started to unravel and they were not able to move them off the trading book, the result being that the risk to the financial system or the stability of the institution is just as great whether they are held on the trading book or the banking book if things start to go wrong.

Q420 ***Lord Renton of Mount Harry:*** Who actually makes the decision at the moment and what does that mean in terms of the backing capital required on the trading or banking book?
Mr Power: I am not technically able to go through that precisely but it can be a factor of eight in terms of the type of assets held on the trading book compared with the banking book depending on the assets that are there. These were set out in the Basel guidelines and these are discussions that are continuing in Basel trying to address this. It was one of the things when Basel II was agreed that they put on the long finger how to address the risks from the trading book. At the time there was not a big pressure, this was something we could take our time about, but of course the crisis has intervened in the meantime and put the spotlight on this, as it has put the spotlight on liquidity, which again is a very low factor in capital requirements and people are trying to get some kind of a parameter as to how liquidity can be addressed and what is necessary in that sense. This leads me on to this question of dynamic provisioning which is one of the issues people are now examining. Under IFRS, the accounting rules, dynamic provisioning was forbidden in that banks could not keep assets. Generally listed companies cannot keep assets to smooth out earnings over a period of time. As this has shown as one of the problems we have had, the accounting in Basel rules tend to be pro-cyclical in that sense and people now want to have in place counter-cyclical provisions, namely that banks should have the ability to set aside in good times more capital requirements that can be used when markets turn down and the need to draw on such provisions arises. This will be another thing we will be bringing forward in the review of the Capital Requirements Directive. Let me just finish on capital requirements, if I may, because an issue that Commissioner McCreevy feels strongly about is trying to get back to greater simplicity in the measurement of risk. He feels very strongly that one of the issues coming out of this crisis is that risk was under-appreciated and, more importantly, that regulators, supervisors and even management in banks themselves were not able to fully assess the risks because of the complexity in how we measured risk and in the types of assets that were trying to be measured in terms of their appropriate value and what risks they presented. He is very much in favour of moving back to a rather simpler form of measurement and this would be, if you want to use it, the old-fashioned leverage ratio, there would be a quantum that would be easier for people to measure in that regard. That is another point that within Basel the Commission is now pushing supervisors to look at to see how this could possibly come about.

Q421 ***Chairman:*** Does the Commission feel that enough has been done on accounting requirements? I can remember having a row with the Banque de France about this because, like all Anglo-Saxons, I believed in mark-to-market. They alas turned out to be right, that it increases stability if you mark everything to market. Do we feel now that the IASB has agreed that you mark only to market those things you are not holding long-term?
Mr Power: No. The discussion has started and you see it happening in a number of fora. The IASB have to address the issue because they have been requested by a number of authorities, by the European Commission, by the Financial Stability Forum, by

other players, to examine how mark-to-market should be viewed in the context of financial stability, and that is what people want to look at. I think most people would say mark-to-market is a good principle on which to operate but it cannot be to such an extent that it adds to financial instability at times and that is where I think the discussion will go when we produce a report, as we will later on this year, on how the various elements in our regulation that contribute to pro-cyclicality need to be addressed. This is both on the accounting side and also on the banking side through the way the Basel rules have applied in that sense.

Q422 ***Chairman:*** When is it expected that this report will be produced?
Mr Power: It will be produced before the end of 2009. We have had some provisional work done by the banking supervisors but that needs to be taken a good deal further. The G20 will also give a push to this at their meeting on 2 or 3 April as well because it is one of the key factors for everybody.
Chairman: I ask because I am thinking forward that this makes another inquiry for the Committee and I must not take my eye off that. Thank you very much, that is very clear.

Q423 ***Lord Woolmer of Leeds:*** Can I just make an observation and you may comment on that and then I will come to the question I have got to ask. At the end of the day, no matter what rules you draw up for leverages and liquidity and mark-to-market or not, and so on, nothing you can do by those kinds of ratios, however sophisticated, could actually make adequate provision for the kind of cataclysmic collapse that we have seen. There must be a trade-off and a care not to try to set these requirements so high that it deters almost any lending at all. I just make that observation. Given that Mr McCreevy's objective in his portfolio is to ensure that there are competitive and dynamic economies, I assume that Mr McCreevy and your Directorate is playing a part in trying to strike this balance between the need for financial markets to be dynamic and responsive as well as quite properly reassuring the investor community. I just make that observation and you might wish to comment on that before I go on.
Mr Power: I think you have put your finger on the hardest challenge we all face over the time ahead. What Mr McCreevy has attempted to do is very quickly address a number of the key issues he saw prior to last summer as urgent. This was in relation first to this question of securitisation. It is not just securitisation because in the Capital Requirements Directive there is very heavy responsibility on the buyers of securitised products to undertake due diligence. This leads me on to the second of the issues he addressed, which was in relation to credit rating agencies. It is clear that when you look at the issues that gave rise to the present crisis, the role that credit rating agencies played had the effect of turning things that did not deserve a triple-A rating, but by them agreeing to extend their brand in terms of triple-A this emblodened people to forego their own proper due diligence and de facto outsourced due diligence to the triple-A rating that the credit rating agencies gave. To put this in context, last year there were twelve companies worldwide that had triple-A ratings and there were 64,000-odd securitised products that had a triple-A rating.

Q424 ***Chairman:*** We had not heard those numbers.
Mr Power: I can go back and get that more precisely.

Q425 ***Lord Haskins:*** We got it yesterday.
Mr Power: That is the magnitude you are talking about. People bought these triple-A products which were horrendously complex. We have all spent time trying to unravel them, to understand what they are, and you see the big difficulties today in every bank that has these on their balance sheets but nobody knows what their real value is today. That is one of the things that is overhanging this crisis because banks do not really want to declare what the real value of these are because the impact would be so horrendous for them at this stage. In our modification to the Capital Requirements Directive we have, by putting due diligence on these investors, either the investors in the large financial institutions have the resources themselves to be able to do an assessment, or what we hope they will do is they will start paying for others to do this and we start to change a little bit the credit rating model that is out there which at present, as you know, is an issuer pays model. Also, it may give the opportunity for new entrants to come into the market to start offering service in terms of doing this kind of rating assessment as well. At the same time we have a rather onerous regulation on credit rating agencies whereby we have put strong requirements on them to separate out their ratings from other business, and we can come to this later. That was what we focused on, including depositor protection. That was all done last autumn. We have been working on a number of issues but we have held back waiting for Mr de Larosiére to present his report. On Wednesday, and I hope you have a copy of the Communication, I can leave a copy if you do not, the Commission adopted a Communication for the March European Council which is coming in two weeks' time where we have set out from an economic, financial and social viewpoint elements on how the Community can come together to respond to this crisis. It is not the answer to it but it is a number of things where we indicate what we want to do on some aspects of Mr de Larosiére's Report and setting out a number of key issues in the

financial services area we are working on to bring forward during the course of this year, part of it being in relation to the capital requirements, as I have outlined to you, part of it being in response to remuneration, how we envisage addressing this question of getting the remuneration structure in financial institutions more in line with the real rewards and benefits that come into the company over a period of years, looking at things like retail products, how common rules on that will become, and you may have picked this up already in terms of a White Paper. That Communication sets out very clearly, and we have an annex that goes with it, the thinking on financial services.

Q426 ***Lord Woolmer of Leeds:*** Can I turn to the question of the Credit Rating Agencies Directive. Some members of the European Parliament—not all—have expressed doubts about the registration and surveillance procedure. How do you see the concerns that have been expressed about the Credit Rating Agencies Directive and what, if any, are the outstanding issues that you still need to resolve between the Commission and the Parliament?
Mr Power: I think the registration part of the proposal has caused us enormous problems in constructing it, to start off with. This comes from the legal framework we have to operate within at present. It is not possible to give the Level 3 Committees, the Lamfalussy Committees, in this case CESR, legally binding powers, so we have had to construct a system that respects Member State competence in respect of the registration and supervision of credit rating agencies while at the same time trying to design a system that would be a one-stop shop for any credit rating agency wanting to register in the European Union. There is quite a complicated system whereby within the framework of CESR the Member States most concerned would come together and agree on how they would share out the responsibility for the supervision of a credit rating agency that is registered in the European Union. This is done in a way that tries to shoehorn this into the legal framework we are obliged to operate within. It is not perfect but it is the best we can do to simplify the process for credit rating agencies because the other alternative would be for credit rating agencies to have to go around 27 Member States and register with all of them which is not something we want to envisage. It is not perfect but it is the best we can do in the context of our legal powers at present. On Wednesday in Coreper in the Parliament, Coreper reached a political understanding between themselves on the main elements of the proposal. We feel there is still some further work to do in the Parliament in the discussions that have to take place there, particularly in relation to the scope. At present the scope has been narrowed considerably and only applies to certain classes of ratings. Our original proposal went wider. I do not think that is going to be a breaking point, at the end of the day I do not see this being major, but there are issues in relation to third country ratings and in relation to the contribution to the ratings process that takes place outside the European Union. Those are issues we are trying to find a pragmatic solution to which we have to do during the course of the trilogue with the Parliament and the European Council. I am still fairly confident we will get a first reading agreement on this as well, but there is work to do particularly on the third country element and on the contribution that comes from the big four credit rating agencies, how they structure themselves where the input to ratings come from outside the European Union. The text that is there goes a long way to solve that problem but the third country one needs a bit more work still.

Q427 ***Lord Woolmer of Leeds:*** You said that one of the objectives of Mr McCreevy is to seek to set up a framework such that the power of the big four does not remain dominant and unchallenged by competition, as I understood it.
Mr Power: That is correct.

Q428 ***Lord Woolmer of Leeds:*** Cleary they have got to be able to operate in a global environment and European investors and institutions do not want to be confined to dealing just with—You have got the point?
Mr Power: Absolutely.

Q429 ***Lord Woolmer of Leeds:*** What kinds of concerns have been expressed to you? You said this is under discussion, how are you proposing to meet those concerns?
Mr Power: What we are trying to do is devise a system that will allow us—it is complicated—to get to some form of mutual recognition. That would be the ideal solution at the end of the day, whereby we would feel happy that in other jurisdictions they have something equivalent to what we have in the European Union and on that basis would allow us to adopt a type of mutual recognition for ratings issued.

Q430 ***Lord Woolmer of Leeds:*** I will observe, and then we must move on, that is almost certainly a guarantee that the big four will remain the big four.
Mr Power: I would hope not. If you look at Japan or South America there are local rating agencies and that is what we would want to try to make sure there is. I agree with you the regulation really deals with the big four but it is what you have to look at on the Capital Requirements Directive and the obligation on due diligence that is put on investors. We hope that starts to operate to try to open up the market for others to come in and offer that service.

Q431 ***Chairman:*** I am slightly struggling with credit rating agencies. I can see how you can improve their performance in relation to institutions but what worries me is their performance in relation to these infinite numbers of securities and assets. All I can see is that we are rather increasing regulatory reliance on these guys. What is going to change is the nub of my question.
Mr Power: You are absolutely right that the credit rating agencies have been much discredited as a result of this process. While they may not like having to be submitted to regulation they recognise at the same time, it might be the only way we can restore our credibility is now to say we are regulated and are subject to some control. We have had these IOSCO principles for ten, maybe 15 years but they were only principles, nobody was enforcing them. Even when credit rating agencies were recently required to register in the US under SEC rules, nobody was checking that even these IOSCO principles were being properly complied with. What we have to have is a system whereby within the credit rating agencies themselves are supervised and ensure there can be no compromise on how the ratings are arrived at. If you look at the evidence that has been given particularly in the US Congress by the credit rating agencies and other observers, it is absolutely clear they were totally conflicted in terms of these ratings because the pressure was on to generate income from rating securitised products. I would need to check the figure but about 60% of their income, if my memory is right, was coming from rating these securitised products, the business model was now switched around to rating these products. They were also engaged in advising the companies on how to structure the products to get the triple-A rating as well. They were totally conflicted. They used the same rating nomenclature, ie AAA that people know for 50 years for sovereign and corporate debt. Overnight, securitised products were getting the same rating. What we are endeavouring at present is trying to work our way through these conflicts and putting in a system that tries to make sure that the ratings process is removed from the conflicts that may arise. We have been looking at whether or not any non-traditional ratings, such as these securitised products should get a different label from triple-A for example. I should say we gave quite a bit of consideration last year to the notion of trying to take all reference to ratings out of our regulations so that, for example, in our Basel rules and elsewhere where we refer to the type of rating and the appropriate capital requirement we would just delete this completely, but at the time it was felt that this would be such a fundamental change to the system it would not be possible to do. My own personal view is it is still the way to go, to remove reference to the ratings out of regulations.

Q432 ***Lord Renton of Mount Harry:*** In that context are you then leaving much more responsibility with the bank itself?
Mr Power: Absolutely.

Q433 ***Lord Renton of Mount Harry:*** I was non-executive director of a bank for eight years and in that time we never thought about what the credit rating was saying, it was up to our executives to decide and convince the board. Here you get to the question of due diligence and what actually did that mean. You could perfectly well say that the banks all along were breaking the rules because they were not exercising due diligence, they were simply going to someone who they knew was going to give them the right answer. Is that not likely to continue, hence I would agree with you leave out thoughts about the credit rating agencies?
Mr Power: In the great enthusiasm that was there with these products in the period from about 2002 this whole market exploded. Nobody is saying that securitisation is not a good way forward, clearly it is a worthwhile model, but the model became severely flawed because the quality of the underwriting was so poor; these products were then turned into gold with the triple-A rating on them. As we learned to our cost, those buying these products effectively outsourced their own due diligence through the blind acceptance of the ratings by the credit rating agencies.
Chairman: That also must be to enable it to do a great deal of business very quickly and people are going to have to give up that luxury.

Q434 ***Lord Renton of Mount Harry:*** Moving to a quite different subject, fascinating as that other one is, in your letter to us of 9 February you stated in point seven that following recent developments in the UK banking sector, the Commission is planning to issue a White Paper in a month or two's time addressing insolvency law issues to deal with possible cross-border banking failures. Obviously since you wrote that letter matters have got even worse rather than better.
Mr Power: Yes.

Q435 ***Lord Renton of Mount Harry:*** Can you tell us a bit more about this?
Mr Power: I think there was a degree of optimism in regards to timing in that letter that may not be justified. We have had some initial discussions with our experts in the Committee of Banking Supervisors in particular to talk through the issues involved in this. What we are trying to do is look at five key stages in terms of what we feel is critical to how supervisors nationally and working together should address problem banks in the context of a crisis. Looking at things at the pre-intervention stage it is necessary that

all supervisors throughout the Union have the same degree of appreciation about how they approach banks in difficulties. The second issue is when banks are in difficulty, how they approach this, what mechanisms are in place and how do supervisors work together on a cross-frontier basis. How are issues which are extremely complex addressed, for example if assets have to be moved around, because all of these are governed by national laws at the present time. As we go further into this, the complexity will slow down the process. It is going to take us at least another three to four months to be able to come forward with scoping out in more detail how we would want to take this discussion forward. Mr de Larosiére has thrown up a number of issues in his report relating to supervision and how co-operation between supervisors needs to be addressed. We need to factor how we might respond to this into this operation as well and to see how this particular factor of supervisory co-operation in terms of managing a crisis would work better in that sense. My best guess at this stage is that it will be late summer before we come with this White Paper because we need to do considerably more work with the specialists from Member States to scope out more precisely how we will address the issues.

Q436 ***Lord Renton of Mount Harry:*** I well understand what you are saying but in the end would this mean in general terms an extension of European law over banks in areas where there is no European law?
Mr Power: That is hard to say at this stage. I think we have to come in first on the de Larosiére Report and trying to get the architecture for supervision right and then where we go in terms of further down the line of trying to see where there may be gaps in the present system that are inhibiting particularly on a cross-frontier basis dealing with financial institutions in difficulty. It would flow logically from my point of view that we would get the supervisory architecture right first and then come in lower down after that to see what we might do.

Q437 ***Lord Jordan:*** How well disposed is the Commission towards the main changes that the de Larosiére Report is putting forward? If they are well disposed towards them, what is the timeframe for their proposed introduction? We have heard about legal difficulties, what legal basis will be used in this regard?
Mr Power: When Mr de Larosiére was tasked with his job last October/November he was given a very ambitious timescale to have to report by the end of February. A number of commentators were speculating whether Mr de Larosiére would come forward with some great new blueprint for European supervisory architecture, namely the idea of a single supervisor either at a European or euro-based level. He decided he would not go down that route because that would necessitate treaty change, so what he has concentrated on is an architecture that can be realised without changing the treaty at present. His architecture is proposed around turning the current Level 3 Committees, the banking, the insurance, the securities supervisors, into agencies and strengthening their powers as agencies to be able to promote, foster, supervisory co-operation, technical rules, this type of an approach. I will leave with you the Communication for the Spring European Council that was adopted this week. The Commission in its proposal welcomed the de Larosiére approach and said we will now set about examining in detail what Mr de Larosiére has proposed on supervision. We have set ourselves a timescale of before the end of May to come forward with our suggested approach so that we can present these to the June European Council. If we get the endorsement by the June European Council in the autumn, probably October at the earliest, we will come forward with the legislative underpinning for what we will put in this May Council. The question that I see at this stage, and there are not a million and one things that need to be addressed, is if we follow the de Larosiére approach, which we will, the question is whether three agencies is the right response, whether we should have two agencies, for example, a so-called twin peaks approach whereby you would have an agency dealing with supervision and an agency dealing with conduct of rules, or whether you would have a single agency pulling this together. In the letter that Alistair Darling sent round to colleagues at the end of the week he seemed to favour a single agency approach but not in the way de Larosiére has proposed it, more in the way of an agency that would be responsible for supervisory co-operation, technical rules, but also enforcement of supervisory standards as well. From a UK approach, as I see it, they understand it is very hard to separate out from a systemic point of view the questions of supervision and conduct and conduct of business as this crisis has shown there is an inevitable interlinkage between them. Our thinking will have to go through this over the time ahead to see whether we adopt the de Larosiére model of three agencies or we come forward with some other variation on that.

Q438 ***Lord Jordan:*** Whether it is one, two or three, could you endow them—or it—with sufficient authority without the need to change the treaty?
Mr Power: That is the great legal debate, how far you can go. De Larosiére in his report has tested some of his assumptions with our legal people and we now have to go into more detail in terms of what it is. Traditionally speaking, we cannot empower agencies to take binding legal decisions, that has generally

been a tenet of Community law. They can advise us in terms of major legislation but it is the Commission under its own responsibilities or through the co-decision process that has to take the binding legal decisions. If I compare the European Medicaments Agency, which is in London, and approves for sale within the EU new pharmaceutical products. So if a drug company wants to have a licence for all of Europe it goes to the European Medicaments Agency, that agency does all the work, all the risk assessment, reaches a decision and says, "Yes, we consider this is safe to put on the market" and the formal decision comes back to the Commission to take. That is the legal divide we are always going to have to tread on how far an agency can go before somebody else has to formalise its advice in a legal decision that is binding from a Community point of view. That is one of the things we have to see with de Larosiére, what that balance is and how we get it right because it is complex.

Q439 ***Lord Jordan:*** Do you believe that particular model you have just used as an example could, in fact, be used in these circumstances?
Mr Power: It could be. There is also a newer model which is the European, what is it called, not the Aerospace Agency, basically what it does is look at safety. That is another model which is slightly more advanced than the Medicaments Agency, but that would be another inspiration.
Chairman: I am going to move on and ask Lord Haskins to ask the rest of the questions.

Q440 ***Lord Haskins:*** We are into de Larosiére, which we are hearing quite a lot about, and there is a bit of controversy. On the one side we are getting the view, as you suggested, that he backed off the big issue about a single European regulator because of treaty reasons and, if it is as bad as it is, does the issue of treaty change have to be on the agenda. Then he talks about placing the responsibility for macro-economic supervision overall with the ECB and some people in the Commission do not seem to think that is a great idea.
Mr Power: I am not sure who in the Commission you are referring to, Lord Haskins, but I have not heard a huge degree of criticism about the need for a greater role by the central banks and others on macro-prudential supervision. There seems to be general support. Whether or not it should all be in the ECB, I have heard some comments about that aspect, but the need for somebody to have responsibility is right. The architecture that de Larosiére has proposed is it is the ECB with the other central banks in Europe plus the Level 3 Committees and some others, but if you look at where the knowledge of difficulties are arising, the central bankers may not be the ones necessarily with that information. Depending on how supervision is structured in Member States, and it may be finance ministries, it might be a financial services authority, but we need those who see when the red light starts flashing. The final formulation of who may be in this macro-prudential committee may need to be a bit broader than Mr de Larosiére has mentioned. That is something we will examine as a Commission as we go forward. In relation to the supervision, you are right in terms of saying if this crisis gets even worse do we have to think of something new. Mr de Larosiére did not chart out that territory but whether we are going to have to in the time ahead very much depends on how the crisis evolves. Whether we see the need for increased bail-outs within the eurozone, for example, if this starts to become a real issue you have seen the comments from both Germany and France that it is not conceivable that the IMF would come in to bail-out within the eurozone which implies that Member States within the eurozone are willing to consider measures that are not on the table at present because there is no facility within the eurozone for bailing out members. This was something specifically put into the setting up of the eurozone at the time because particularly from the German point of view they needed to have discipline and the idea then that there would be a bail-out would have created the moral hazard that people might not have exercised appropriate discipline. We are not in that situation today, things have changed so much that it is not necessarily true malfeasance that a number of Member States have found themselves in the situation that they are in. If those issues need to be addressed then the debate may move on.

Q441 ***Lord Haskins:*** This is the concept of the eurobond?
Mr Power: Part of it being the eurobond issue but also the fact that the European Central Bank is not able to intervene in primary markets, only secondary markets. There are a number of issues that need to be addressed here. You are also into this whole question which has been tortuous for any discussion at a European level which is the question of burden sharing and who pays at the end of the day.

Q442 ***Lord Haskins:*** The Germans!
Mr Power: That is always the joke that Chancellor Merkel has made, that whenever she hears of solidarity she reaches for her chequebook.
Chairman: That is probably very fair.

Q443 ***Lord Woolmer of Leeds:*** The overall architecture that is being suggested is not just for the eurozone, it is for the whole EU.

Mr Power: Absolutely.

Q444 ***Lord Woolmer of Leeds:*** So how will the burden sharing work if the driving force is the protection of the eurozone for a country like the UK that is not in the eurozone?
Mr Power: Given the timescale Mr de Larosiére had, he obviously made the decision that it was going to take so long to work through the complications of something like this that he felt in any event that would take years to put on the table because huge changes would be needed, not least the treaty changes, so that is something that has not been addressed. I can tell you that before this crisis when we talked about relatively simple things like deposit insurance schemes, for example, for four, five years now we have had discussions among Member States about how to get a coherent deposit insurance scheme going for retail investors in Europe. These discussion were bogged down between discussions on pre-funded, post-funded, who pays. Suddenly when the crisis started to unravel sharply last summer there was agreement within about four weeks that we needed to have something in place quickly. We needed to provide some kind of security to depositors. The debate about pre-funded or post-funded is going to come back on the table again because we have to produce a report on this issue. This is where you get into issues related to burden sharing in these cases because where the bank goes, and it does not matter whether it is or is not in the eurozone, how do you recompense depositors from this point of view. You have had the problem with the Icelandic banks in the UK which has thrown the thing into sharp relief from that point of view. But this whole debate has been bogged down in details and there has never been an agreement among finance ministers on how burden sharing would operate.

Q445 ***Lord Woolmer of Leeds:*** That is different from bailing out on a government and Member State scale. That is relatively easy by comparison with, "You bail out Ireland".
Mr Power: At the end of the day there are models for bailing out countries, the IMF, the structures are there. As a Commission we have contributed to the support in Hungary and in Latvia with the IMF, but as a Commission we are precluded from helping within the eurozone.

Q446 ***Lord Haskins:*** Why is that?
Mr Power: Because that was the structure that was set up at the time not to envisage bail-outs within the eurozone.

Q447 ***Lord Haskins:*** To anybody. The IMF cannot intervene.
Mr Power: No, the IMF can. The IMF can intervene but politically, and I would agree with the comments, it is not conceivable that the IMF comes in to bail-out the eurozone and the eurozone members are not able to do something themselves.
Chairman: That one could see would be awful.

Q448 ***Lord Jordan:*** But that does not preclude the development of a mechanism for bailing out a member of the European Community.
Mr Power: No, it does not. I would be very surprised if an awful lot of thinking has not gone into this already in finance ministries and places if that event did occur.

Q449 ***Lord Haskins:*** But that requires treaty amendment.
Mr Power: It does not necessarily require treaty amendment. It is a question of who pays at the end of the day

Q450 ***Chairman:*** We are reaching the end of our time with you and we have left a couple of things that are quite important to be asked. We ask everybody this in a statutory way: is there a danger that the response to the crisis will create a kind of supervisory monster?
Mr Power: I think that is something everybody needs to be concerned about. I hope that we are all given the time necessary to be able to reflect and design our rules to ensure that we have a stable financial services industry going forward and that we are not necessarily closing the door after the horse has bolted. You will be aware of the political pressure and the atmosphere in Member States among people and people want to see things done. Like any other institution, the Commission is subject to the same political pressures in that regard.
Chairman: I am sure that is very wise. Colleagues, have I suppressed anybody because you have got about two minutes?

Q451 ***Baroness Hooper:*** Given that three Commissioners are involved in this issue, are you confident that the unified approach is there?
Mr Power: Yes.

Q452 ***Baroness Hooper:*** We talk a lot about joined-up government at home and it does not always happen even within a department.
Mr Power: One of the things that was done very early in this crisis was there was a crisis cell set up. This has permanent members, the President, Commissioner Almunia, Commissioner McCreevy and Commissioner Kroes, and we have other Commissioners joining us as needs be. We meet regularly at my level and at Commissioner level. We have always had a very clear view among ourselves about what was needed to be done in terms of how

each of us was responding to it. You would find it hard to see any significant difference between any of the members of the college who are involved in this crisis in terms of how we view the appropriateness of what we do going forward and what we all have to contribute respectively from that point of view and through this crisis team this has been one of the ways we have endeavoured to do it.

Q453 ***Lord Renton of Mount Harry:*** What do you expect to come out of the G20 meeting on 2 April that will affect you?
Mr Power: The G20 will endorse, I think, most, if not all of the measures we are taking in response to this crisis. In our own particular area, what they will say about capital requirements, about pro-cyclicality, generally about credit rating agencies, remuneration, all of this is going in the direction which we are currently working on within the European Union. I do not think there is going to be anything enormously revolutionary in our particular area, in the area for which Mr McCreevy is responsible in regulatory reforms. This will probably be reflected because the finance ministers are due to sign off on this part of it on 14 March so the heads of the G20 when they meet on 2 or 3 April will be able to concentrate on some of the bigger picture issues from that point of view. Those bigger picture issues will be the most important in terms of what markets will read from this. One of the issues that people have to address is what role the G20 is going to play as this goes forward, whether the G20 has a permanent status in bringing the people together because moving from the G8 to the G20 has been important in engaging the number of participants to include all geographically relevant jurisdictions.

Q454 ***Lord Renton of Mount Harry:*** A very big step.
Mr Power: A very big step, yes. Is this the forum to take this forward again? How will the Financial Stability Forum be enlarged, because that needs to be done as well, it is probably the most important forum in how the co-ordination on regulatory response is handled. We also have the issues of the role of the IMF, how is international co-operation and surveillance going to be strengthened over time. Those are the bigger issues that the G20 itself as heads of government will have to focus on. I have no doubt Gordon Brown will want to show the relevance of this process and try to provide to the market some signals that people feel they have a sufficient understanding and willingness to address what is there. That is the huge challenge because, as we have seen up until now, the crisis has been greater than the measures we have been able to take and that has been the reality.
Chairman: I think that is a very good place to stop, that the crisis has been greater. Mr Power, thank you so much for coming, it has been enormously helpful. Thank you very much.

Examination of Witness

Witness: Mr Anthony Whelan, Head of Cabinet for Neelie Kroes, Commissioner for Competition, European Commission, examined.

Q455 ***Chairman:*** Mr Whelan, thank you very much for coming. I am sure you have given evidence to these committees before. The rules are simple. We are taking a transcript, it will appear in the published evidence and you get a look at the transcript before it is all done and dusted so that any infelicities can be removed.
Mr Whelan: I will try to keep them to a minimum!

Q456 ***Chairman:*** You may, of course, speak off the record where you have to but we would rather you did not, if at all possible, it just makes our life difficult. You have had a list of the questions. Because we find that when we ask them we are getting quite short of time I have tried to narrow what we want to ask to what only the competition people in the European Union can really answer for us. What I would like to ask you about is the more general question will bank recapitalisations and the economic crisis lead to Member States implementing policies designed to protect their own financial institutions at the expense of the Single Market? Are we seeing any of this? What measures are you taking to avoid this protectionism?
Mr Whelan: Thank you, my Lord Chairman, and my Lords. Our approach to this is from a State Aid point of view, because pretty much all of the measures that we have seen since the September crisis, and even before in the cases of a few individual outlier or precursor banks, amount to State Aid, and intrinsically State Aid involves a certain degree of distortion of the Single Market. That is our starting point. Our question is really what degree of distortion can we accept in order to achieve some other public good, bearing in mind in particular that the funds available for these sorts of interventions are, broadly speaking, available at national level. The greater good involved was first and foremost to stabilise the financial system to avoid what is sometimes referred to as meltdown, which would have had catastrophic effects on the wider economy. As the crisis evolved from September through to December, for example, we have seen an evolution in the public policy objectives from that simple conservatory aim to something more general and more proactive, if you

will, namely not only to keep the banks alive but also to keep them lending. Perhaps not at the levels of the old pre-crisis period when risk assessments were probably far too optimistic on the part of the banks, but to keep them serving their normal function as a conduit of credit to the economy in order to avoid the so-called negative feedback loop where absence of credit leads to problems in the real economy, which in turn would weaken the banks and so on. In particular, I would refer to the approach taken by the Commission to recapitalisation, which followed an initial move in, let us say, September/October for guarantee measures, which were more of a liquidity device. This approach had many of its roots in the approach of the UK Government in around the month of October, if I remember well, that led to the eurozone and general European declarations in favour of combinations of guarantees and recapitalisation. That type of aid has been typically accompanied by certain commitments to lending to the real economy, as it should. In fact, we encourage the Member States to make these sorts of linkages so that the aid granted is, in fact, linked to the service of a more general common interest. Does that mean that all is inevitably well? Not necessarily. What we tried to do in the guidelines published on recapitalisation in early December, which followed about five individual decisions, was to lay down broad guidance or rules of the game for these sorts of measures, which at one and the same time would allow banks to take up state capital at a price which was not the market price, which at that point was thought to be around 15% and really too high for all banks to continue their normal function, but a price that is not so low as to give massive and unwarranted advantages relative in particular to banks that do not take up such public capital, and some do not for various reasons which are no doubt good, or relative to countries which for budgetary or other reasons do not have such a scheme. We established a sort of price corridor for capital pricing depending upon the level of subordination of the capital and a variety of criteria that I can go into if you wish. This established, roughly speaking, a level playing field across countries. The individual pricing in individual countries after that was to be situated in the corridor depending largely on the type of capital instrument that they choose, and we have seen a variety of such instruments. It also depends to a great extent on a trade-off between what is paid now and certain disincentives to keep the capital in the banks' books. We also wanted to promote the exit of state capital given at subsidised prices. We have no objections to states acting as investors like any other, at the market rate, but if it is capital provided at a subsidised rate we encourage its redemption as quickly as possible and there are various devices to encourage banks to do that. That may be dividend restrictions for as long as that capital is on their books or step-up clauses which make the capital more expensive over time or certain automatic or semi-automatic redemption measures. That has led, we think, to a reasonably sound and consistent system across Europe, on which we have since taken a number of decisions. These decisions are often preceded by relatively tough negotiations with the Member States involved. The scheme rarely comes out precisely as it arrived, but that is our job as well, to guide Member States into that channel which we have sought to establish in close co-operation with the European Central Bank. As regards the possible protectionist aspect, one concern that has been raised in the debate recently, perhaps particularly in the newer Member States, is a fear that banks which are recapitalised or aided in some other way will be encouraged by the contributing state to concentrate their activities in the home market and there would be a drying up of credit in other markets where subsidiaries or branches are active. I am happy to say that the signals from the market do not all go in terms of that particularly pessimistic prognosis.

Q457 ***Baroness Northover:*** They do not seem to be lending to anyone whether at home or in any other country.

Mr Whelan: That, I guess, is the most pessimistic view, that there is no distinction for good or ill. Even to the extent that these measures have done good, and I think there is a broad recognition that they have not yet achieved all that we would wish for, which is why in particular the debate has moved on to the question of toxic or impaired assets, so that if you cannot solve the problem on the liabilities side of the balance sheet then perhaps you attack the problem at source on the asset side, this is probably where the problems really lie. Even to the extent that banks are remaining active, I am not aware of any bank that has completely stopped lending.

Q458 ***Baroness Northover:*** Okay.

Mr Whelan: The Swedish Government, for example, whose banks have a very important position in particular in the Baltic countries, has been quite vocal in encouraging its banks to maintain their presence and a normal level of activity in these other countries with the support of capital provided by the Swedish Government as part of a good medium-term strategy that they had gone into these countries as welcome investors and that should be acknowledged. In practice, the question sometimes comes up, reverting to something I said a little earlier, when Member States ask banks in return for capital to make certain commitments about lending to the real economy. Those sorts of commitments are typically expressed in terms of lending to companies active in the economy of the Member State in question or resident in that Member State. It is difficult for it to be any other way, if only because the Member State is not well able to control lending in any other Member State and is probably best able to set targets in those terms. I do not think that in itself constitutes a problem because provided there is a reasonable balance between the capital provided and the commitments received this should not have any knock-on negative effect in other countries where the banks in question are active. There may be extreme cases where there is a capital sucking effect simply because the commitments requested from the banks are so great relative to the capital provided that it does distort the activities of the bank, and I am not sure I have seen such a case I should add.

Chairman: That is a very interesting set of comments. I can see all the virtues of requiring banks to acquire their capital from the state at somewhere near the market rate, but as the crisis wears on, if I may put it that way, presumably this position is very difficult to hold from the point of view of the Competition Commission because if they pay a market rate for their capital in the desperate straits they are in the whole position may get worse. For example, there is our own dear Lloyds Bank who has just been bailed out again fundamentally. This must be a matter of public record, I simply have not seen the terms. I do not know whether you were able to hold the line on new capital going in at market rates on that bail-out.

Q459 ***Lord Woolmer of Leeds:*** Has it formally been announced as opposed to it is near to an agreement?
Mr Whelan: In the case of Lloyds?

Q460 ***Chairman:*** The Lloyds further bail-out.
Mr Whelan: We have the case of RBS.

Q461 ***Chairman:*** Do let us discuss RBS; it is obviously easier.
Mr Whelan: I am not aware that Lloyds is already on our books, but that can be checked. I should perhaps just clarify we say that the capital provided should not be too divergent from market rates, but clearly it is not at market rates as they were observed. Just to be more precise, the corridor is in the region of seven to 9.3%, if I remember, whereas, as I said, capital was typically being procured by those who went to the capital markets in November/December at around 15% and I am not sure it has really changed since then. There is a very substantial discount. We have not seen any great reticence on the parts of banks to avail themselves of the capital at that price. If we bear in mind that participation in these schemes is typically voluntary—there may be a degree of encouragement but it is typically voluntary—we see, for the moment at least, that the pricing model worked out in fairly close collaboration between the Commission and the ECB, but also very much discussed in the Council of Finance Ministers, is one that can hold the road. We keep these things under constant review obviously.

Q462 ***Chairman:*** Do you perceive a need to further redefine and clarify State Aid in relation to the banks?
Mr Whelan: Having given guidelines on 5 December, which feels like a long time ago in terms of the crisis, we keep it under review but do not have evidence at the moment that that particular approach to capitalisation is not working. I should add that the pricing model is one which also takes into account the applicable risk-free interest rate in the country in question. There is a correction mechanism as central banks take into account the fact that interest rates may need to be lowered. The corridor can move with the underlying risk-free rate of the country in question.

Q463 ***Chairman:*** So there might come a point when the corridor for a United Kingdom bank bail-out goes down to 1% at the bottom?
Mr Whelan: It is not solely described by the risk-free rate because we are not suggesting that banks receive capital at the same rate as sovereign borrowers.

Q464 ***Chairman:*** More like four really.
Mr Whelan: There can be a tendency downwards. I would not like to speculate on where it will end up because I have not done the arithmetic.

Q465 ***Lord Haskins:*** Are you getting complaints already from other businesses and countries that foul play is afoot and that you should be looking at some of these practices that are taking place?
Mr Whelan: In terms of the recapitalisation process as such, that has been relatively consensual *vis-à-vis* the Member States. There was a broad political perception of a need (a) to recapitalise and (b) to try to define some sort of common approach with lots of local divergences depending on the instrument and so on. There has not been any great objection taken by the banking sector. Certainly in October/November, if memory serves, some banks which did not feel the need to take state capital warned of the need for safeguards, prudence and so on, which we tried to factor into our approach. There has not been a great deal of criticism since the approach became widely known and was bedded down, as it were. On the possibility of protectionism, or favouring lending or investment at home relative to abroad, I would not say it has come up in terms of complaints but in the political discourse in recent weeks concerns have been expressed that this effect might be at play. I do not think anyone has gone so far as to suggest foul play or anything like that. It was, I think, addressed by the heads of state and government among other items at their informal lunch last weekend.

Q466 ***Lord Haskins:*** The real economy issues like the French initiative in the car industry would be on your table straight off.
Mr Whelan: It is a good example insofar as if we were to find in recapitalisation, or other aid schemes for banks, conditions that were fairly clearly related to the location of activities then we could have similar concerns to those which we publicly expressed about the French scheme, which were finally addressed through formal commitments by the French Government.

Q467 ***Baroness Northover:*** How is the Commission working to avoid disruption of the Single Market created by the movement of resources back to the home country of cross-border financial institutions as we saw moving out of the EU in terms of Lehman Brothers when they moved resources back to the States?
Mr Whelan: The Lehman Brothers example is not one I am very well qualified to comment on because that was the one bank that did not get State Aid in the end and we know what happened afterwards.

Q468 ***Baroness Northover:*** Just taking the principle of the thing.
Mr Whelan: In terms of ring-fencing assets in what may be an impending insolvency of a bank, there we get into some aspects of supervisory activity, company law and insolvency law, and I regret these are a bit off my territory. In terms of banks which do receive State Aid and, therefore, which do not reach the point of insolvency, or if they were insolvent they are not immediately wound up but hopefully something along the lines of a restructuring or an orderly winding up can be organised, I have not become aware of problems of repatriation of assets of that type, perhaps because that only becomes most interesting for the mother company if things are heading towards an insolvency in the normal sense, with the consequence that the company is put into liquidation. In a situation where a bank receives timely aid from one or more Member States—because there are a few cases where there have been collaborative interventions by Member States—then one does not see the immediate need for the bank, as it were, to bring the legions home in order to try to maintain at least the home market. The area which I have seen more in practice is the question that we were just discussing of how to make sure that State Aid intervention does not come with conditions that would distort activity, always bearing in mind, of course, if a bank is not only in need of a capital cushion to reassure the markets but in real distress, then State Aid by the home government, if I can put it that way, will bring at least some benefits for the activities of the bank in other countries, namely that they do not perhaps collapse in a very disorderly way, which would never be good for the local economies.

Q469 ***Lord Renton of Mount Harry:*** Is State Aid intervention going to do just what you have said? State Aid intervention is generally only to stop a bank going bust and surely under those circumstances it is understandable that the particular national government would do whatever their treasury says is necessary to go with the additional State Aid? Take the case of Lloyds, which we only heard about overnight, presumably moving from their preference shares that do not have the vote to taking preference shares into equity that have the vote, so the Government is now the majority share holder, that is not going to be without strings and state attachments to make certain that Lloyds survives.
Mr Whelan: I have two points to make. First of all, it is not the case that State Aid that has been rolled out in a number of countries at this stage is confined only to banks which are literally on the brink. The move in October/November regarding recapitalisation was in part inspired by the need for banks which hopefully are fundamentally sound, but which are nonetheless facing a crisis of confidence in the markets and an uncertain operating environment in terms of the degradation of certain of their assets, that would need a capital cushion in order to withstand possible future losses, or at least the market expectation of future losses. Much of what I have said about the pricing corridor and so on for recapitalisation is actually the regime that was foreseen for so-called fundamentally sound banks and we anticipate a rather stricter regime, either in the shorter or longer term, for banks that need to be rescued, who have in a sense lost out in the Darwinian struggle. In terms of the attachment of conditions, be it in a rescue or, as it were, capital cushioning intervention, if the conditions are that the bank maintains a certain level of lending to the local economy that is not in itself something which causes concern, quite the opposite, it means that the aid is hopefully being deployed to serve a common good interest and not simply to preserve a zombie bank which does not fulfil its social function. If there were to be other conditions we would obviously look at them more closely, in particular if we detected a protectionist element.
Lord Renton of Mount Harry: I had not thought of it as a Darwinian process before.

Q470 ***Lord Jordan:*** However you look at it, the bail-outs fly in the face of competition policy but the truth is the Competition Commission was presented with Hobson's Choice, was it not?
Mr Whelan: Indeed. In a way, it was not that difficult a choice to make precisely because the stakes were so high for the economy in general. What we need to do

perhaps, and this relates to one or two of the other questions, is address the underlying problem, which is that banks which serve this important social function, and in particular if they are of systemic importance, and in concentrated markets that will be the case for many of the banks, do not end up having the possibility to act as private operators subject to the normal rules of the market including, of course, profit in good times but the problems because of their social function are socialised in the bad times. That is not a problem one can easily address through the State Aid rules. The State Aid is called upon normally in the bad times and one has to try to address that as best one can if there is a systemic aspect to the problem. Certainly in the ongoing review, both within the European Community following the de Larosiére Report and so on, and in the global process around the G20 meetings and so on, finding means of preventing it happening again through the regulatory/supervisory role of the public authorities has to be a major priority.
Chairman: Lord Woolmer, would you like to ask about a specific case.

Q471 ***Lord Woolmer of Leeds:*** I am sure you have been in discussion with Her Majesty's Government and, as I am sure you know, Northern Rock has recently been given the go-ahead to start expanding mortgage lending again. While no doubt in general the mortgage or the borrowing public will be very pleased with this, it would be helpful to know how this fits into the original endorsement of the actions to save Northern Rock. Is that re-emergence into the mortgage market at variance with the normal guidelines you would give in the rules? In your view, welcome though it may be in general, is it a precedent that raises any worrying issues for you?
Mr Whelan: Here is a point where, if you permit, because we are discussing an individual and pending case, I will have to weigh my words a little bit.

Q472 ***Lord Woolmer of Leeds:*** When you say a "pending" case, you mean this is still under review, is it?
Mr Whelan: Yes. If I recall the announcements made by the Treasury in which Northern Rock was mentioned, along with the asset scheme for RBS and some other measures, they were indicated to be subject to review by the European Commission.

Q473 ***Chairman:*** Still *sub judice*.
Mr Whelan: I can say a little bit about it just to clarify how we got to where we are at the moment. The Commission authorised rescue aid for Northern Rock in September or October 2007. The normal rule under our rescue and restructuring guidelines, because we had not adopted any specific measures for the banking sector at that moment, was that rescue aid could be authorised for six months provided a restructuring plan is presented during that period, which occurred. The aid remains, as it were, temporarily authorised while we examine the restructuring plan. A plan was presented which foresaw certain downsizing of Northern Rock and the principal terms were in the public domain. We opened proceedings on that in March 2008. In State Aid procedural terms, that is merely a step which allows other market participants to have procedural rights, to express their views and have them taken into account. Obviously the new plan for Northern Rock has a number of changes relative to what was previously foreseen. In particular, the "bad bank" aspect whereby the bad assets are migrated into another vehicle is quite new. It is perhaps a little bit in the zeitgeist but we have to look at it for all that. There is the plan to engage in more mortgage lending than was originally foreseen, moving from a figure of around five billion to something more like nine billion. That is still, of course, a good deal less than the lending rates in the pre-insolvency period, which were at a rate of around 30 billion a year. I know that the UK Government has raised certain public policy arguments about the inopportune character of an imposed restriction in lending at this particular moment in the life of the economy. Those are arguments which are still fairly fresh to us and we will examine them and probably have to extend our procedure in order to let other participants comment on them as well.

Q474 ***Lord Woolmer of Leeds:*** Do you have a working paper or report that sets out which Member States with which banks or institutions have been rescued in a form that we could have?
Mr Whelan: I do not have it on me but we do have something on the website which I can very easily bring to the attention of the Clerk.

Q475 ***Lord Woolmer of Leeds:*** On that, I thought you implied there were some proposals that you have turned down, or have you approved every single proposition put to you?
Mr Whelan: We have managed to guide all of the proposals received to dry land, let me put it that way.
Chairman: Excellent.
Lord Woolmer of Leeds: That is Sir Humphrey! Masterly, masterly.

Q476 ***Chairman:*** So far perhaps would be a fair qualification.
Mr Whelan: So far, yes.

Q477 ***Lord Renton of Mount Harry:*** Just in this context, looking at the Eastern European countries that are now saying they are potentially in real trouble, how are you going to handle that?

Mr Whelan: There are a number of different levels. From my point of view, because there are issues of balance of payments and each country has its own profile—

Q478 ***Lord Renton of Mount Harry:*** Of course.
Mr Whelan:—the Commission is very reluctant to speak of a category.

Q479 ***Lord Renton of Mount Harry:*** I can understand that.
Mr Whelan: There are two countries that have received a combination of Commission and IMF assistance and there are others that are still enjoying economic growth, who are to be envied rather than anything else in the current climate. Where this perhaps reaches my table most directly, and it is something I mentioned earlier with regard to the Baltics, is in a number of new Member States large tracts of the banking industry are actually held by international groups. That raises a number of issues. It raises the general issue, which we also have in Western Europe, of the regulation of cross-border groups and there is a debate about how that can best be done and whether home supervision is sufficient, whether we need colleges of supervisors, whether we need a European level supervision mechanism that works hand-in-hand with either colleges or individual home supervisors. On that I cannot say much more than the Commission said on Wednesday in a Communication in advance of the Spring European Council, where it takes a position on a number of the de Larosiére recommendations in this regard. To the extent that foreign held banks in a given Member State may need aid either for rescue or for the more general sanitisation of the system, the question arises whether that can be adequately done by the home Member State alone, whether there should be burden sharing and what is the capacity for burden sharing in these matters. We are at an early stage in the debate. As I said, if memory serves, we have seen at least two cross-border bail-outs, namely of Fortis Bank and of Dexia, one by the Benelux, the other by Belgium, Luxembourg and France. These operations are more complex, not least because if, for example, guarantees are being provided by three sovereigns quite what the allocation of responsibility is is an issue, and no doubt there are many others. From a State Aid point of view we would certainly have no difficulty with such common interventions if they were to arise. More than that is probably more for my colleagues in DG Markt.

Q480 ***Lord Renton of Mount Harry:*** In short, presumably you would always say in my language that rather than have a national bank go bust you would look the other way to make sure that the necessary aid is given?
Mr Whelan: It is not a matter of looking the other way because even before the crisis, and this is the case with Northern Rock, we had guidelines on general rescue and restructuring, which are as applicable to the widget sector as they are to the banking sector, which foresee that governments can use rescue aid to save companies in distress, but there is normally a trade-off in terms of restructuring. That is typically not only restructuring that one would wish to engage in anyway on good commercial grounds, namely reducing a bank to core activities which may be more viable and so on, but it can also entail what we call compensatory measures, that is to say a bank or a widget maker, whatever it is, would renounce profitable activities and divest them in order to compensate for the distortion of competition that arises from the very continuation of its existence through state intervention. The discussions on what is an appropriate compensatory measure for such distortions can sometimes be quite interesting.

Q481 ***Chairman:*** Just before I ask Lord Jordan to ask his extremely important question, can I observe that presumably you have got troubles still to come. You allow a state intervention, a state bail-out, put conditions on it and in six months' time who knows whether we will be able to meet those conditions, as in the example of Northern Rock where the United Kingdom Government has had to come back and say, "Look, sorry, could we not do quite what we said because it is causing damage in another part of the field?" Presumably one may expect a few of those.
Mr Whelan: Just to use the Northern Rock example, we had not yet blessed the previous restructuring plan, we were examining it, so we had not imposed any particular—

Q482 ***Chairman:*** Even before we produced the new one.
Mr Whelan: We had not imposed any particular substantive condition at the time of the rescue other than that a restructuring plan would be produced which should, upon examination, be found to restore viability or lead to an orderly winding down, whichever is the preference, and which should involve a certain contribution by the stakeholders in the bank which would normally occur if the shareholders are—

Q483 ***Chairman:*** Are still there.
Mr Whelan: In that case they are not. Then the compensatory measures that I mentioned. In terms of the wide range of new cases that have arisen through recapitalisation, and there may perhaps now be a number of cases dealing with impaired assets, the restructuring process with the full rigour of what I just described will normally be triggered only in certain circumstances, in particular in the case of recapitalisation to deal with distressed banks rather

than fundamentally sound banks that merely get a public policy driven cushion of capital at an appropriate price. In the case of our recent guidance on impaired assets which we issued last week on 25 February we foresee certain triggers for in-depth restructuring, such as if the transaction involves more than 2% of risk-weighted assets. What the appropriate shape of a restructuring should be or what the appropriate timeline for that restructuring should be is something that has to be devised case-by-case in the circumstances in which we will find ourselves when these plans are received. Some of them should be arriving fairly soon. The timing of the necessary measures, the articulation of the restructuring with wider public policy objectives regarding the role of the banking sector in the economy, these are things which will need careful attention. To that effect we have announced that fairly soon we will issue guidance on our approach to restructuring in the banking sector and that is normally done first in draft and discussed with Member States and stakeholders and we have a debate as to what the issues may be. In any event, restructuring is nearly always a case-by-case process, there is not a one-size-fits-all approach to it.

Chairman: I must go to Lord Jordan's question because it is the one we have to ask the competition people.

Q484 ***Lord Jordan:*** A previous witness, Professor Goodhart, suggested that some banks are becoming too big for proper regulation and fair competition and when the dust has settled on this particular crisis his concerns may be even more relevant. Do you share those concerns?

Mr Whelan: Yes. This relates to something I said earlier anticipating your question. Clearly there are public policy problems if banks are too big to fail and nonetheless allowed to act as if they were not, that is really the problem. I am not sure the answer to the too big to fail problem is to make them small enough that we can let them go because that would involve a restructuring process far beyond anything we could dream of in the State Aid control process I was speaking of a moment ago. I think the answer to the question is primarily on the regulatory and supervisory side, that is to say if we have banks which are too big to fail, that are of such systemic importance that their failure would have a domino effect on the rest of the financial sector and the economy in general, then we must bear in mind the real problem of moral hazard, that is that there is either an implicit or explicit government guarantee against all of the fall-out of their mistakes which would inevitably feed into an overly lax attitude to risk. If banks can be regulated in such a way that they do not act as if they are normal market operators who can be allowed to fail, then we get to the nub of the problem. I do not think it is one that we can easily address through competition policy because competition policy comes in three flavours basically: the State Aid control aspect comes when we are already in the crisis in which a systemic bank cannot be allowed to disappear, or not to disappear in a disorderly fashion; in an anti-trust context it is not really obvious to me that the sort of market behaviour that is generated by moral hazard and excessive risk-taking comes within the rules against anti-competitive behaviour; and from a merger control point of view that is something that comes up only in certain cases, it is not a general means of regulating the behaviour of institutions and it is not obvious that a merger control regime that is based upon there being a sufficient degree of competition between players really addresses that systemic problem. In a number of the Member States we have extremely competitive banking markets and we have others which are perhaps more concentrated than one would like, but that is a structural situation. The difference between the more competitive and more concentrated banking markets does not give you very good guidance as to which banks are sounder or more risk averse or anything else. The solution has to pass by the regulatory supervisory channel rather than by the competition policy channel.

Q485 ***Lord Jordan:*** Can your department define that a bank is now too big? Is there any institution within the European Community that can act in an anti-trust capacity and break it up?

Mr Whelan: We do have the power under the relevant rules on anti-competitive activity through Articles 81 and 82 of the Treaty. Article 82 is probably more relevant on dominant positions. We do have the power to adopt what are called structural remedies and in the energy sector we have adopted structural remedies in a couple of cases in the last year or so. That presupposes not simply that you have a dominant position but also that there be an abuse of that position, and types of market behaviour that may entail excessive risk-taking and so on do not obviously, or at all, fit in the normal categories of abuse of a dominant position. I should also mention that the category of a company in a dominant position does not necessarily read across perfectly to the category of bank of systemic importance. Because of the interconnections between banks, both within a Member State and sometimes between international banks, and the failure of Lehman Brothers is an illustration of this, the fact that banks are engaged with each other as counterparties can mean that the failure of a bank has systemic consequences even if it is far from having a dominant position or is present in a highly competitive market. We have seen some

Member States with highly fragmented banking markets, perhaps even excessively so from some points of view, where nonetheless the possible failure of certain banks was thought to have likely systemic consequences. The concept of a systemic bank may be different for different purposes. In terms of rescuing a bank which is on the threshold of a disorderly liquidation, the threshold may not be that high because of these interlinkages. As regards the question what is a systemic bank in terms of aid necessary to foster lending to the real economy and, therefore, deserving of an impaired asset relief scheme or something like that, the bar could legitimately be set higher by a Member State for that purpose.

Q486 ***Chairman:*** That sounds to me a good place to stop, much though we regret stopping. We could go on but it would be discourteous to the next witness to do so. Thank you very much indeed for coming, Mr Whelan, we found that very useful.
Mr Whelan: Thank you for your attention and questions. I will send a table of decisions through to you.

Q487 ***Chairman:*** That would be very kind.

Examination of Witness

Witness: Mrs Valérie Bros, French Permanent Representation to the EU, examined.

Q488 ***Chairman:*** Mrs Bros, thank you very much for coming. I am not sure you have ever given evidence to one of our committees before but we record every word you say. We let you have a transcript so that anything you did not mean to say can be sorted out, and we publish it as an annex to our report. We are scrutinising on behalf of the United Kingdom what the European Commission is saying, what we think about it and how it all works. Of course, we have now rather widened the scope of this to report on the effect of the de Larosiére propositions which have rather changed the name of the game because they go into great detail. I know you have had a list of the questions we had hoped to ask, but we do not think we are going to get through all of them so we have cut out some at the end of the list. We can either ask you questions or if you would like to make a statement first, please do.
Mrs Bros: My Lord Chairman, distinguished members of the Sub-Committee, I would like to say that I am very honoured to participate in this hearing. As my English is not that good thank you very much for giving me the opportunity of checking afterwards that I do not say things that would not be completely adequate or comprehensible. If I say anything that is too obscure or unclear, please feel free to interrupt me and I will do my best to give a clear view of the vision we have on the questions that you kindly sent to me before this hearing. I do not have any specific statement but maybe I could go through the questions that you sent me.

Q489 ***Chairman:*** May we ask the questions in order to help.
Mrs Bros: Yes, please.

Q490 ***Chairman:*** How has the financial crisis shown the need for reform of financial supervision?
Mrs Bros: We think that this financial crisis can be viewed as the result of different factors and some of those factors are not linked to the regulation or supervision of the financial system, they are more of a macro-economic nature, like the high level of indebtedness of households or high level of liquidity on the markets, and at the same time global imbalance probably played a role in the unfolding of this crisis. However, there were some reasons that were linked to the supervision framework and to the regulation itself. There are at least two kinds of activities that are considered as having a strong impact on the existence and unfolding of the crisis. One is the activities of rating agencies and the lack of regulation and the other one is the securitisation activity with regard to financial products that are more and more complex. It is a mixture of different factors, but certainly the regulatory and supervisory factor has played a role in the crisis. There is a need to address this and to change the way the regulation and supervision of the financial system as a whole is done.

Q491 ***Chairman:*** Do you feel that we need an EU-wide supervisory body?
Mrs Bros: What we need is that we have real co-ordination and convergence of practices of supervision across Europe. In Europe you have different financial groups: there are small, national groups which have no cross-border activity and there are a few financial groups which have very large cross-border activity, and in general this activity is not only pan-European but internationally developed. For this reason it is more appropriate to develop a co-operation framework and convergence of practices more than an EU-wide body which would address not only pan-European but also small companies which do not need to have such an EU-wide supervisory framework. We feel the most important thing is that companies are not confronted

with different practices or cannot be in a position to do some forum shopping which would allow them to take the best or lightest supervisory framework. In that context it is very important that we find a strong enough system that would create the conditions for this co-ordination and convergence of practices which we do not have at the moment because the co-ordination bodies at the European level are very informal in some ways or unable to take binding decisions or their legal structure is not sufficient to make sure practices are converging and co-ordination is realised.

Q492 ***Chairman:*** How does the French Government feel about the recent suggestions that the European Central Bank should play a role in EU financial supervision?
Mrs Bros: The ECB certainly has a role to play in this framework, which it already plays in the sense that the ECB is very active in analysing the situation of the financial market in Europe. This analysis is not only provided for internal purposes but shared with finance ministers and other national central banks. This does exist already, but at the moment it is very informal and it does not need to be taken into account by the supervisors, the regulators or the national authorities more generally. We think this role is important in the framework of macro-economics or what we call macro-prudential analysis. There is some legal ground, as everyone knows, for the ECB to have a more active role in supervision, at least for the banking sector, however in this case we come back to the question of is it necessary for the ECB to be the supervisory body for companies which are very national. The ECB and the national banks consider there is a case for supervision at the most appropriate level, so in general at the regional or national level and not at the federal or pan-European level for most companies. Certainly the ECB is not necessarily the most appropriate tool for supervision of the whole financial system in Europe.

Q493 ***Chairman:*** Perhaps I will pick away at this when we come to how you feel about the de Larosiére Report. You will know, I am sure, that Lord Turner, the Chairman of our FSA, says that he does not believe you can have an EU-wide financial supervisor while the lender of last resort for any bank is the Member State. Do you think that is right or do you envisage a different system?
Mrs Bros: Certainly there is a strong link between who is the lender of last resort and who takes the decision. What we can see from the de Larosiére Report is that this question is taken onboard because if you consider the Report it more or less proposes that some competences could be transferred at the EU level but they would be mostly co-ordination, orientation and mediation. It would not take over the responsibility of the national supervisors, it would just make sure that those responsibilities are tackled in a co-ordinated and converging way through the creation of this European System of Financial Supervisors and, therefore, national supervision will continue to play a strong role.

Q494 ***Chairman:*** In this context France really shares the United Kingdom view that he who bails out the banks has to supervise.
Mrs Bros: There is a strong link between the two aspects. The question is more complex when it comes to pan-European companies because it is hard to say who is the lender of last resort. Some questions have been raised that we might not have thought about when we had cases of pan-European banks being in difficulty, like Fortis and Dexia, which shows it is not so clear-cut who is the lender of last resort and who is responsible for the problem that arises. Sometimes the supervisory body responsible for the problem is not even in Europe because the entity that created the turmoil in the company is not located in Europe. There is a strong case for that link, but at the same time when you consider pan-European companies the line is not so easy to draw between the responsibilities of different supervisors and, therefore, the bail-out and who is the lender of last resort for such a company. Therefore, it is all the more important to make sure there is a system that works and creates a convergence of practices of supervision in Europe.

Q495 ***Chairman:*** One of the reasons we were so glad you could come and see us was we wanted to talk to another European country with a lot of big banks that went cross-border and even into the United States, like Paribas, to see whether there was any comparability between our points of view or what the interesting divergences were. If I can move on to the de Larosiére Report, do you think that the proposals to create a European Systemic Risk Council for macro-supervision and a European System of Financial Supervisors, the old Lamfalussy Committees for micro-supervision, are a sensible way to go?
Mrs Bros: Yes. We think that the de Larosiére group provides some pragmatic solutions for the current situation. Obviously it is a compromise report so some Member States in Europe would like to have another system, a probably more federalist structure of a supervision system, some are not of that view and the de Larosiére Report strikes a balance between those different views. I think we can consider those proposals as very pragmatic. The European Systemic Risk Council is a way of structuring something that exists already, the informal dialogue between the ECB, supervisors, finance ministers and other bodies, but it is important to create a structure that works as

a council that really will evaluate systemic risk. As far as a European System of Financial Supervisors is concerned, we think it is the best possible solution in the current context, and I am not talking about the political context here but first of all the legal context because of the treaty and, second, what is acceptable for Member States at such a time, what is most realistic.

Chairman: Thank you very much. I am now going to stop asking questions and ask my colleagues to come in.

Q496 ***Baroness Northover:*** Can I ask whether you perceive a need to reconsider the home/host country divide?

Mrs Bros: We do not feel that there is a need to reconsider this divide from the point where we are now. We had this debate in the framework of the discussion of the two Directives that are currently under discussion in the EU, one is the Solvency II Directive for the insurance sector and one is the CRD Directive for the banking sector, the Capital Requirement Directive. The debates that we had on those Directives, notably on the Solvency II Directive, which were very intense debates about precisely the division of responsibilities between home and host supervisors, showed clearly that there is no political support today within the EU to change the home/host divide. Of course, in the Solvency II Directive, for example, the idea was to transfer more powers to the home supervisor within the college of supervisors and this option, which was supported by my country in the first place, proved impossible in the political context of 27 Member States. In that sense we feel we have come to the best possible solution on Solvency II which is not what my country would have preferred in the first place but which is a result of the current political balance within the European Union on this home/host divide. On CRD it was more or less the same question. We felt that the introduction of colleges of supervisors, and the creation of a truly European system of supervision such as what is suggested by the de Larosière report would be the only possible alternative to this home/host divide and was the best possible solution. It is also a way of making practices more convergent. It is not a bad solution, at least it is the only solution that is realistic and possible in the current situation.

Q497 ***Lord Renton of Mount Harry:*** Is it possible that your support of the home/host country divide in France may possibly be influenced by the fact that so far the French Government has only had to devote about 1.5% of gross domestic product to the rescuing of banks whereas in the UK's case the figure is already about 8% of gross domestic product? In that context obviously the present situation is very much favouring France and the French Government, and equally Germany, much the same.

Mrs Bros: For the home/host divide?

Q498 ***Lord Renton of Mount Harry:*** Many of the major banking groups are not centred in France, therefore you are not getting in the difficulty at the moment that we in the UK are, and in the United States even more so because the figure in the United States is already over 10% of gross domestic product.

Mrs Bros: The debate between home and host responsibilities at the beginning was linked to the fact that the structure of pan-European companies is such today that decisions are mostly taken by the mother companies.

Q499 ***Chairman:*** The owner.

Mrs Bros: The owner, exactly. Be it liquidity, investment, *et cetera*, more and more decisions are centralised in the owner companies. For this other company which has the relationship with the home supervisor there is more logic to give more powers to that supervisor organising the supervision of the group because the group is probably more centralised than it used to be and, therefore, decisions that are taken in London, Paris or Frankfurt have a strong impact in Slovenia, the Czech Republic, Holland, *et cetera*. This is obvious today because when Parliament is advocating the fact that it is important that mother companies of banks, for example, do not repatriate or take over all the liquidity in the subsidiaries because they need it in the mother company it shows how those decisions can have a strong impact on the subsidiaries. The debate on who is responsible for the main supervision of a company was linked to this structure. The debate became even more complicated because in some cases supervisors of the subsidiaries indicated why should they trust the supervisory body of the parent company when in some cases the supervisor had supervised a company that had made billions in deficit, which did not make the debate on Solvency II or even on CRD easier to tackle because this was done in a very specific situation. In my view the debate on home/host was more linked to the companies, the banks and insurance companies themselves, because they pointed out how they were organised and how supervision was not organised in the same way that they were.

Q500 ***Lord Haskins:*** One of the more pressing issues on your and our agenda is the Capital Requirements Directive which is coming to a head at the moment, I gather. There are two issues about that. First of all there is the percentage figure that is being debated, and we have heard that figures from nought to 20 are being discussed and it would be interesting to know what the French position is on that. On the more general issue, slightly predictably, the British Government, for which we do not hold any brief, has concerns that the scope of the Directive may be too wide and, therefore, may limit those institutions which are trading globally. What are your views on both of those issues?

Mrs Bros: We think that today the CRD revision is the most important tool that the EU has for answering and giving solutions to the current financial crisis. It is a very important tool and comprises a lot of different measures, notably dealing with securitisation. The figure that is under discussion in the text is 5% which is the compromise figure which was reached during last semester's presidency, so during our Presidency, which we support, we think it is a balanced figure. There are very specific provisions on liquidity management and on tier one definitions. It is a very important and far-reaching text and we think it is a very important answer to the financial crisis at least at the EU level. Of course, this text is still under discussion because the European Parliament is working on it and there might be some changes. Also, we now know that the Commission is going to propose some changes to this text as soon as it is adopted in order to take into account the Basel work which is underway, which is logical, notably in order to heighten the level of capital charge for some risks contained in the trading book of the banks and also on some links to securitisations there might be some impact of the Basel II committee works on this Directive. Basically, I think the scope of the Directive in general is appropriate, but at the same time it is hard to have a definitive view on that scope in the sense that it is still under construction and negotiation within the European Parliament and it has to take into account future works that will be finished probably by the end of the year. Another issue that will be tackled is the incentive schemes in the financial sector. These will be taken on board in the CRD revision that will come next fall. More generally, the scope seems to be appropriate but at the same time the scope is evolving due to these different works that are underway.

Q501 ***Baroness Hooper:*** Earlier you referred to the fact that the credit rating agencies had a responsibility for the crisis that has descended upon us all. Do you feel that the Commission's proposals are adequate to meet the future regulation of credit rating agencies?

Mrs Bros: First of all, there was the Commission's draft, and we have worked a lot on this text, and there is the compromise text that has been discussed within the Council which has led to a position of the Council. This was two days ago. This will now be discussed with the European Parliament. In general we feel that the compromise text we have reached in the Council is a proper answer to the situation because in the beginning there was absolutely no oversight or regulation of rating agencies within Europe and the first objective of this regulation was to change this situation to a situation whereby rating agencies were regulated and there was some oversight in Europe. That was the first objective of the text. The second objective, which we think was properly obtained, was to limit the conflicts of interest that probably hampered the proper work of rating agencies in the past. In this context there have been a lot of provisions introduced in the regulation on credit rating agencies with a view to limit the conflicts of interest and which are designed in a way that we believe is appropriate in order to obtain the result of limiting these conflicts of interest. Another objective of the text was to obtain more transparency in the rating process. There has been a balance to be found between the fact that it is a private activity and all rating agencies have their own methodologies, and it is part of their business model to have their own methodologies, so it is not for Member States to over-regulate this part of their activity, but at the same time it was necessary to make sure that, whatever the methodology, the result was obtained in a proper and transparent way. In general we feel that the system that is put in place by this regulation is appropriate, so we will have a situation where those rating agencies will be registered and supervised in Europe.

Q502 ***Chairman:*** A question that has occurred to me about rating agencies is I know there was never any European-wide system of regulation, and we did not but did France ever try to regulate credit rating agencies on a national basis? Did the French Government see that as an area that might need regulation? I cannot claim that we did, I wondered whether the French Government did.

Mrs Bros: To answer your question properly I should check back with my capital. I know that some rating agencies are working and active in France through subsidiaries or branches so they do issue ratings in France and if they had any contact with supervisory bodies that is very likely, and I know they were in close contact with the Finance Ministry for example. I do not think there was some national regulation but I will check this.

Chairman: I ask only because both your Ministry of Finance and the Banque de France have always been more dirigiste than us and I just wondered whether this had been an area in which they had been working.

Q503 ***Baroness Hooper:*** It was not really the fault of the rating agencies that things went wrong, it was the fault of the reliance of the institutions on the opinions of the rating agencies. We have already discussed in previous meetings that institutions and other entities need to do their own due diligence. By actually

introducing these requirements it is giving the companies or the institutions an out and as a result of these proposals they can rely on the ratings of the agencies in a way which they should not have done before.
Mrs Bros: This question was very high on the agenda when we discussed this regulation, ie how to avoid clearing the ratings and giving them public endorsement. It was carefully drafted in the Directive in order not to give the impression that these ratings were perfect: on the contrary, we made sure not to go beyond the responsibilities of the public authorities, which is to make sure things are done in a transparent and proper way, not taking over the responsibility of the credit rating agency itself and, of course, the users of the ratings even more so.

Q504 ***Lord Renton of Mount Harry:*** It is interesting to me that Mr de Larosiére in his recent report has a chapter four which is headed "Global repair" and he recommends that the IMF, the International Monetary Fund, in close co-operation with other interested bodies is put in charge of developing and operating a financial stability early warning system accompanied by an international risk credit register, ie a global supervisory body. Do you think that this suggestion will get support in France?
Mrs Bros: We support that kind of proposal globally, ie giving the IMF—

Q505 ***Lord Renton of Mount Harry:*** You would support it?
Mrs Bros: We would support it in the sense that the IMF has a role to play in evaluating the global financial stability of the world's financial system which it already does in some cases through analysis in some countries and it could work more on a global level. I would not say that this is a worldwide supervisory body because there is a huge difference, in our view, between supervision in the sense that the supervisor has the authority to impose some decisions on a company and the fact that a body like the IMF does a general analysis of the situation of the financial system. I do not think it would be right to call this an EU supervisory body because it has no binding powers in terms of companies on a day-to-day basis. Supervision is imposing decisions and regulating the companies, not having a global overview of the financial system. The IMF should not be viewed in these proposals as a global supervisory or worldwide supervisory body, it has more of a role in analysing and giving solutions, proposals or recommendations, but without any binding powers so far at least.
Lord Renton of Mount Harry: Is Mr de Larosiére suggesting that, the IMF in a way takes on further international powers on the whole question of supervision? Is he indeed anticipating a change in the role of the IMF but very much in association with the Financial Stability Forum?
Chairman: I am not sure the IMF are being expected to take on a supervisory role.
Lord Renton of Mount Harry: Developing and operating a financial stability—

Q506 ***Chairman:*** Stability is different from supervising, I think.
Mrs Bros: It could be envisaged that the IMF gives some recommendations on linkage to the FSF on some stronger supervision of such a sector, but to take effect these kinds of recommendations would have to be taken on board by the supervisors themselves wherever they are.
Lord Renton of Mount Harry: I take that point.

Q507 ***Lord Haskins:*** Are you not saying that the distinction is that the supervisor is supervising individual companies whereas the IMF is not in that business at all, it is supervising states? That that is the distinction and the concept of a global supervisor of companies just does not bear thinking of.
Mrs Bros: Exactly.

Q508 ***Lord Woolmer of Leeds:*** What role does France see for the potential future development of the Financial Stability Forum because that is where even de Larosiére sees the possibility of the FSF being developed further in playing a part in global supervisory arrangements? What is the French view of that at the current time?
Mrs Bros: Reinforcement of the FSF is an important way to move forward and at the same time the FSF is different, particularly in the sense that it is an assembly of regulators or supervisors. We believe it is important that there is a link between this kind of forum and the more general and political fora like the IMF whereby the IMFC notably has a very strong role in orientating the work of public authorities. There is a difference between the IMF, which has this political control over it, let us say, and FSF which is more or less based on self-regulation and supervision. Moreover, at the moment the situation is that the FSF is very restricted in terms of composition, but this is something that is being addressed currently and FSF enlargement is a very important issue in that respect.

Q509 ***Lord Jordan:*** While hedge funds are not being seen as the arch villains of the present banking crisis, any study of their worldwide activities show that they are not innocents. Does your Government believe hedge funds should be regulated?
Mrs Bros: Yes. We feel that regulation of hedge funds is high on the agenda at the G20 and also within the EU as well. The meeting on 15 November last year in Washington stated that all systemic actors should be

subject to oversight or regulation and hedge funds certainly are systemic actors because, if I am not mistaken, they account for more or less 50% of the daily activity on financial markets, which is very, very important.

Q510 ***Chairman:*** Where is that quote from?
Mrs Bros: The 50%, I am not too sure. I can try to find that information.
Chairman: 50% sounds a little high to us.

Q511 ***Lord Woolmer of Leeds:*** I thought it would be higher. The vast majority of trading is people taking positions, they are not buying spot. I would have thought 50% is rather low. I would have thought 90% would be very high in the sense of hedge funds taking positions and most trading in the markets is taking positions, not spot, is it not? Sorry to interrupt you.
Mrs Bros: I can try to find out.

Q512 ***Chairman:*** It turns out to be done mostly by banks, but not hedge funds.
Mrs Bros: I will try to find the origin of the number.
Chairman: That would be kind.

Q513 ***Lord Haskins:*** The French Government takes hedge funds much more seriously than the British Government does.
Mrs Bros: I would not dare to give an opinion on that!

Q514 ***Lord Haskins:*** The evidence looks that way.
Mrs Bros: We think it is important to organise some regulation of hedge funds and this regulation should best be taken in parallel at the EU level and internationally because we have a twin-track approach and it is useful that the EU paves the way for ambitious decisions to be taken at the international level because hedge funds are active internationally. The approach that is currently being followed that the European Commission should come up with a proposal to regulate hedge funds during the spring of 2009 seems to us to be the right approach to pave the way for ambitious decisions at the international level. Regarding the design of hedge fund regulation, we are of the view that it should cover at least three aspects. The first one is to ensure registration of hedge funds in the countries where they operate in order to ensure data collection by supervisors. Data collection should address hedge fund leverage and their high level investment strategy, *et cetera*. Alternatively, or together with this mechanism, there could be an EU single registration system in order to simplify the registration process for hedge funds, there is no need to be too bureaucratic or over-administrative. Another aspect is to give prime brokers who finance hedge funds the proper incentives to strengthen risk management control of all the exposures they have towards hedge funds. Basel prudential regulations could be used as an appropriate tool in that respect. Also, there is a suggestion we are making that bankers could be asked to define maximum leverage for each hedge fund which they operate. Finally, we believe it appropriate to define a global European framework for alternative funds, so notably hedge funds, and this framework could include aspects like governance or investor information, consumer protection aspects, risk management and product distribution. Such a framework could create a European label for alternative funds which would be a factor of competitiveness for the European financial markets also and that could be a good option.

Q515 ***Chairman:*** That is interesting. I do feel that has exposed the difference between the two countries. The French Government appears to be much more concerned about all sorts of alternative funds, including the hedge funds, and we tend to dismiss their activity as peripheral. It will be very interesting to see which of us turns out to be right.
Mrs Bros: Yes. Nobody knows at the moment.

Q516 ***Lord Haskins:*** Presumably it extends into short selling, that you would have a stronger position on short selling for the same reason?
Mrs Bros: Yes, probably.

Q517 ***Lord Haskins:*** Would you ban it?
Mrs Bros: Short selling has been banned as a very exceptional measure for some time during the crisis. The financial market authority in France is not considering this as a definitive measure but we think it is appropriate to have at least a co-ordinated approach within the EU on short selling to ban it or take it, but to do it in a co-ordinated manner.

Q518 ***Chairman:*** Against this background I cannot resist asking you about accounting principles and mark-to-market because three years ago I found myself in a great argument with officials from the Banque de France who believed that mark-to-market would destabilise banking as we knew it, and I was taking the typically Anglo-Saxon that, "No, no, it is vital that we all have to do it". I wonder where you come out on that debate. I have moved a little from the Anglo-Saxon view. Does the French Government and the Banque de France still feel that mark-to-market ought to be outlawed?
Mrs Bros: Mark-to-market has not been outlawed but was changed partly last autumn for banks. It was not just an EU move, it was more internationally accepted, notable through IASB. It has been changed and the reason for that was banks were taking a very strong position that these rules were highly pro-cyclical and in the current situation this could lead to an extremely difficult situation for the banks

themselves. In general, not only on these rules but in the IASB the accounting standards, a debate and reflection has been launched on their pro-cyclical effects and it is generally considered they might have some pro-cyclical effects. The way we address this situation is by trying to find some anti-cyclical rules in the EU Directives or through a more general reflection on accounting standards and how to redesign them. We have entered a process of largely redesigning these accounting standards so as to avoid the pro-cyclical bias that they showed in the last financial crisis. Should mark-to-market be outlawed? That is a very extreme position in the sense that mark-to-market exists because it is supposed to give you a very good view of the situation of a company but when markets do not exist or do not function properly, or when they go through ups and downs which are very far from a natural movement, the mark-to-market valuation is partly inappropriate.

Q519 ***Chairman:*** It did at all events turn out to be pro-cyclical just like the Banque de France said.
Mrs Bros: It did.

Q520 ***Lord Woolmer of Leeds:*** Some people have suggested that bank recapitalisations, guarantees of bank assets and other forms of substantial state assistance will distort the internal market. What is the French view of that?
Mrs Bros: We believe that there should be a distinction among different tools for intervention. When the situation appeared that some Member States had to save the banks or guarantee banks because the interbank market was not functioning any more it was useful to have a co-ordinated EU approach so as to avoid distortions which are created by state intervention. We had a co-ordinated approach for guarantees or capital interventions by states in the banking sector. Whilst not all Member States decided to do that, we have noticed in the EU most Member States have given guarantees to their banking sectors to make sure that the interbanking market is functioning or going back to normal. As far as state capital injections are concerned this was done very differently among Member States but there was a common view that this could be an approach and at the same time some criteria were defined for this kind of intervention so that state intervention is limited not only in amount but also in timing. We reached a rather flexible approach which at the same time had sufficient criteria to minimise the distortions. We have now entered a new phase and a new instrument is appearing which is asset guarantees or defeasance structures for the banks, whatever their name is. The presidency, which is now the Czech Presidency, has undertaken the work of co-ordination on this in the sense that we did during the French Presidency of the European Union. There was a common view reached regarding this kind of intervention, not only the fact that these interventions by nature are rather distorting because they address huge amounts of assets in general and, being designed by nature for companies in difficulty, that should be addressed in the framework of State Aid. That is the framework that we have in Europe and the basic condition for authorising those kinds of interventions, because they are authorised on a case-by-case basis by the European Commission, is that there should be compensation for state intervention and that is the best way to limit the distortion of competition which is necessarily linked to state intervention in particular. We have developed a number of criteria to explain what kind of compensation should be taken by the state which allows a company to have this kind of intervention while at the same time keeping sufficient flexibility to address the different cases, some flexibility in the eligibility of assets, some flexibility in the decision of guaranteeing or not the assets, et cetera. It is a very complex tool and I would say there is a difference between this tool and recapitalisation or guarantees because one of the most important questions is the valuation of assets and the price at which the assets are transferred to the deficit structure. So far we have not found the best solution to valuate assets. If there is no common method for the valuation of assets across the board each and every situation might lead to a different level of state support to the company concerned. It is very important to make progress in terms of valuation and this is not finalised yet.

Q521 ***Lord Woolmer of Leeds:*** There is one extreme form to deal with valuation and that is writing it down to zero, the toxic debt, to nationalise a bank, a matter that is of great concern in markets. What is the French view of that?
Mrs Bros: Of nationalising banks?
Lord Woolmer of Leeds: The desirability or not and the potential impact on the markets of nationalisation.

Q522 ***Chairman:*** You have had to bail out a bank, Dexia, the same as us and you must have thought about this.
Mrs Bros: The banking sector was largely nationalised in France 20 years ago.

Q523 ***Lord Woolmer of Leeds:*** I am not talking about nationalised banks, but in the current situation dealing with toxic assets where no-one knows what the value is and the continual creeping of more and more injection of state funds, capitalisation, more and more guarantees against assets that fundamentally nobody knows what the value is, and some commentators, certainly in the Anglo-Saxon press, having said the best thing at the end of the day is to nationalise these banks, write these assets down to zero, a complete loss of value for equity shareholders and so on, but that at least gets rid of this uncertainty. That is a serious debate that has been going on, as you know. I am not taking a view on that but I just wondered if that was the subject of any discussion in France, not because you are thinking of doing it in France but because of the knock-on effects on banks in America, Britain and so on because it could be argued that really would be changing the internal market landscape and the global landscape.

Mrs Bros: In France the debate over capital injections in the banking sector is more linked to the usefulness of strengthening the capital structure of the banks. Most banks in France, even though they have some exposure to sub-prime credits, et cetera, have managed to limit it in the sense they do not have large deficits and the maximum deficit for 2008 was more or less two billion euros which was considered a high level but not comparable to what you can find in the US or even in the UK and other Member States. The debate on capital injection in France revolved around the need to strengthen the capital structure, the tier one of those companies, notably in order for them to be able to continue to finance the real economy. This triggered the debate in France. When a company is nationalised because it cannot respect the tier one ratios or it is on the verge of something terrible then the debate is a bit different. Regarding nationalisation through capital injection and at the same time writing down all of the losses all of a sudden, *et cetera*, the debate is in a way logical because it is a natural way of going back to a starting point for the company. However, nobody knows exactly what the real economic exposure is and if you decide to write down all the assets that might be impaired down to zero, then the capital injection by the state might be very high in order to match the write-downs that you have in the balance sheet. It can be even more costly than other forms of support. Sometimes it can be a first step which proves insufficient and then the other step, which is to guarantee some assets, can be taken after nationalising the bank. In the UK some banks are already state owned and even in those banks some new steps are being considered.

Chairman: Thank you very much. We have kept you longer than we said we would, but thank you very much indeed for coming, it has been most useful.

TUESDAY 10 MARCH 2009

Present	Browne of Madingley, L	Northover, B
	Cohen of Pimlico, B (Chairman)	Renton of Mount Harry, L
	Haskins, L	Steinberg, L
	Hooper, B	Watson of Richmond, L
	Jordan, L	Woolmer of Leeds, L
	Moser, L	

Examination of Witnesses

Witnesses: Mr Eddy Wymeersch, Chairman, the Committee of European Securities Regulators (CESR), and Mr Carlo Comporti, Secretary-General, CESR, examined.

Q524 ***Chairman:*** May I welcome Mr Wymeersch and Mr Comporti to the inquiry and thank you very much for coming. We are on the air and being broadcast on the Parliamentary Channel. You will get a transcript of all your evidence to look at and, after you have looked at it, it will be published at the back of the report along with everybody else's evidence. You will find on the table before you a declaration of the Committee interests. I think one of the more striking of the Committee interests in this particular case is that I am on the Board of the London Stock Exchange and am an ex-banker. I guess it puts me in the dock with everybody else! You have seen a copy of our questions. Would you like to make an opening statement?

Mr Wymeersch: This is a very great pleasure and a very great honour for us, speaking on behalf of the Committee of European Securities Regulators. This is certainly the first time that this Committee has been invited to a meeting with the House of Lords and it is a great advantage that you have invited us and enabled us to explain what our positions are on a certain number of things. Should I perhaps give an introduction on the Committee or is it sufficiently known to your members?

Q525 ***Chairman:*** I think we would find it helpful if you just ran us in by explaining about the Committee. We all understand the Lamfalussy Committee and we are glad to hear about it.

Mr Wymeersch: You have the three committees, one for banking, one for insurance and pension funds and we are the third one, the oldest one, which started in 2001 dealing with markets and securities. We have united the securities supervisors in the 27 Member States plus you have two states, which are Iceland and Norway, the EA states, which are also observers in our Committee. The Commission is also taking part in our work. The Committee is financed by contributions from its members which secures its independence. We are very much attached to the independence of the Committee for reasons which you can understand. The Committee has been essentially an advisory body to the Commission but also a body in which cooperation between the national supervisors takes place. Over time I think the function advising the Commission has become less predominant, and we are now more and more engaged in general work for rule-making for the securities markets. We are making guidance and you say, "You will not necessarily like that," but our guidance are interpretations. Our practice rules are not rules to be compared to the ones which you have at the level of the Council and Parliament. What we are doing is giving life to the rules which are made at a higher level. For example, we have rules about inducements relations to the MiFID conflicts of interest. Directive provisions are trying to detail in which cases there might be a conflict of interest so that market practitioners know this is a case where they should stay out. So it is more refined and more detailed work. In addition, we also do quite a lot of review work, where we find out that the regulations in the Member States are so extremely divergent today, we map these divergences leading to an overview of all the differences in the States which we publish with the intention that you, our political masters, should know how the situation is and also that the Member States could take some action to correct that and to increasingly converge. One of the points is, for instance, the sanctions regime. If you look at the insider trading provisions, in some jurisdictions insider violations are fined with something like €2,000 but in others you will have a fine of €2 million or more. There might be an inclination—and it is a little bit ridiculed—to go to that jurisdiction because there you pay your fine in advance and do whatever you like. That should not be the case; it should be more or less the same. We also have quite a few operational groups. For instance, if insider trading takes place in Europe in several jurisdictions we will call for common action and exchange of information. We have been quite active in two recent cases, which are Lehman Brothers and Madoff. We are collecting information, informing the markets about what to do to protect investors but also looking at the

deficiencies in our present regulations. That is a very brief overview.
Chairman: Thank you very much.

Q526 ***Lord Watson of Richmond:*** Let me just preface the first question in view of what you have just said in the explanation of the work that your Committee does. The mandate for the De Larosière Group was: "how to organise the supervision of financial institutions and markets in the EU; how to strengthen European cooperation on financial stability oversight, early warning and crisis mechanisms; and how EU supervisors should cooperate globally." May I take it that you are happy with that presentation of the mandate?
Mr Wymeersch: Yes.

Q527 ***Lord Watson of Richmond:*** Let us move from the mandate to some of the specific proposals. How do you view the proposals in that report to create a European Systemic Risk Council (ESRC) for macro-prudential supervision and a European System of Financial Supervision (ESFS) for micro-prudential supervision? You were saying that your job is to breathe life into these things. I want to know how you breathe life into that.
Mr Wymeersch: There is perhaps a reservation I should have presented to you right from the beginning and that is, we are securities regulators, we are not banking regulators and you have to be very careful that you do not mix the two sides of the business as they are quite different. In the securities field the concerns for macro stability are less predominant than in the banking field. Our main task is to make sure that the markets function and continue to function efficiently, that the securities are settled, i.e. the post-trade issue, which is an important business, and that there is sufficient transparency in the markets and so on. However, we are also involved to a certain extent in macro issues and in stability issues. The proposals which have been made by Mr de Larosière in general are very substantial. We will have to act on the macro stability issue. We have seen for almost the last two years is a real deficiency in our systems on macro stability, but how to deal with it is another question. I think the Systemic Risk Council could be used as a general overarching mechanism. One of the questions is the composition. I know there is a concern—and I fully understand that concern—that the Bank of England should be involved, which is a political question.

Q528 ***Lord Watson of Richmond:*** Do you feel its proper place is within the European Central Bank or do you think it should be an independent body?
Mr Wymeersch: I think it should be an independent parallel body such as the European system of Central Banks for several reasons. One of the reasons is that unless the UK joins the euro, which I am not going to discuss—If you have **??**thos Council within the ECB you cannot have the other central banks at the same level. So we would have to look at the composition, probably in a separate framework, such as the ESCB. What is the main point of substance? The main point is that we have a mechanism that draws on the national existing central banks or prudential securities supervisors, gets the information on systemic issues, studies at a very high level the systemic issues and then it gives an input to the national bodies. There was such a big imbalance and such a threat coming from the US real estate markets that was not generally known in Europe, although if you look at the financial stability reports by the central banks, it was one of the 15 risks. If you go through all the financial stability reports of all the central banks you will find a large convergence, but the first one was hedge funds, not the sub-prime market. We have to have a mechanism that identifies these risks and then say clearly to the supervisors, "You are going too far. You should correct that." Then the question is how to impose these orders. I think there can be a mechanism of comply and explain and for the monitoring before taking it up finally at the political level.

Q529 ***Lord Watson of Richmond:*** Given what has happened and the crisis in which we find ourselves, there is obviously great concern that in future similar dangers would be identified via an early warning. You have already referred to the fact that Europe did not really see what was coming. Are you satisfied therefore that what is being proposed here is strong enough and substantial enough to achieve that or do you feel we will have to move to a single EU supervisory body in some way?
Mr Wymeersch: As the Systemic Risk Council is the overarching board in charge of identifying these issues, it is not a board itself that is going to do the daily work. You have to have a small internal entity, very independent, very high level, with excellent economists who can analyse these developments and this body will be supporting the work of the Council and it is probably that it can direct in the longer term the activities. In my view it has to be done by a much smaller entity. To have urgent decision making—when something significant is going on, like we have seen at the end of September—there is a major imbalance in liquidity, coming in like a Tsunami within two days—with a board of 31 people, that is not workable. That is the way I would look at it.

Q530 ***Lord Watson of Richmond:*** I feel this is of fundamental importance because what is the point of engaging in great constructions if they cannot actually do the job that is really required?

Mr Wymeersch: You may need the great construction to support this work because you will have to draw on confidential information coming from all sides and if you do not have the support of the national authorities, e.g. the national banks, you will never succeed. There is also an international point here. There should be a good exchange of information with the outside jurisdictions, especially the US, but not only.

Q531 ***Lord Watson of Richmond:*** So it is small, tight, sharp investigatory and advanced warning and then endorsement representing all the Member States?
Mr Wymeersch: But general instructions can be developed in the Council. With all due respect to the economists, general guidelines cannot be left to six or seven economists.

Q532 ***Lord Mosser:*** Macro problems are the result of micro problems, these are not different animals. So what is the case for separating organisationally the micro approach and the macro approach?
Mr Wymeersch: I have been a banking regulator in my former activity and banking supervisors look at the banks one by one and have a very good knowledge of the banks, but what they do not have is the overall economic or financial knowledge. Even the overall knowledge of the banking system is not sufficient because you have to look beyond that. For instance, you have to look at the commodity prices, the oil prices and the real estate market. There are many fields that are not directly in the normal purview of the banking supervisors. It is useful to have this macro entity which has been proposed in the report especially addressing these systemic issues because they will have the necessary sharpness of views to detect gross imbalances. Very often these systemic questions are difficult to detect. Sub-prime was not easy to detect. Some of the others are very easy. If you look at the carry trade going on in the Central European states, it was evident that that would turn sour. There was nobody saying, "You should stop that". I have spoken to my Hungarian colleague and said, "Look, do you really know what is going on?" and he replied, "politically I cannot stop it." There certainly is some virtue in having this body and looking at risks from the different angles, banking, securities, individual Member States and so on, and put these together in one single entity.

Q533 ***Lord Woolmer of Leeds:*** A previous witness said to us that the Lamfalussy committees are under-staffed and under-resourced, music no doubt to your ears. The De Larosière Report acknowledged this. In what ways do you think that the powers of CESR should be extended, and what changes do you think ought to take place in terms of budgets, staff and pay structures to reinforce a revised status?
Mr Wymeersch: I will take up first the budgets and the staff point. Of course we are under-funded and therefore under-staffed because our ambitions are so great. We do a tremendous amount of work with existing means. I would invite you to look at our website. CESR is the most advanced of the three committees and therefore we often undertake work, that is not yet undertaken by our colleagues. We are under-funded, that is right. There are a certain number of things that we cannot do. If tomorrow we were charged with new tasks, and the Commission is asking us all the time to undertake new tasks, we would have a real bottleneck. How to solve that is another question, but I think there are quite a lot of tools to do that. No organisation will ever refuse more means, we know that. We have to find a good balance. We are very aware that the Commission is willing to contribute to our financing. However, we are afraid of having strings attached to the financing. The main string is the one of independence. I have discussed that extensively within the Committee and also with the Commission. If we can come forward with financing without any threats to independence we can go ahead, but we do not want the Commission dictating what we have to do because that is changing the basic pattern. At present our members are all national, independent securities regulators and they would not accept to lose their independence. If the funding would be decided at the European level by the Commission, Council and the Parliament, this direct influence of the Commission would be neutralised and that would certainly be a step forward. Powers is another question. I think we should distinguish between powers and means. What I think is the main weakness in the present Lamfalussy organisation is the fact that we are doing excellent conveyance work, eg making recommendations which are very much supported by the markets, but we are not sure that the recommendations are followed up. Very often we find out that some of the Member States object, although when adopting these recommendations they agree with the text, but in practice the situation may be different. The core of the problem is how to make these recommendations maybe not binding but sticky at least, and very sticky if possible. When we changed our Charter I introduced the idea that the recommendations would be "morally binding" but that was refused by the members. It was a trick but it did not work! If we are talking about having a more harmonized market, indeed an open internal market, we should have more or less the same rules everywhere. If there is one complaint the industry makes again and again, it is that when they go from one state to another the rules are different. Ssometimes the difference relates to very small details, such as the font in which the documents have to be printed. What the states are often doing is

ridiculous from an integration perspective but, nevertheless, that is the way it is. There should be somebody who puts some order into that, so that the firms can address the same issues with the same manner all over Europe. For example, I think it would be interesting to see how many public securities issues there are per year that are truly pan-European. I think you could probably count them on your hands. It illustrates that the internal market still has not been achieved.

Q534 ***Lord Woolmer of Leeds:*** You are expressing frustration with the existing situation but it is not clear to me what new powers you would like. You were hinting that you would like to have binding powers and then you retracted from that. Are you seeking binding powers? What else could make a difference? Would these extra powers require a Treaty amendment?
Mr Wymeersch: What we would like to have is binding powers, this is clear. Binding powers means not only that we declare that the instruments we adopt are binding but that we can actively enforce them *vis-à-vis* the members. Would that require a change in the Treaty? I cannot answer that yet. At present we are investigating with a number of high level lawyers to see what limits there are within the existing mechanisms. The Commission is also working on this subject. The Commission has put forward the idea of creating an agency. There are many—about 26 European agencies. Up to now the Commission has never given rule-making powers explicitly. They are now analysing within the legal service if that would be acceptable. If that is the case, I think we can go forward. If the answer is negative, then there may be a certain number of instruments to make these binding. I will just give you one of the lines of reasoning but there are four or five. What we are doing at level 3 is giving interpretations of existing Directives without making new rules. We say what is inside the Treaty and we elaborate on that, but we do not make new rules. What we could do is set a mechanism whereby the Commission was in charge of Level 4 in the Lamfalussy. The Commission would say, "Okay, that's a good interpretation. Rubber stamp it and you can follow that. If there are violations, I will use this interpretation to go before the European Court of Justice," and use that as a standard interpretation. You are moving towards more binding instruments.

Q535 ***Lord Woolmer of Leeds:*** That would mean that within CESR your participating members would have to agree on some basis that you would make such a recommendation in committee otherwise the functionality of your committee would pretty quickly break apart. So I hear what you say, it seems a rather shrewd alternative, but it does seem to me you do not get away from the issue of how you get agreement amongst 27 members in order to agree a binding rule that then is enforceable, and enforcement must mean penalties. That would remain a problem, would it not? That is not being critical of the idea, but it is a problem with it.
Mr Wymeersch: It may be a problem, but problems are there to be solved. There are two answers: first, what we are doing is the result of work with the 27 supervisors. All the work we are undertaking is not dictatorial, it is cooperative. If we adopt a standard or a recommendation, it is a recommendation supported by the members. Since September last year decisions taken by Qualified Majority Voting but, in any case they are supported by a vast majority of the members. The difficulty is that some of the members may have afterthoughts and then not apply the rule or change it. How to enforce that common rule is a real issue. Imposing fines on our members is rather ridiculous. We will have to find something more subtle than that. What we could do is, within a certain procedure, respecting due process, invite that member to change its rule or practice. If you feel that one of the members is stubborn and does not want to change or to adapt you could say, "Okay, this is the common interpretation, this is the European rule, all 27 agreed on it and you do not want to implement that. We will substitute our view for yours and in your order we will say this is the way it should be read. If that member then contests it, it goes before the courts, but in the meantime the rule is there." It would change the burden of proof and the the legal position.

Q536 ***Lord Woolmer of Leeds:*** How would a strengthened CESR fit into a revised global supervisory system?
Mr Wymeersch: At present CESR is already actively involved in quite a lot of what you call global work, mostly international work. We have a very active relationship with our American counterparts, not only the SEC but also CFTC, FINRA, so we are almost in contact continuously. That is already taking place. It is mostly geared to the UK, I must confess that. We should also be involved in the work of IOSCO. There is a link to be established there. We also have some concerns about some other bodies such as IASB where we are not present in the monitoring board of IASB. Although we applied the Commission did not follow up on our urgent demands. That is a political point. Nevertheless, we have already established this kind of international relationship. I see our function—most of this has not been expressly discussed with the members—as being a technical, implementing function. High level policy matter such as agreements with the US, on the integration of IFRS and the US gap, are political and belongs to the politicians, the Commission,

Parliament and Councils. We are executing policies, but when it comes to deal with the technical matters then we consider that to be our task. We were in quite advanced discussions with the SEC on mutual recognition, but that programme has now been stopped due to the crisis. We agreed on the review of the national systems of regulation within the framework of the agreements made by Mr McCreevy and his American counterparts. The verification work, how our regulations stand *vis-à-vis* the American regulation, would be done by CESR. This is the dividing line between general policy and implementing rules. I think there we have a role to play in the latter.

Q537 ***Lord Renton of Mount Harry:*** I find what you are saying absolutely fascinating. Some of us were in Brussels last week and certainly after two days of listening I came away very much with the feeling that people were searching, but there was a lot of frustration in terms of moving from searching and ideas into actually accepted practice, not least among the executives of the Commission. One of our witnesses previously called the level 3 committees "soft bodies with soft powers". Do you think that is fair? Do you think that the powers of the Level 3 committees should be codified or not? If they were codified, would that put a negative impact on the flexibility of the rules that has been very useful in recent weeks?
Mr Wymeersch: One of the ways of dealing with this is the way which has been indicated by the Larosière Report, that is by strengthening the committees, one would arrive at a system which is, on the one hand, not a European single regulator, a body written in the Treaty, but would be more flexible being based on the coordinating role of the committees and on the existence of the national supervisors. That was in my view the core of the proposal of Mr de Larosière, but you will hear from him what he thinks about it. It is this balance between centralisation and local supervision that is at the basis of this report. I call it central rule making, local supervision. This balance has to be further clarified, but it is something that could work.

Q538 ***Lord Renton of Mount Harry:*** Did you say it is not working?
Mr Wymeersch: At present it is not working. Why? For several reasons. On the one hand it is because the central rule making is not binding. There is no mechanism of transmission to the local entities, which is what I have just explained, and then the division of the remits between one and the other is not very clear. One thing that is clear to me at least in the securities field is that at CESR, there is no ambition to engage in do day-to-day supervision except perhaps for credit rating agencies, but that is very specific. The thousands of prospectuses have to be approved daily cannot be dealt with on a centralised basis. What you have to make sure is that the prospectuses give the same information, least to the same outcome in each of the jurisdictions. You have to make sure that there is a sufficient analysis of risk, that the annual accounts are there, but you cannot detail rule by rule what is to be the substance or the content of a prospectus. You say that at present we are soft bodies with a soft attitude. What was the other word you used?

Q539 ***Lord Renton of Mount Harry:*** Soft powers, which is better than an attitude!
Mr Wymeersch: Our power is the one of conviction, the one of trying to understand what the necessities are of the members and then adapting them. We have no effective powers and that is exactly what has to be changed, that is the main point. If we want to have one single European financial market I think we will have to choose, otherwise the market would remain very fragmented and remain weak and inefficient.

Q540 ***Lord Browne of Madingley:*** Recognising your mandate to do with securities, I am going to ask a question but see if you can relate it to your activities and give us a wider opinion. When the General Counsel of the European Central Bank talked to us he suggested a potentially different way of organising supervision in Europe and that was a two-tier system, one for European chartered/supervised banks (for very large cross-border, systemically important institutions) and second of nationally chartered/ supervised banks. What do you think about that particular proposal and its consequences?
Mr Wymeersch: It is a proposal that has been floated for many years. It is clear that some people think that the only important banks are big banks. However, I think we will have to secure a level playing field. If you make two systems of regulation, which is already a little bit the case in Basel 2 (as there is IRB for the advanced institutions) you will have an unlevel playing field and you will distant competition. There is quite a lot of concern about this point in some Member States, especially Germany, where you have a lot of small banks. On the other hand, I do not see why you cannot apply the same rules in a proportional way to all participants. I should not be talking about banking by the way as this is outside CESR's remit. Sorry! You have seduced me to talk about something I should not. In the securities fields I think it is quite clear that we would not accept that investors for a big issue are better protected than investors for a small issue. They should have the same information and protection. For the banking fields it is delicate, but personally I think there is a question of balance. The other point was who is going to do

the job for the big banks? There we know what the idea covers.

Q541 ***Chairman:*** I want to ask you about credit ratings because to me, as an ex-banker, the problem seems to lie almost entirely with dependence on credit rating agencies. In a situation where, as one witness told us, you have ten triple-A rated banks and 30,000 triple-A rated securities, how can the credit rating agencies ever have taken that line? Is this not in some sense the root of all evil, that securities were very much overrated by the credit rating agencies and banks and purchasers then depended on a rating of some of these very highly leveraged, highly derivative securities divorced from all connection with the original proposal or indeed the original institution? I was in banking in the days when you lent people money and people looked to the bank to see what they were doing. Somehow in the last seven years securities have become rather divorced from the originating institutions. I suppose this is a very general question but I did think that CESR would have a very useful view. What do we do know? I do not believe we have to do it urgently since nobody is depending on a ratings agency any time soon. If we are going to have these securities divorced from the originating institutions how are they to be regulated? Are credit agencies an inevitable part of the system, and what should we be doing to credit rating agencies?
Mr Wymeersch: It is a very general and a difficult question, but let me try to give you some elements of an answer. I think the first point is that the banking system has been relying on the ratings blindly. Why would you rely on somebody saying, "This is a nice pudding"? I think you would like to taste it yourself. That is what they did not do massively. Of course, in the proliferation of the instruments the easy way was to say, "Okay, it is triple-A. We do not care." I think the new capital requirement rules will introduce a clause stating that the bank has to determine itself the quality of the product, but then it can take into account the ratings. That is a better balance, and should always have been like that. There is a definite risk of writing the credit ratings into regulatory instruments because everybody will rely on that. The implicit point is that you will shift the risk to the ratings agencies and that is one danger, but if behind the ratings agencies there will be a supervisor, you will create a moral hazard risk and that we cannot accept. Ratings are useful. By the way, we use ratings for all kinds of purposes. I am sure you happen to go to a good restaurant from time to time and so you will consult a reliable guide that gives you indications. That is also a rating and we happily rely on that. That being said, on the one hand we have to make sure that the ratings are more efficient, that the way they express the probability of default, because that is the only thing they purportedly do—is really based on objective criteria, using robust algorithms and with no conflict of interest, with adequate information and so on. If you go back to what happened in the CDO crisis, this was really a crisis where everything went wrong, starting with the brokers who transferred the mortgages, to the originators and then to the supervisors, the banks. The auditors obviously have disappeared into their corner. There is a real problem, why did the auditors accept these instruments in 2005–06? They did not look into this nor the supervisors nor the central banks, nobody did. What I wanted to say implicitly is let us not distribute blame to anyone when the entire system has failed from the beginning to the end.

Q542 ***Chairman:*** Without distributing blame, CESR seems to me the organisation that knows what it is doing in the securities field.
Mr Wymeersch: More or less.

Q543 ***Chairman:*** That is where the present fount of expertise lies. Should we for the future and without distributing blame and should we for the past have asked CESR to take a more beady view of the credit rating agencies? Has CESR a role in keeping an eye on credit rating agencies?
Mr Wymeersch: The future regulation, which has now almost been adopted at the European level, will give a larger role to CESR, but in an advisory capacity. The reasons are the ones you explained. There is no legal body, there is no legal power. I expect that if the plans of Mr Larosière come true, if we would have an agency, that would probably be the first field in which CESR would have supervisory powers. If an agency structure allows for such powers.

Q544 ***Lord Steinberg:*** Do you think it would be helpful for the agencies if there was a registration process?
Mr Wymeersch: Yes indeed. That is what the European regulation also proposes. It would be registration, leading to a follow up. An the initial registration, the decision will not be so difficult. With the three big ones, you cannot refuse registration, but then the next step is to make sure that the conditions are adequately maintained and that is quite important. There is one point on which I would like to give you my feeling and it is the question of the possible impact on ratings—although the regulation is not very clear in that respect coming from the national bodies, governments, local communities and so on. The agencies have insisted on this point on being fully protected against political influence by the national bodies. The agencies tell me that if they give a downgrading to one of the governments or the public authorities, then the pressure that is being exercised on them is tremendous. I think the CESR

has to make it very clear that this can not be accepted, because then we undermine the value of the ratings. A future European agency would be in charge of implementing this regulation, centralising the procedures. It would be the one-stop shop. We could also develop the expertise as this is not an easy business. We could put the expertise it at the disposal of the markets. It would also avoid this kind of conflict that may exist between the Member States and a rating agency. We have a definite interest in having a very clearly stated independent position in this matter.

Q545 ***Lord Watson of Richmond:*** I just do not want to lose what I thought was a very important observation on your part. Rather than allocate blame to any one agency or any one actor in all this, the entire system failed, it was a systemic failure. The question therefore still remains for us, I think, which is, in all that is now being proposed are you satisfied that we are going to be able to join these things together and that we will have an overview which addresses the systemic problem? My fear is that we are going to separate off lots and lots of items, try and do what we can item by item, organisation by organisation, but that we will not address the systemic problem.
Mr Wymeersch: Supposing we have a coherent system encompassing a large part of financial regulation, having on the one hand sufficient, strong mechanisms for systemic risk and on the other hand a sufficiently organised strong system of financial supervision and in addition you would have the adequate tools, I am pretty sure that we address the issues to refer to. Today we are living in a situation where all the Member States do more or less what they want, they add regulations gold plating provisions, they have add-ons. Take the Capital Requirements Directive, there are more than 100 national reservations. What happened is that when the Directive was made the different states and the banks in the states said, "Yes, but I want to have this small exemption and I want to have this special rule," but afterwards the rule often was not practised because their competitors did not practise. We will have to clean that up. All these special rules stand in the way of our large financial market. That is the fundamental objective. If we want to have a large financial market which is bigger than the one of the US, what is already the situation, we will have to do away with all these small exceptions.

Q546 ***Lord Jordan:*** When you are looking to put something right you have to find out the reason why it went wrong. Is there one overriding cause that caused what you described as almost the mass abdication of duty of responsibility for due diligence by the banks during this period? Some obviously think it is personal greed or gain. Do you see a less disgraceful reason?
Mr Wymeersch: There certainly is a good dose of greed in all this, let us not fool ourselves, but that is going a little bit short. On the other hand, there was so much money available everywhere that you could finance anything. Private equity financed 10 billion, 30 billion and 40 billion deals in two weeks, so there was plenty of money. Why was there plenty of money? You know the answer. There is also the herd instinct. On the products that were launched in the markets, one bank started with so-called capital guaranteed securities and all the others followed and the investors thought, "Oh, this is a safe product, nice, capital guaranteed, I have no risk, I can only have a difference on the return," but it was never explained that the capital guarantee was the claim against Lehman Brothers. Everybody did the same, it was herd instinct, with a lack of due diligence by the investors themselves. It is also a question of were the investors able to understand what they were buying. I think it was before a Commons Committee that one of the leading bankers was asked, "Did you understand the CDOs?" and he answered that he did not. This cannot be. If the banks do not understand what they are buying for themselves, and moreover then they sell it to the public—please!

Q547 ***Lord Watson of Richmond:*** What witnesses also told us was that if they did not buy they knew that somebody else would immediately afterwards. The herd instinct was an impulse not to be left behind.
Mr Wymeersch: I agree with you.

Q548 ***Chairman:*** Mr Wymeersch and Mr Comporti, thank you very much. We could go on all morning. We await the equally distinguished Mr de Larosière to speak to us. Yours is a very practical and useful view and we are delighted to have had it in person.
Mr Wymeersch: Thank you very much for allowing us to explain our position. I hope that it will contribute to the general good—that is the only thing which is motivating us—of our populations because they will need it in the next few years.

Examination of Witness

Witness: Mr Jacques de Larosière, Chairman of the Strategic Committee of the French Treasury, and Adviser to BNP Paribas, examined.

Q549 ***Chairman:*** Perhaps I may call the meeting to order and welcome Mr de Larosière. Thank you very much for coming. We are being broadcast. You will receive a transcript of the session which will become part of the public evidence when you have had a chance to look at it. There is a sheet in front of you which declares the various relevant financial interests of the Committee. I need to declare mine specifically because I am on the Board of the London Stock Exchange and Vice President of the Borsa Italiana, which seems fairly relevant to this inquiry. Mr de Larosière, we have read your report and you have had a copy of the questions. Would you like to make an opening statement?
Mr de Larosière: No. I would prefer to go through the questions.

Q550 ***Chairman:*** Then we will do it that way. Your report outlines a macro-prudential supervisory role for the European Central Bank within the proposed European Systemic Risk Council. Like you, I think we generally feel that there is most certainly a place for the European Bank, it is just a case of where. Would the Systemic Risk Council have any powers that went beyond an advisory capacity, and what would be its legal basis?
Mr de Larosière: As you may have noted, the report does not propose that the European Central Bank (ECB) should take on micro-prudential supervision in the European Union. The report states in some detail the reasons for this position. I will not repeat the reasons. I would just like to state a few views on this subject. Conferring micro-prudential duties to the ECB—which, as you know, is a proposal—in our view would be particularly difficult given the fact that several of the central banks, composing the European System of Central Banks (ESCB), have no competence in terms of supervision. Secondly, in the case of crises, and crises will always happen, the supervisor would be heavily involved with governments that would be asked to provide taxpayers' money for rescuing financial institutions. Would governments accept easily having to provide such funds, which can be massive as we have seen, given that the ECB (in my example the supervisor) would be completely independent in its supervisory activities from national authorities? There would be an obvious problem of accountability and this is something that we had very strongly in our minds. This also applies to a single supervisor, non-central bank orientated. You could imagine having a system of supervision in Europe that would not be centred on the ECB, that would be "independent" but supra national, but it would run into the same difficulties in cases of crises. Thirdly, the Maastricht Treaty does not entitle the European Central Bank to deal with insurance companies. In a world where banking and insurance transactions are tightly intertwined, a micro supervisory system that could not consider by law the insurance activities would run the risk of being a fragmented system of supervision. I understand that the suggestions expressed by some representatives of the ECB were focussed on the eurozone, including countries in the process of their accession to the euro, and were not intended to cover non-eurozone countries like the United Kingdom. You might ask me whether that is a good idea for the euro system. I am not sure it would be because conferring micro supervision to the euro system, which is not responsible for the monetary policy of all the EU countries, would not in my view resolve the issue of an integrated system of supervision. Those are the reasons why we did not favour the notion of a supra national supervisory entity and we preferred, perhaps in a more pragmatic fashion to rely very much on the national supervisors who are close to the field but who have to be more coordinated, and that begs the question of better coordination between the national supervisors which is a separate but associated issue.

Q551 ***Chairman:*** Thank you very much. The ECB proposal that came our way really suggested that since the United Kingdom is on the Council of the ECB it could have a role in relation to all of us, to which I would personally see no objection at all. The ECB is a big bank with a great deal of experience. Given that the UK is on the Council, I had some difficulty seeing why they would not be able to make an effective contribution, including the United Kingdom as well as the eurozone.
Mr de Larosière: I am very close to that view, if I may say so. You know the links I have with London and this city. I was an active participant when I was Head of the EBRD and I know what the City of London is. I also know that most of the banking assets are not in London, actually they are on Continental Europe. I think it would make a lot of sense to have a Systemic Risk Council that was under the *aegis*—I would favour that word—of the ESCB, where the Bank of England is a full and major member, to tackle these systemic problems. I think it would be a plus to have the UK in that entity. It would be a plus for the Union given the importance of the financial system in this country. It would also be a plus for the United Kingdom because in matters pertaining to systemic risks you cannot compartmentalise these matters, you have to have an overview of what is going on. Why did we say, unanimously by the way, in our Committee that the ECB could provide the logistical support to this Council? Well, we said that because the ESCB—and I prefer to use that formulation—is

by definition the grouping of all central banks, be they in the eurozone or not, of the European Union and so this body of central bankers is well placed to deal with systemic issues. I very much liked the question, if I may say so, of Lord Jordan a moment ago when he said if you want to repair things and make new regulations, you have to know really what went wrong. When you look at all this, I think there has been a terrible failure in terms of understanding what was going on on the macro financial scene. The leverage was not easily understood. Letting passively bubbles proliferate was not really understood in its consequences. There was a very rudimentary theory saying do not prick bubbles, you do not know how to recognise them. Yes, with hindsight we know how to recognise them, *et cetera, et cetera*. I think that if you put together central banks in such a body you are going to have the right people in the right place because it is going to force these central banks to be more active on the essential thing, which is detecting systemic risks, understanding the financial system as it works globally. A central bank has a monetary policy function which is obvious, it has a function in terms of payments and settlement, but it also has a function in terms of financial stability. I think some central banks have not been concentrating enough on financial stability. Now they are going to do so. They will have the assistance of the Level 3 committees revamped plus the Commission. Now, you may say that is going to be a very big body, 27 central banks, two members of the European Central Bank, that is 29, one representative of the Commission, that is 30, and the three Level 3 committees revamped, that is 33. Yes, it is big, but you can handle a 33 member meeting and all the more so if, as was suggested by Mr Eddy Wymeersch a moment ago, you can organise a smaller body within that to do the homework. It is very important to have these people meet. They are not going to meet very often. I would surmise that they might meet three times a year but at the top level, which they do not do presently in that format. I think it is very important to have that and to have a secretariat; you need to have that sort of thing.

Q552 ***Lord Haskins:*** With regard to the ESRC, you know the difficulties certain people in the UK have with the ECB. If Britain did not join the ESRC would it be viable without the City of London being involved in it?

Mr de Larosière: I think you could ask the question, "Would it be viable for the City of London to be out?" I would like to put forward a figure which is rarely computed. If you look at the total banking assets in Europe and only concentrate on the assets of the top five banks per country, you see that in Europe this is €30,000 billion. That compares to €4.5 trillion for the United States which, as you know, have a small banking system because they are basically on the markets. If you look at the EU, that is the €30,000 billion, that is 80% of the total worldwide, if you add Switzerland and others, and in that 80% the United Kingdom is only, if I may say so, 16%. So the bulk of the assets of the banking system are in Continental Europe. I appreciate your question, my Lord, but I would tend to look at it both ways. Yes, it would be a pity for this body which hopefully is going to be created not to have the benefit of the knowledge and the experience of the United Kingdom central bank, the Bank of England, but I think it would be perhaps more of a pity if the United Kingdom, especially with the present state of its financial affairs, were to turn its back to something that creates no super national powers by the way. If I may say so, that is a very British concept. You put together the people who ought to know and hopefully will better know and then you get into this hardwired procedure that we have tried to describe in the report, which is when you detect something wrong you issue the warning, that is not compulsory, and you see to it that the warning goes down to the right bodies that are the source of the problem. Let us suppose the European Systemic Risk Council had detected that it did not make a lot of sense to have so much borrowing in Eastern European countries denominated in foreign currencies. Suppose they were in that hardwired system that we have been proposing and then the system forces itself to percolate down. You will have had a warning address to the central banks or to the monetary authorities of those countries that were indulging in borrowing in foreign currencies. They would have had to act and what we say—this is not a compulsory action, this is still a relatively "soft" system—is that you would have to explain if you do not reform, if you do not act according to the warnings recommendations and advice, and if you persist in not acting or in acting in the wrong way then there is a mechanism whereby the European Council is informed of the situation and this is elevated to the political level. You may say will this change things? I have the inherent optimism that this is going to change because it is not just words, it is dangerous to borrow in foreign currencies when your own exchange rate might slip one day. It is not going to be words, it is going to be a procedure, a process. I think it is going to be something that would change the situation. I would very much like that to happen with the Bank of England. By the way, the Governor of the Bank of England could very well decide to be substituted or replaced in one of those meetings by the Head of the FSA if the matter were indeed a supervisory matter rather than a monetary policy matter. It is a flexible entity. We did not want to put 27 central bankers plus 27 plus supervisors together. We wanted it to be centred on the central bankers. We would like this to be integrated into the global system because macro surveillance by definition is global.

You cannot do macro surveillance in the EU and turn a blind eye to what is happening in the United States and in the rest of the world. What we propose in the report is a very close-knit relationship between the Systemic Risk Council and the Forum for Financial Stability that would be enlarged geographically with the IMF, with the Basel Committee and the like. I think the chapter on global linkages, which is the last one of the report, provides quite a number of helpful proposals in this field.

Q553 ***Lord Watson of Richmond:*** It is very stimulating to hear you thinking allowed in this way. I particularly enjoyed the reference to the Governor of the Bank of England. It would not be like a football match where the manager would replace one player with another, it would be his decision. Right at the beginning of this session you used the phrase, and you did so very deliberately, "under the aegis" of the ESCB and that is your preference. Can we just press that to a greater point of definition? Is "under the aegis" under the authority of or with the facilitation of? If a danger is perceived and identified is action simply advised or is there a procedure which would go back to the European Council but which would actually authorise something has to happen and by a certain time or there are definite consequences?
Mr de Larosière: If I may say so, although this is perhaps a little bit out of my reach, I would have loved to have you on the Committee because you are asking exactly the right questions. We encountered these problems. The word aegis is sufficiently flexible to give the idea that the ECB would provide the technical assistance, crunch data that it would receive from the national authorities and provide some facilities in terms of location, like the BIS does it with the Basel Committee. No, the ECB would not be the driver in the seat. The drivers in the seat would be the central bankers composing the General Counsel of the ESCB. That is a nuance you might say but it is a very important one and particularly important in this country. We tried to do it with some clarity because these things are sometimes difficult to explain, especially when you write a report that is not in your mother tongue. We tried to express the view that I have just given. It will be the gathering of these central bankers, who will only come together two or three or four times a year, depending on the circumstances, that would provide the advice and the guidance. It would be helped on a technical basis by the ECB and there is nothing wrong with that. That is basically what I had in mind.

Q554 ***Lord Renton of Mount Harry:*** How would you translate the word *aegis* into French?
Mr de Larosière: I thought this was a French word—*egide*! It is sad to see how little the French language is known in other countries.

Lord Renton of Mount Harry: It is a very important word.

Q555 ***Lord Haskins:*** At this stage the only institutions which can recapitalise banks are national institutions and therefore if the power lies where the natural fiscal costs lies then Lord Turner argues that that means ultimately the regulatory power must lie with the national institutions. The question is whether it is conceivable in the future that the EU should get engaged in what is called burden sharing; in other words, if banks fail in poorer countries larger countries like Germany could perhaps intervene. This discussion has already taken place around the Irish banks which have failed, as to whether the ECB should be participating in that, including a deposit guarantee scheme which worked right across the EU. What are your views on all that?
Mr de Larosière: What Lord Turner said, which is that regulation has to be where the money is, if I could put it simply, is one of the strong reasons why we have not proposed a single supervisory power in Europe. When you have in the EU some €3,000 billion that has already been spent on guarantees and re-capitalisations, without counting the last figures that I just read in the press on Lloyds and RBS, it is absolutely obvious that you are not going to be able to move those funds if it is a supra national entity that has nothing to do with the political powers that says, "This is the bill". It is not going to work. Your question is very interesting, if I may say so, my Lord, because you say, "Could you imagine having a burden sharing system that would be at the European level, at the federal level if you wish, which could justify the existence of a single super national supervisor?" I am not the master to answer that question. It is really a very political question. It means that the Union would have turned towards a very strong federal budget because you need a lot of money to do these thousands of billions of rescue operations. To be honest, I do not think I will see that in my lifetime.

Q556 ***Lord Haskins:*** It is excluded from the present Treaty arrangements.
Mr de Larosière: Yes, because you have the "non-bailout rule". I really think it is not realistic at all to start writing in advance proportions of burden sharing country by country. I think that is bound to go down the drain. What we wanted to do in this report was not to agitate bold ideas, which by the way are not necessarily good it was to try and arrive at a reasonable set of proposals that would be seen globally as improving on the present system and hopefully avoiding a repetition of what we have seen. It is not that the report is a key to avoiding any future crisis, I think that would be very foolish. No, the report says we will not avoid future crises, but what

we could and what we should and what we must avoid is the repetition of this massive set of events that led to the crisis. One of those massive events was the looseness of monetary policy, the excessive laxity of money conditions, very low spreads, very low interest rates, sometimes zero in real terms if you look at inflationary expectations, and all that of course, with the herd instinct and greed and all this, fostered an over-extended, over-leveraged system that, as always, breaks down when things reverse. That we can avoid. The amount of the blindness in terms of what was going on, leverage, the mortgage system in the US, monetary policy, the imbalances in the world, is perfectly detectable in rational minds, but will the politicians follow? Will they accept that when good times come back you put buffers, capital requirements on financial institutions so that you dampen somehow the enthusiasm of those years and use those buffers in bad times? The force of the vested interests is such that governments have to be very strict. I think central bankers are probably the best placed to take away the punch bowl when the party starts getting a little hectic.

Q557 ***Chairman:*** Other witnesses have floated a sort of soft suggestion with us, which is that it must be a bridge too far to have a committee and a fund to bail people out. Would the involvement of Treasury officials from the Member States in colleges of supervisors be a practical way of starting to address this difficulty?
Mr de Larosière: You mean in colleges of cross-border banks?

Q558 ***Chairman:*** Yes. Somebody who, if not themselves directly responsible for a bail out, would be able to alert their Member States of the potential.
Mr de Larosière: I think you have to have a division of responsibilities. The supervisors are in charge of supervising, it is not the Treasury people. Supervisors must do their work. When it comes to cross-border institutions it is a good idea—and this is now being applied more and more—to have colleges of supervisors which are in a way under the aegis of the home supervisor and to have these people talk, share and hopefully decide on what to do. To have Treasury representatives in those supervisory colleges I think would be a mistake because it would reduce the independence of the colleges and it would blur the responsibility lines. When a crisis—God forbid—erupts then of course the Treasury people are involved in dealing with the crisis, in the rescue operations, which become then a joint operation between supervisors and treasuries. That is what has happened over the last few months. I would not put them in the colleges or in the supervisory bodies ahead of events. If supervisors they have not done their job in a reasonable way, if they have proven to be incompetent in the prevention phase, then national authorities have the leeway to sanction their supervisors.
Chairman: The suggestion probably came from the Treasury now I come to think about it!

Q559 ***Baroness Hooper:*** I want to revert to your comment about not allowing this massive buildup to occur again. It seems to me that the problem was in part due to the complexity of the transactions, the volume and the speed with which they were carried out. That has only become possible because of new technology and the ability to press buttons and make things happen very fast. When you referred to the need to bring in buffers, does that actually mean time? Does it mean there should be more time introduced to the system or an allowance of more time so that people can think about what they are doing as well as just press buttons?
Mr de Larosière: If I may say so, I think the problem is perhaps more complicated than just a technological problem, computers acting at the speed of light. I think it is that the securitisation has been perverted. In the old days banks kept most of their loans on their balance sheets, because securitisation was a rather small part of their activities. By definition, the rotation of the balance sheets, the speed by which banks could "rejuvenate" their balance sheet to lend again, because they are always constrained by capital requirements, was limited. Now you can, like with a magic wand, take out of your balance sheet through securitisation a lot of credits that you have been originating and therefore, as I said in familiar language, you rejuvenate your balance sheet perhaps in 14 or 15 days and then you can start again and you are always okay with your capital requirements. The system turns much quicker and introduces a multiplier effect that is enormous. Things are worse than that because it happened that the process of securitisation was used not only to give banks more leeway in the way they could provide credit to their clients, but the system was abused in the sense that investment banks and also the investment part of commercial traditional banks started to construct very complex products that were not only the reflection of the initial securitisation of a simple credit, be it for instance a mortgage loan. Banks started mixing different types of credit in one instrument. They started slicing these products and organised them in different layers which were proportionate to what they thought was the risk of these products. That was a completely different ballgame because banks thought that they could continue doing more and more risky types of loans given that they had the facility to sell them off to the investors' world and this is exactly what they did. So it is not only the speed of the transaction, it is also the deterioration in the standards of credit quality that

became the problem. Of course the credit rating agencies, which you mentioned a moment ago, have a great responsibility in all this because they participated in the rating of these very complex instruments without having the tools that would have allowed them to do a reasonably good job in rating them. I think it is very important in times where things seem to go well, because assets tend to increase in bullish times, to have regulators and supervisors who impose on financial institutions the obligation to constitute reserves either through dynamic provisioning, as sometimes it is called, or through increases in capital requirements. This would dampen the exuberance of financial institutions in good times and you could use these buffers in bad times, therefore reducing the procyclicality of the system because nowadays when you have no buffers and when times become very difficult the only option you have is to sell your assets and therefore you precipitate the downward trend. We have to think in terms of a longer time horizon, on that you are absolutely right and this is true for the Basel rules, this is true for the accounting rules which have systematically privileged short-term recognition of profits and not "through the cycle" evaluations. I think all this has to be, as we propose in the report, reviewed and overhauled.

Chairman: We are running out of time. I am terrified personally of the House of Lords lunch arrangements! What I would really like to do is to ask Lord Renton to ask the question about the Level 3 committees on which we would most value your opinion.

Q560 ***Lord Renton of Mount Harry:*** Your proposed European system of financial supervision does build upon the Level 3 committees. Can you outline to us perhaps how you think their powers might be increased, what measures could be taken to ensure that they are effective, whether these changes would require a Treaty amendment and how the proposed ECFS could mediate successfully between national supervisors?

Mr de Larosière: The "authorities" that would be the translation of the present Level 3 committees would be in our view endowed with limited but effective decision-making powers. I will list five examples of these limited powers and afterwards I will try and answer the legal question. For cross-border institutions, authorities would have the power under our proposal to make legally binding mediations when there is a divergence within a college of a cross-border institution. You could have a home country that is completely against an interpretation or rule that emanates from the home supervisor and in that case you cannot just rely on conviction, persuasion, peer pressure, but you have at one point to decide. We thought that giving that decision-making power to the home supervisor was not a do-able idea.

Q561 ***Lord Renton of Mount Harry:*** It would not work.

Mr de Larosière: It would not because you have a number of countries, in particular in Eastern Europe, whose banking systems are practically entirely owned by other banks, foreign banks based in Europe. The idea that the bank of such a country, as well as a central bank, or a supervisor of such a country should be completely under the dependence of a home supervisor, the supervisor at the headquarters of that bank which might own 30% of the local market share, is something that does not fly. If the Directive on Capital Requirements has been practically made void of its contents a few months ago, it is exactly because of that. There has been unanimous opposition from these countries. When peer pressure does not work, when there is a remaining conflict between the home and the host country you can elevate that issue, which is of a technical nature of course, but which could be of very great importance for the host country, and bring that to the independent, upgraded, Level 3 committee that we would call an "authority". Then the perspective is different because these authorities are independent, they have a board, they have a mandate. They are not just going to decide "This is good for you". I think that is probably the only way to make it work. That is the first one, mediation powers. The second one is gathering information from other supervisors cross-border wise. If you look at the way some cross-border banks have been living through the present difficulties in some European countries, you see that the importance of exchanging early information within the colleges between the supervisors is of the essence. The Level 3 upgraded committees would have a decision-making power, if I may say so, to obtain this information. The third example is to ensure the consistency of prudential supervision for all actors and that is very important given what Mr Eddy Wymeersch was saying a moment ago on the fragmentation of the rules and the interpretations of the rules at a national level. So it is very important that in some cases, when you have two, three, four, different interpretations of the same rule—and the British insist very much on that and they are absolutely right—we should have one rule book, it is the only way to have a football competition work, you need to have that. When you have different interpretations we think that that authority should have the decision-making power to say, "Well, that's going to be the right interpretation." It is not a revolution but it is something that is important. These committees will be the emanation of all the supervisory authorities. The fourth example is licensing and supervising some EU-wide institutions like credit rating agencies or post-trading infrastructures. You need to have at the level of CESR the authority to license and to survey, for instance, credit rating agencies. You said a word about that a moment ago. I do not think this should entail at all a micro-prudential role on the agencies to check whether such as such a rating is all right or not, that is not at all the spirit. The spirit is to give them a licence after having checked the quality of their teams, their knowledge and then to look at what they have been doing, sort of a performance test. If the performance test is not satisfactory you can have sanctions that are graduated, you can say, "Well, some sectors you are not going to be dealing with for the next year because you have not performed well," things like that. These are the main examples. They are limited. Do they need a change in the Treaty? I am not a lawyer. We were asked when we started this work four months ago not to enter into the legal aspects of what we were proposing and I think that was very wise. They asked us to make our proposals. They said to listen to these gentlemen, Level 3 committees, and we heard them all.

Q562 ***Lord Renton of Mount Harry:*** They are sitting behind you!

Mr de Larosière: Yes, they are. This time I am speaking and taking advantage of that. We heard them and we made up our minds unanimously by the way. It is very rare that in a report all the proposals are agreed upon by all the members. We thought that those limited enhancements would be fine. Will they entail a change in the Treaty? We have been told by our friends at the Commission: probably not. None of our proposals goes as far as entailing a change in the Treaty, but I am not a lawyer. This is going to be reviewed by the Commission and their legal specialists and we will see.

Chairman: I must thank you for the most interesting evidence session. I am afraid you have got another one this afternoon with some of my colleagues. I hope they will be asking you slightly different questions. I do thank you very much for coming. It has been incredibly useful.

WEDNESDAY 25 MARCH 2009

Present	Browne of Madingley	Northover, B
	Haskins, L	Steinberg, L
	Hooper, B	Trimble, B
	Moser, L	Woolmer of Leeds, L (Chairman)

Examination of Witness

Witness: Mr Philip Lowe, DG Competition, examined.

Q563 ***Chairman:*** Welcome, Mr Lowe, it is extremely good of you to visit us here in Westminster and to give us your time. It is a busy time for you, I know. Verbatim minutes are taken and, as you know, I am sure, you will have the opportunity of seeing a draft of those, and if there are any tweaks that you need to make, you will be able to do so before we publish. We have only 40 minutes or so and we have a number of questions we want to get through. If it is agreeable to you, I would like to go straight into questions, but at the end if you feel there is something we have missed that we really ought to have in our mind in these times, we will give you the opportunity to fill in the gaps. Is that agreeable?
Mr Lowe: That is perfect.

Q564 ***Chairman:*** Could I start off. How is your directorate, DG Competition, working to ensure that bank recapitalisations and other rescue measures do not distort the single market? We have seen the list that no doubt is being added to probably weekly. There is an enormous list of rescues and capitalisations and so on that have been going on. How are you working to ensure that these do not distort the single market?
Mr Lowe: Our role, alongside the central banks, who are very much concerned with restoration of financial stability and providing liquidity, and alongside the regulators, who are concerned to ensure solvency, is to vet, monitor and authorise the intervention of public authorities into financial institutions and others under state aid disciplines. Why are there any state aid disciplines in the European Union? First of all, because public intervention into markets can cause spill-overs in terms of unfair competition between Member States, it can also cause problems in so far as some banks are helped and some are not helped and the result is serious difficulties on the market in terms of not just competitive distortion but moral hazard. Naturally, in dealing with banks in difficulty and other institutions in difficulty, it is also important to have an orderly management of situations of insolvency and rescue. The way in which the European Union, and in particular the Commission have developed state aid disciplines in this respect is outlined in the so-called Rescue and Restructuring Guidelines. Basically speaking, Member States are given a very flexible framework for rescue of firms or banks in difficulty. But, within six months of the rescue, either they have to reverse the aid because they have solved the problem or they must put forward a restructuring plan to restore the firm's or bank's viability. For banks this is the case with respect to not just recapitalisation schemes, which offer immediate rescue to individual banks but also to the granting of guarantees and the relief of impaired assets. How have we dealt with it internally? We are organised as a competition authority, looking at competition problems in markets. We have to know what is going on in markets before we use legal instruments such as antitrust or state aid law to intervene in them and therefore we have organised ourselves, primarily, on the basis of a division of our resources by markets. At the beginning of last year, one of our markets Directorates, dealt with financial services fiscal issues and pharmaceuticals. By the time we entered into the period after the collapse of Lehmann Brothers, we had around 40 people dealing with financial services but whom we transferred to financial crisis cases. But we also redeployed, within a fortnight, another 26 people from elsewhere in DG Competition into the area to deal with the crisis measures. That meant that we had just under 70 people who were immediately redeployed to deal with the schemes and taken off other work throughout the DG. We are a project-based organisation. We have to work by teams. We are deploying staff flexibly because whether it is in the merger area or the state aid area or antitrust, we are faced with priorities which change. As a result, however, of the initial urgent redeployments we asked the Commission to authorise the immediate recruitment of some extra staff to help us, particularly those who had a deep knowledge of the banking sector. Today we have already been able to recruit 33 extra people, which has allowed us to redeploy back the people we had on other tasks. The main focus of the 50 state aid decisions taken so far has been on rescue situations: 24 individual measures for individual banks and 26 schemes of which already five have been amended. When I refer to schemes, I mean national initiatives taken where they ask the banks to take part or they open eligibility for the banks to benefit from them. We also have four ongoing in-depth investigations

related to restructuring plans which need to be authorised before the aid can be finally approved. Restructuring is the second and more disciplinary part of the dealing with banks. Rescue provisions are flexible. They help restore confidence in the situation of the bank and restore market confidence. But restructuring in the longer-term is a crucial element, not just to help restore the viability of a bank, but also to restore market confidence. Because if the market does not feel that the bank's underlying problems are being tackled, then there is continuing uncertainty and continuing lack of trust. The six-month period which Member States are given to submit restructuring plans is coming to fruition for many of the beneficiary banks which we are dealing with now, including those who benefited from recapitalisation schemes. There is around €320 billion of recapitalisation aid, €2.1 trillion guarantees and €400 billion in asset relief which has been authorised, although the take-up by individual banks remains below that level. All these schemes and measures benefit individual banks. It means, nevertheless that for banks which have already received aid, restructuring plans must be submitted within the six months. These plans have to ensure that the banks concerned return to viability. And returning to viability means the capacity of a bank to operate profitably on the basis of a sustainable business model without state aid, in competitive market conditions, in line with all the relevant regulatory requirements. And these requirements may need to change in the light of the current crisis, for example with respect to capital adequacy and risk exposure. In addition to looking at the issue of returning to viability or, alternatively, winding down, which is equally a reasonable scenario for many banks, we have to look at the competitive impact of the aid provided. The aid has been provided for rescue. It can be continued but must be transitory, for the period of restructuring. The restructuring may need to be deeper if the effects of this aid on the competitive position of the bank *vis-à-vis* its competitors is significant. In the past, when dealing outside the context of a systemic crisis, we have been asking for significant downsizing of businesses and divestments of those parts of the businesses which cause serious risks to viability, but which may also, if continued, cause some permanent damage to competition on the market.

We have not yet reached the stage of hard negotiation of restructuring issues. However, if one looks back, before the fall of Lehman's, to the initial cases we dealt with, which had characteristics of failing business models which needed to be addressed,—I refer, for example to German cases, Sachsen LB and IKB, both of whom had invested heavily in subprime in various subsidiaries—they have had to downsize as part of the decisions taken to authorise the recapitalisation of the banks concerned. For Northern Rock, we expected that we would already be taking decisions very soon on the extent of restructuring. However, as you are aware, the UK authorities changed their mode for the future of Northern Rock, creating, on the one hand, effectively, a bad bank and, on the other hand, proposing a good bank which would expand lending to the real economy. It is not the intention of state aid control, and of those who are looking at a bank's activity from a wider competition point of view, to prevent people expanding their business if they are competing on the merits. but the important thing is that if they are going to compete on the merits, the activities of that bank, or any other bank, must be shown to be capable of being based on a financial structure which does not depend upon public funds. I would like to just add there that the issue of whether a bank is in public ownership or private ownership is not something which is addressed by the European Union: the law in Europe is neutral on that question. The test we have to apply is whether any public owner is acting in a commercial, market-oriented way. It is often difficult to apply as a test, but it is the one which we do apply and it is something which we have been applying for more than 40 years. There is a considerable degree of European case law which has been robustly massaged in the European courts on this issue. So we have some benchmarks to work to. To conclude, we are on our way to the decisions on restructuring which need to be taken. We have already taken decisions on several cases which came to a head before the crisis. But, for example, the major schemes for individual banks which have been the subject of considerable discussion in the Netherlands, the United Kingdom and Germany, remain to be taken in the course of the next three to four months.

Chairman: That is very helpful indeed. You have covered parts of some of the questions, but, if you will bear with us, we may go over some of them again.

Q565 ***Baroness Hooper:*** Thank you. Indeed, I think my questions follow on very closely from what you have been saying, but I still think there are two specific areas that I may raise with you. One is would the Commission, as part of the European Union policy, allow a bank to become insolvent if you believed the recapitalisation plans would distort the single market and financial services, and the second question is how are you ensuring that Member States are implementing their plans to restructure or wind down businesses that have accepted or been given state aid? In saying this, I would like to emphasise that this area of the single market is one in respect of which the UK is, I think, wholeheartedly in support; so we do believe the single market is a very important issue.

Mr Lowe: The presentation of a restructuring plan following any rescue is a legal requirement on Member States, and until they obtain authorisation for that plan,there is no legal certainty as to whether the aid is approved or not.[1] If we come to a negative view about a restructuring plan, there is a serious decision to be taken by the Member State concerned. I give you the example of our longstanding investigations of Polish shipyards over the last few years where there has been a clear indication from the Commission that certain yards are not viable and, therefore, need to be the subject of winding down, whereas others can survive. It is quite clear that in the area of banking the need for urgent rescue decisions is part and parcel of resolving the crisis as a whole. On the other hand, rubber-stamping is not possible for the Commission. We have to look very carefully at whether the models proposed for the banks to get out of the crisis are viable ones. The conditions for viability have changed significantly from a year ago. There is definitely an undervaluation of risk, and forms of investment which have been undertaken up to now have been called into question. I would expect, in all cases a very rigorous examination of viability plans and a very strong insistence by the Commission to make any necessary changes. I am not quoting any individual cases, but I can assure you that this is the subject of active debate with all the finance ministries and there are serious issues to be addressed. I am referring not simply to the competitive impact of aids and the consequent need for further reduction in the activities of the banks to prevent competitive distortions, but also to the whole issue of asset relief which requires very vigorous analysis of what valuations have been carried out. For that purpose, in conjunction with the European Central Bank, which has agreed to help us, we are examining the impact of asset relief measures. I would underline again that the approval of any restructuring plan is a legal requirement. The plan has to be approved. Otherwise the aid can be attacked in court and in the end recovered from the bank concerned.

Q566 ***Baroness Hooper:*** This is the European Court?
Mr Lowe: Yes. In fact, anyone can go to a national judge and get illegal aid recovered. This is possibly the strongest power under state aid rules in the European Union. But it is a situation which we would not want to get ourselves into in a context where, as I said at the beginning, we are trying, together with the central banks and the supervisory authorities, to contribute in the short term to restoring financial stability and normal market functioning by authorising assistance in the short-term, but making sure that longer-term measures are taken, and that "longer-term" cannot mean decisions in one or two years' time. Market confidence is seriously affected by the fact that there has not been, as yet, adequate clarity as to what the future business model of banks, which are currently in difficulty, will be, and how viable they can be in the longer-term. I have no doubt that these state aid powers of the European Union have been an unexpected but very useful instrument for getting some coherence and co-ordination between interventions of Member States in the crisis. And this leads on to one of your other questions: do we need to change the rules? We do not need to change the principles or the basic substantive rules. However, we have learnt that we have to take decisions on a timetable relevant to the reality that we are dealing with. The Commission has therefore given Neelie Kroes, our Commissioner, an empowerment to intervene, if necessary, on the day, to approve rescue aid. It has also made it obvious to us that it is not possible simply to take a legalistic approach to state aid control. You have to enter into a proper dialogue with all the authorities concerned, central banks and others, to explain what the intention of the intervention is. The intention is to ensure a return to viability, to look at the competitive impact, to make sure that the long-term effects on the market are not negative and to ensure that the signals for proper functioning of markets remain intact. If we leave these decisions on restructuring indefinitely on a calendar which will stretch beyond 2009 in many cases, we risk entering the kind of world in which there would be piecemeal recapitalisations of banks and, in fact, almost a "Japanese-type" situation of zombie banks, instead of creating what is needed for the rebirth of a functioning banking sector in Europe, which is good banks, viable banks. I would just add something on the issue of future regulation. If you want to prevent a crisis, you certainly can use regulation to do it. A complementary and important instrument is to be able to deal with insolvency in a way which does not have systemic effects. Just because a bank has not become competitive, does it mean it should be immediately saved? And if it does fail, should that have immediate systemic effects? It seems to us that it is essential to keep using the instrument of control of aid for rescue and restructuring in order to have an orderly management of possible insolvency situations. But leaving decisions on restructuring hanging in the air creates as much lack of trust and confidence in the market as preceded rescue measures, which has been the characteristic of the last year's activities.

Q567 ***Chairman:*** We have got four more questions to get through.

[1] *Note by Witness*: If we declare the aid incompatible, then the funds have to be recovered by the Member States, with obvious consequences for the bank concerned.

Mr Lowe: I am sorry; some of these answers overlap.

Q568 ***Lord Haskins:*** Viability. You talk of returning to viability and you mentioned the Polish shipyards, which we have been discussing for a number of years now. It seems very optimistic to assume that the banks are going to return to viability on your terms, ie without state aid, in the foreseeable future. We might be looking at this in five years' time, 10 years' time.

Mr Lowe: I think the issue is about taking decisions on restructuring—that is the urgent timetable. The implementation of a restructuring plan, including elements of state aid for a period of time, will take a much longer time. But surely the essential discipline here is to make sure that state aid, when it is given, is necessary, proportionate and transitory. That is a general prescription which is distinct from the specific situation where it is decided, for one reason or another, to take any particular institution into permanent public ownership. But even when a bank is in permanent public ownership. it does not mean that state aid is not present.[2] As you know, there are some Member States of the European Union who are quite happy with public ownership as the basic model and where we have continuing negotiations and debates in order to ensure that they comply with the law.

Q569 ***Lord Browne of Madingley:*** Coming from a slightly different angle about the crushing nature of the economic crisis combined with bank recapitalisations and the effect of that on Member States who might move to take action to make policies which create protectionism. Are you seeing it, do you think it is going to happen and what would you do about it?

Mr Lowe: The first issue is whether, in fact, banks themselves have any alternative but to turn to their national authorities if they want to have support for a situation of potential insolvency. There is no mechanism for a European-wide or even global rescue of cross-border banks, although there are plenty of moves towards dealing with situations of insolvency on a cross-border basis between regulators But in terms of looking for support in terms of guarantees, or loans, or recapitalisation, it is natural that they go to the Member States concerned. However, if the Member States themselves start imposing conditions on the banks which have the effect of being discriminatory, then we take action. As I think Anthony Whelan must have told you, there has been virtually no scheme where we have not had to intervene to correct texts which gave the impression, if not the reality, that the measures were designed to help national banks as opposed to other banks operating on their territory. We take action when there is any discriminatory element of a scheme which has to be authorised by us The next question is: what about the downsizing of banks in order to achieve viability? Is there an automatic assumption in the minds of either the heads of the banks concerned, or the ministers of the country concerned, that the downsizing must create some kind of national champion or be based on retrenchment on national markets? From our point of view—the point of view of state aid control—the issue is viability and competitive impact. In a number of situations, viability depends not on retrenchment nationally but on maintaining activities in other countries. That has been, for example, the case in Sweden, where banks have a very strong presence in the Baltic countries, and they need to keep that pressure to ensure viability. In relationship not to banks but cars, the President of France recently seemed to indicate that the loans to be given to the French car industry would be dependent on protection of jobs in France. However, we were able to obtain written assurances from the French Government that this was not the case. It is obviously not possible for the Commission to control all behaviours or all decisions inside individual boardrooms, because, despite what is written down, it is, indeed, possible that decisions could be taken with a degree of political influence. But I think one should be relatively heartened by the fact that all the official statements of the Heads of State of the European Union, running up to the G20, but also in the European Council, strongly back the need to fight protectionism and strongly back the need for the Commission to use its legal powers to step in if there is any protectionist element in national initiatives. We have done that many times in the energy industry, where there was a considerable attempt at national level to frustrate cross-border mergers. Of course, any delay in a merger can prejudice the final results. In the last major situation we had in Spain, we were frustrated in our capacity to protect a bid from one Member State to a Spanish company. Happily now, that Spanish company is in the hands of another Member State company and there is cross-border competition coming into the market. In banking, as in other sectors, it is essential that there should be no element of barriers to entry between markets. That being said (and this is a final remark to be realistic), if indeed the viability of the bank depends upon some degree of retrenchment, we are not in a position to dictate in a micro-way all the different aspects of that from a geographical point of view. It could be that in one case, a Spanish subsidiary is heavily loss-making, for example, because it has been involved in the construction boom and, therefore, there is an objective reason for downsizing, which is nothing to do with national

[2] *Note by Witness*: the test under EU law is whether publicly owned undertakings are, or are not, behaving in a commercial way.

fragmentation but to do with the economic reality behind it. That is the general philosophy, and it is a constant battle to look at the perception and the reality of what could be protectionism. I think that my own Commissioner, and previous ones, have tried to act as beacons for protection of free markets across the European Union.

Chairman: On a related theme, Lord Trimble.

Q570 ***Lord Trimble:*** Mr Lowe, a couple of times you have mentioned Lehman Brothers, and we vividly remember how, a matter of hours before it went insolvent, a very substantial sum of money was transferred from London to New York, which then left the institution in London seriously short of resources for the obligations on it. If a similar situation were to occur within the single market and you had a cross-border institution and funds were being repatriated from one country to another, would that have an impact on the single market and is there anything that can be done to effect this?

Mr Lowe: I referred earlier to the negative spill-over effects of national schemes and, as you remember, when the Republic of Ireland's scheme was first announced it was clearly discriminatory. Not only was it discriminatory between Irish and non-Irish banks. It offered guarantees to new deposits and it caused, over a few days, a considerable degree of capital flow which, happily within a week we were able to remove. We were not able to reverse the flows, but we were able to remove the discriminatory nature of that characteristic similar regime through amendments to the scheme which were agreed by the Irish Government and on the other by the introduction of guarantee schemes in other Member States. With respect to situations of potential insolvency where there are transfers going on—and this is only a personal view—I believe that the primary responsibility here is with the supervisors and regulators, who in principle are in charge of administering the process. They have the detailed knowledge of when a bank is reaching capital inadequacy, at which point there has to be some behavioural control in order to make sure that there are not effects which make the situation worse for competitors, consumers, creditors, shareholders and everyone else. I believe that in the regulatory reform programme, which the Commission has promised it will bring forward, based upon the De la Rosière recommendations, there will be proposals to tighten up the whole process of dealing with insolvency from a regulatory point of view. These proposals should address the phenomenon. But from a state aid point of view, we are normally faced with a *fait accompli* where something has already happened which forces the Government to intervene.

Chairman: You have led very neatly on to Lord Steinberg's question.

Q571 ***Lord Steinberg:*** Central banks provide liquidity and not capital, but in December 2007 the Commission said that the emergency assistance by the Bank of England to Northern Rock did not constitute state aid. We all know, I am sure, that each country looks after its own interests first, so there can be accusations of being discriminatory and protectionist throughout anything and, obviously, the Northern Rock situation was the Bank of England looking after our own problems based here in England. However, the situation of illiquidity can very quickly go into insolvency. I am not sure whether the rules on state aid by the banking sector have been adequately written out and taken into account. Would you be kind enough to comment on that?

Mr Lowe: Yes. At the time of that assistance, we were discussing with central bankers and supervisors a guidance paper on how to deal with rescuing and restructuring in the banking sector. Fortuitously, by the way—it was a year before the crisis—and one of the main issues which they brought up was the extent to which we would want to classify all liquidity assistance as state aid, which could be one interpretation of the law. Given that it is liquidity assistance, the central banks were arguing that this kind of assistance should not in principle raise a state aid problem, and we discussed it with them.We ended up with a series of criteria on which we would say that emergency liquidity assistance is not state aid: where the beneficiary is solvent, according to the regulators; where the assistance is not part of a larger package of rescue, where the facility is fully secured by collateral to which haircuts are applied and where the interest rate above the market rate, is not penal. In addition it was essential to ensure that the measure was taken at the Central Bank's own initiative, with its knowledge of the liquidity situation, and not counter-guaranteed by the state. We applied that to the first announcement of the Northern Rock decision and for four days we said that there was emergency liquidity assistance. which was not state aid. But on the fifth day the Treasury added a public guarantee to the liquidity assistance, at which point the UK authorities were entirely in agreement with us, that the assistance was then state aid. From that point on, the state aid disciplines have been respected. As I have indicated earlier, the Northern Rock situation has evolved in the sense that the UK have proposed a new plan, which means that we had to delay discussions and decisions on the final restructuring of Northern Rock But the issue of what is emergency liquidity assistance or not is laid out in the first guidance paper which the Commission published on 8 October on aids in the banking sector. I will look again to see whether it is clear enough, but it is on the basis of the criteria which I have just put forward.

Q572 ***Lord Steinberg:*** Can I just come back with a small supplementary? Illiquidity is a very strange thing, because very often the board of directors of a

building society or a bank may think they are not illiquid but, looking at it from another perspective, the authorities may say they are illiquid. Is the definition clear enough? At what stage does the bank or the building society say, "Hey, we are illiquid and we need help"? How is that covered? Just a tiny little point going on from that. We have currently got another building society which has stated that it is in trouble, the Dunfermline Building Society. Will the same rules as applied to the Northern Rock apply to the Dunfermline Building Society, which admittedly is a much smaller building society that Northern Rock was?
Mr Lowe: To attempt to answer the first part of your question, it is true that there are some elements of interpretation here on two issues: (1) is the institution illiquid, and (2) to what extent should they there be adequate collateral? What was regarded as adequate collateral by the Federal Reserve and European Central Bank and the Bank of England in 2006 would not be exactly adequate collateral today. With respect to the first element, we have covered by saying, in any case, if this is really emergency liquidity assistance, it is not the decision of the Dunfermline Building Society whether it is illiquid or not, it must be the decision of the Central Bank. That is a fundamental condition. Of course, if the Commission could eventually disagree with the Central Bank's view, that is another question but at least they will have . . .

Q573 ***Lord Steinberg:*** We will not go into that.
Mr Lowe: On the issue of "Will the same rules apply?", we have on the basis of the Rescue and Restructuring Guidelines produced ex-ante guidance on aid to the banking sector on 8 October 2008, and we have produced more guidance on recapitalisation measures at the end of November. And on 28 February we produced guidance on the treatment of impaired assets. We are now in the process, as we promised to the European Council in a Commission document of 4 March, of issuing further guidance on the process of restructuring and the return to viability. I think that is a direct response to the concern you express: do Member States and bankers know what the policy and the rules are? What kind of framework is there which guarantees coherence and a level playing field for everyone and reassure competitors that things are being dealt with in a proper way? We have found that in providing this upfront guidance, it has been pedagogical and helpful for those to whom it can be applied. But it has also been essential for us to define and consolidate what our policy is and not just take decisions from one day to the next.

Q574 ***Lord Steinberg:*** You talk about penal rates?
Mr Lowe: Yes.

Q575 ***Lord Steinberg:*** Is that not inclined to drive the bank or the building society into a worse situation than getting it out of trouble?
Mr Lowe: If there is an issue of temporary illiquidity but the bank is, in the opinion of the Central Bank and the regulatory authority, solvent and viable, then the issue of a penal rate over a short period to remove the liquidity problem does not seem to us to be a life-threatening event. If a penal rate on liquidity aasistance does have the effect of calling into question the bank's solvency, we are probably dealing with a situation in which liquidity assistance is only the forerunner of a demand for a wider rescue package.

Q576 ***Baroness Northover:*** A previous witness, Professor Charles Goodhart, has suggested that some banks are becoming too big for proper regulation and fair competition. Do you share his concerns and, if so, what follows from that?
Mr Lowe: One of the beneficial aspects, as much by luck as good judgment, of our activities is that we are actually able to look at merger control and state aid control and the future of banks at the same time. And we have to take a view about what viability means. We also have to take a view as to what the effects on competition of further consolidation are in the event that solutions are found which point to the direction of more concentration on certain financial markets rather than less. The first thing to say is that the Commission is not in a position to prescribe specific business models for individual banks or individual member states. However, if a bank is to be viable, that means operating profitably on a sustainable basis without state aid in competitive market conditions. Creating a bank which is heavily reliant on its size to achieve viability has to be looked at carefully because it almost certainly will have competitive impacts if it becomes, through a merger, dominant in any particular market. Should that point competition authorities in the direction of either asking for the break-up of banks or insisting that restructuring should result in downsizing? Usually it is our experience that, in order to be viable, the banks do have to contract their activities in certain areas to avoid the risks and the losses which have occurred already. But it would be very difficult to prescribe any limit or ceiling to the size of a bank. That being said, both in the regulatory area and in our own assessment of viability in state aid control, it is very important to manage risk successfully. And if management of risk means that in a downside scenario—which is basically what the Americans talk about in terms of stress-testing,—the bank could not cope without further state aid, then that would not, for us, be a viable concept. And I think this is very

much linked to the general issue as to whether the future of large banking units relies more or less on privatising profits but socialising losses. If the concept of viability is without state aid, that must be without state aid even in the circumstances of the downward cycle in the industry. It is of course, a matter of judgment as to what is the bottom of a cycle. If there is an every-200-year crisis which no-one expects, one might have some doubts. But, nevertheless, this current crisis has certainly raised issues about undervaluation of risk and about the combination of businesses which arguably in the future should be kept more separate. Whether they need to be kept separate simply in terms of regulatory control or whether one should insist on separation of ownership remains an issue to be discussed among the regulators. In conclusion, I would say we have to look at this issue on both sides: on the state aid side and the merger side. Our concept of viability means there should be no state aid under the most likely circumstances, which includes the downside situations as well as the upside. Too big to fail, too interconnected to fail, may be true for the reality of certain institutions today, but to ensure that they do not need state aid later?[3] However, I think that dealing with these issues is now a major challenge for every single government on both sides of the Atlantic but elsewhere too.

[3] *Witness Notes*: On the merger side, it is also impossible to ignore the negative impact of further mergers in already heavily concentrated markets. It may not be possible to improve remedies for this in crisis conditions. But there must be a rendezvous to review these situations later.

Q577 *Chairman:* You have been exceptionally helpful and generous with your time. As I said at the start, if you think we have missed anything that we ought to have reflected on, I will give you the opportunity to draw it to our attention.

Mr Lowe: Chairman, I do not think so. All I would say is that we have learnt a lot of lessons from this which are valuable for any competition authority. We happen to be a competition authority which works alongside OFT, the Cartel Office in Germany, and other sister EU authorities on anti-trust and merger issues. But we also have to police these on state aid rules. The one thing we have learnt is that it is not possible to solve a crisis by inventing solutions in policy silos: regulation, supervision, state aid control, or other areas of policy. You have to develop an integrated approach. It means that I have spent now a part of my time, which I have never done before, sitting with central bankers and supervisors. They may have regarded me as an alien body that they would have liked to spit out of this ecosystem at the beginning! But now we have realised that we have got an interest in common, which is to make the markets work again properly and make them work competitively. The second thing is that we have realised that a public service-minded approach dictates that we should react by applying state aid policies and rules in a way which is firm on principles but flexible on procedure. Thirdly, it is essential that we use our resources in a responsive way in relation to new priorities but of course that we do not waste them either.

Chairman: Thank you very much indeed.

TUESDAY 31 MARCH 2009

Present	Haskins, L	Renton of Mount Harry, L
	Hooper, B	Steinberg, L
	Jordan, L	Trimble, L
	Moser, L	Woolmer of Leeds, L (Chairman)
	Northover, B	

Examination of Witnesses

Witnesses: Mr Paul Tucker, Deputy Governor, Financial Stability, Mr Andrew Bailey, Chief Cashier and Executive Director, Banking Services and Mr Andy Haldane, Executive Director, Financial Stability, Bank of England, examined.

Q578 ***Chairman:*** Good morning Mr Tucker and colleagues. Could I welcome you to the Sub-Committee and thank you for sparing time to be with us? You should have in front of you a list of interests that have been declared by Members of the Sub-Committee. You will know that this session is on the record and that it is being recorded for the webcast. You will receive a transcript of the meeting, as I am sure you know, and you will have the opportunity to make appropriate adjustments should that be appropriate. We have a limited number of questions but clearly covering some very big issues, so we may in some cases obviously go a little wider as those questions emerge. Before we start, is there anything that you would like to say, Mr Tucker—and you may like to introduce your colleagues—before we go into questions?

Mr Tucker: No, thank you very much, Lord Chairman. My colleagues—I am joined by Andrew Bailey, who is the Executive Director for Banking Services at the Bank of England, the Chief Cashier and also the senior official who has led the Bank's contribution to the resolution of individual banks over the past six to nine months. On my right is Andy Haldane, who is the Director for Financial Stability at the Bank of England.

Q579 ***Baroness Hooper:*** Good morning. Given all the reports and all the discussions that have taken place over the current financial crisis do you believe that this shows that there is a need for greater links between macro and micro-prudential supervision? If so, does the Bank have a view on how this can be achieved?

Mr Tucker: The short answer is yes. This is a crisis which has its roots in a sense in what have been for too long two separate spheres—the world of global macroeconomic conditions and the intricacies of the financial system. The world was characterised by large accumulating current account imbalances between essentially Asia and the West, through which the Western economies became indebted; and that interacted with the intricacies of the financial system to bring us to this pretty pass. And we are in a very dreadful position throughout the Western world. So looking forward there just needs to be much closer integration of top down analysis of the world economy and world financial system, and bottom up analysis. In terms of what should be done, I do not think that the Bank of England has a definitive prescription, I am afraid, partly because we are not yet through this crisis and there are more lessons to be learned. But I would say this: that it is sometimes characterised as bringing together, on the one hand, the macroeconomists in Central Banks—the monetary policy experts—and, on the other hand, the line supervisors, the people that deal with individual banks that are at ground level. That is true; that is an important part of it. But there is a world in between those two things. It is not just macroeconomics and line regulation; it is also markets, the infrastructure that supports the financial markets, law, accountancy. And so there is a great world of expertise and intelligence and information to be synthesised in ways that have probably been attempted before but perhaps not with the vigour that we will need to show in the future, internationally as well as domestically. Our view is that in terms of the institutional structure, whether this is global, European or domestic, it is too early to tell because the biggest question is what instruments we have available to avoid the accumulation of these problems in the future before it is too late. As yet nobody—certainly including the Bank of England—has a prescription of what those instruments should be; or indeed whether we should be trying to make the banking system more resilient to downturns in the international or domestic economy on the one hand; or, more ambitiously, trying to tame the credit cycle so as to cushion the effects of very rapid credit growth and asset price appreciation on the economy itself. So one objective would be trying to address the impact of the economy on the banking system; the other objective would be trying to ameliorate the effects of the banking system on the economy. And these are massive debates which should precede questions about institutional structure.

31 March 2009 Mr Paul Tucker, Mr Andrew Bailey and Mr Andy Haldane

Q580 ***Lord Renton of Mount Harry:*** Thank you, Mr Tucker, very much. I am very interested in what you have just said about what instruments do you have and that so far there is no clarity or no decision on that point. I do not find the definition between macro and micro at all easy to follow, to accept—it seems to me that there will always be arguments about what is macro or micro. I have always been rather attracted by the idea that we should introduce something like the Glass-Steagall act which made, of course, the definition, the separation—and I quote here—"of high street deposit-takers from the casino investment banking businesses that invested in an alphabet soup of complex financial instruments"—a description that must be quite familiar to you at the moment. Do you think there is a point there that something akin to the Glass-Steagall act might be sensible?
Mr Tucker: As the Governor has said, we think that this is a debate that has to be had; we think that there is no ducking that debate, for precisely the reasons that you say. If one thinks back 30 or 40 years high street banking would have been a relatively subdued affair compared with the activities that commercial banks have been undertaking through their investment banking activities over the past ten years. But whether we can get back to a Glass-Steagall world and whether it would be the right thing to do is a pretty hard question. The reason that Glass-Steagall broke down was in part because commercial banks were providing services to their corporate customers that had become quasi investment banking, in the sense that corporate customers were using interest rate derivatives, foreign exchange derivatives to hedge things; not to speculate—to hedge things. And as corporate treasurers and finance directors around the world became more sophisticated and more aware of the opportunities that were available to them to manage risk it was a natural by-product of a lending business to provide those services. So I think that those who advocate a return to Glass-Steagall are doing more than that; they are also advocating a return to a world well, well before the removal of Glass-Steagall, where the services that commercial banks provided were very vanilla indeed. If we were to return to that I think it would mean that corporate customers and others would look to investment banks and the capital markets for a great deal of their financing and risk management activities, in which case we would face the challenge of ensuring that that part of the system was safe and sound. So returning to utility-type commercial banks would not necessarily of itself have prevented a crisis of this kind. What matters ultimately is what the demand for financial services are and what risks that can give rise to, not solely the type of financial institution that is providing that service. But we do think that this is a debate that should occur and do not think can be ducked.

Q581 ***Lord Renton of Mount Harry:*** Can I ask one other question actually on our domestic situation? I myself remember quite well going to the Bank of England some years ago at the time when—and I quote—"One twitch of the Governor's eyebrow would be enough to get our banks to behave responsibly." The FSA was created in 1997 and I sometimes wonder whether there has not been too much division of work between the FSA and yourselves which perhaps complicated matters which perhaps sometimes made you each think the other was going to look after it and the other did not. Is there a case for not continuing with the FSA?
Mr Tucker: I think one of the things we have learnt—and I hope everybody has learned from this episode—is that underlap may be comfortable for bureaucrats but it is bad for society.

Q582 ***Lord Renton of Mount Harry:*** Can you say that again?
Mr Tucker: Underlap may be comfortable for bureaucrats because it avoids accusations of turf wars but it is bad for society; that we need at least to tolerate a little bit of overlap in working together. Personally I think this is a grade one lesson for our institutional framework and indeed for the way that public officials conduct themselves in general. Actually, I think that and the question of instruments is much more important than the question of where and how the deckchairs are organised. If I may just say something about the earlier part of your remark, I do think that authority matters; I think it is too often said that we live in a world where we need rules and prescriptions. The way that the Governor's eyebrows worked, in my view—and it is not really for me to say, I think it is for the people who have the eyebrows—

Q583 ***Lord Renton of Mount Harry:*** But you were at the Bank at the time.
Mr Tucker: I was at the Bank at the time and worked closely with a number of Governors. I think that it was not some special magic talismanic power. I think what the Bank could do is convey to people home truths in a calm way and with authority. I do not think that need be unique to the Bank of England. I do think authority as well as regulation and force is important to the conduct of these things.
Mr Bailey: If I could add one thing there, because we were both at the Bank during this period. I think the other point that is implicit in what Paul has just said is that that authority has to be based on a very clear understanding of the nature of the problem with which you are dealing. You cannot randomly use eyebrows.

Mr Tucker: No, absolutely.
Mr Bailey: You have to actually use them on the basis of a very clear understanding of the problem and a very clear understanding of the risks with which you are dealing; so that is absolutely fundamental to this. Whoever has the authority has to have that.
Mr Tucker: And use it sparingly.
Chairman: What I get from that—and we will come back on this in later questions—and what I took from your evidence there is that under lap, as you call it, is dangerous—that is, if the silos are not talking to each other, if different institutions are not really working close enough together then that can have its own dangers and of course that kind of issue arises at the European level, which perhaps we can dome back to. Lord Trimble wanted to come in on question one.

Q584 ***Lord Trimble:*** In your original answer you were expressing caution and saying that there were still lessons to be learned and that we need to think more about what new measures could be put in place. Are you going to get the opportunity for any further thought on the matter? There are other people who are rushing in with solutions; you are going to have solutions pressed on you very firmly in the next few days. How are you going to get the time for that?
Mr Tucker: One of the reasons we are making this point from the Governor downwards is precisely that; that it is important, whether at the global level or the EU level or the UK level, not to let institutional structures rush ahead of a clearer idea of what instruments are available. I should not overstate this. The work of the G20 finance ministers and Central Bank Governors and the Financial Stability Forum has already—and I am sure this will be underlined this week –come up with a lot of concrete things that can be done and will make the system safer and more resilient in the future; and precisely because of the political leadership in this country and elsewhere the official sector internationally is working much more effectively over the past few months than perhaps over the past decade.

Q585 ***Lord Haskins:*** We are a European Committee and the issue that is coming up to us all the time is that we have a single market operating in the EU with pretty inadequate financial regulation as part of that single market: in other words, that the regulation is still left with national Member States. Indeed, as Lord Turner said, he thought that was the way it was going to be. However, we have a new factor now in De Larosière who is introducing a concept of EU wide regulation—still a little bit vague and compromising areas, where do the paths lie, will that committee have real teeth to do things—and the Bank of England is going to be very much part of that process. Where do you think this De Larosière bandwagon is going to run to?
Mr Tucker: I think there are two key components to the De Larosière report's recommendations. One is that across the EU there should be a greater emphasis on macro prudential supervision, as people now call it, and that essentially is bringing together the Central Banks at the most senior level to talk about what the threats to the system could be and drawing on the regulatory world as well. To a degree that already happens, but in a sense sometimes a little bit of institutional shake-up is necessary to underline things and to give impetus to things and that is needed in this area; and to put permanent machinery in place so that Central Banks and regulators cannot avoid getting together at the most senior level to discuss these things is highly desirable. It comes back to the question of instruments: if the only output of that group were to be reports to other parts of the EU machinery, that would be better than where we are now but our hopes for it insulating us against crises in the future, which may be 20, 30 or 40 years away, should not be that great. Writing reports is not sufficient in itself. Our own experience as this country's Central Bank is of having written reports and given speeches, perhaps not always with the punch that they should have had, but nevertheless ourselves, the BIS, the Banque de France, the IMF all produced reports and they were not enough to prevent this crisis. So what I would say about that part of Larosière is that it is very welcome indeed to give impetus to that debate. It will certainly make a difference but we should not exaggerate the difference it will make. The other part of Larosière's recommendations, which are less in the field of Central Banking, are around rule making for the supervision of the EU's financial sector. And that I think again essentially amounts to an edict that rule makers and regulators should work more closely together, and it is changing the institutional machinery to inject greater energy into it in broad terms, and we think that is a desirable thing too. I am being quite high level about this because that is the essence of what Larosière is promoting and there is a great deal of detail in it, but it is that high level impetus on two fronts that is the essential component of it.

Q586 ***Lord Haskins:*** The first part I think most people would agree is quite uncontroversial. The controversial side is: is Larosière suggesting that rules would be established by the ESRC which would have to be enforced and implemented by national regulators, and if that is the way that I suspect Sarkozy wanted to go what would the Bank's position be if that is the way they are going to go?
Mr Tucker: One has to distinguish here between regulation, or rule making, on the one hand and supervision on the other hand, and I am sure you have heard that from lots of witnesses and it is a

tremendously important distinction. Rule making in one form or another occurs at global level, EU level and national level. At global level in truth it is not quite rule making, but the great consensus is achieved at global level, whether it be in the Basel Committee for bank supervision or in IOSCO for securities regulation. That consensus drives a great deal of what goes on internationally and within the EU. The EU has for a long time codified international consensus into rules and there is a good deal to be said for that because nations then have to get on and implement it. There is a big question, of course, about whether that is done by unanimity or qualified majority voting, and those are constitutional, jurisprudential type questions which lie well beyond the competence or capacity of the Central Bank.

Q587 ***Chairman:*** Could I just pick you up on a couple of things—and Baroness Northover if you want to come in, please do. You said a number of times early on that we should not be talking about new institutional structures and so on before we are clear on the instruments and so on and so forth; yet you are here now talking eloquently about institutional structures. What are the instruments that would make a macro prudential supervisory body worth having? As you have said, it is no good just producing reports—you have produced reports in the past—so what are the instruments that you are actually talking about that will make such a macro prudential supervisory body effective and valuable?

Mr Tucker: The one that is most often debated is countercyclical capital requirements for banks and I think this is most easily explained by using the language of Basel I rather than Basel II for banks. So Basel I says that all banks should have a minimum capital ratio of 8% but some banks should have a higher capital ratio requirement depending on their individual circumstances. So you can divide that into two components—an idiosyncratic requirement of 8% plus a delta for the individual bank and the 8% which is system wide. One could think of one possible macro prudential instrument as moving the 8% up and down over the course of a credit cycle, so that as credit growth started to accelerate beyond what appeared to be warranted, given economic fundamentals, so the "8"% could be raised to 8.5% or 9%. An alternative mechanism would be margin requirements on secured lending by banks to other parts of the financial system—the US introduced a system of that kind after the 1929 crash and the 1930s problems—and there are lots of variants of it. There are many difficulties with it, but one of the difficulties or challenges amounts to this—and it is helpful to make a comparison with the world of monetary policy. In a world of floating exchange rates it truly is possible for a nation to say, "We will pursue our own monetary course; we will adopt our own definition of price stability" and the Central Bank is able to set its own interest rates, taking account of what is going on in the outside world, but differences in target or approach will be reflected in fluctuations in the exchange rate. That is why we were able to pursue a domestic monetary policy. In this field, if a country, in the example I have described, were to raise capital ratios across its banking system, which would raise the cost and availability of credit from its banking system into its economy and into its domestic financial system, that of course would not work hugely well if what happened was that domestic borrowers turned to banks overseas to borrow if they had not been subjected to the same increase in capital ratios. So the fact that we live in a world of freely flowing capital and cross-border banking makes this a little bit more difficult than otherwise. I am not sitting here saying, "And therefore we think it is impossible"—if we thought it was impossible we would be saying that and saying that the debate is not worth having. But decades were spent thinking about monetary policy, and in this country quite a few decades were spent getting it wrong before we settled on a process around the world which broadly seems to work. This is an area where the prescription is incredibly ambitious and therefore we just think that there needs to be further thought about that. You are right, Lord Chairman, to pick me up on then slipping into addressing the institutional structures. We would make a distinction between institutional structures and the organisations that are about doing things, acting on the economy; and institutional structures that are about writing reports. Creating new institutional structures that are about synthesising, bringing together analysis and producing reports or letters is a sensible thing to be getting on with internationally because it will put some energy into all of this. It is quite different though to say, "Here we have an institution that in future will have this macro prudential responsibility and will be able to tame the credit cycle." That would be a brave thing to say without greater clarity about the instruments.

Q588 ***Chairman:*** I must ask one of the supplementaries, for the record. In what you have described as the countercyclical, the capital ratios and the requirements and so on, you envisage potentially, as I understand it, a European wide macro prudential body possibly having as one of its instruments to be effective the ability to issue an edict of what should happen to these measures. But of course there are two issues here: one is a Euro zone monetary policy type area and then there is the EU wide single financial market. What role does the Bank of England believe that the European Central Bank should play in macro supervision because it has a role in terms of monetary policy in the Euro zone, but are you suggesting that the European Central

Bank should have a role over effectively capital issues and so on across the European Union, which would actually mean that the Bank of England would be redundant, would it not?

Mr Tucker: Going back to the instrument, I think that is most easily thought of as a national instrument and what lies above it are debate and analysis, as goes on at the moment, and rule making for the micro regulatory sphere. In terms of the role of the ECB, the ECB plainly has a very big role to play in the debate and the assessment of threats to stability; it is the Central Bank of the second biggest or even perhaps the biggest currency area in the world. Whether one pitches this at a global level or a European level, it is a very significant institution in this. Alongside others, including I hope the Bank, it can perform a very important role in bringing that analysis together. That is quite separate from saying that the ECB or Jacques de Larosière's new committee should itself have instruments.

The Committee suspended from 10.00 am to 10.10 am

Q589 Chairman: We are now back on the record. We had got to the point where we were talking about policy instruments that a macro supervisory body might or might not have and I think, Mr Tucker, having waxed eloquently about particular instruments you said that really they are for national level and we did not really get from you what instruments you thought that the macro prudential supervisory body at European level might have if it is to be a meaningful organisation; and if it was not meaningful with real instruments and real power what role does that give the European Central Bank in relation to non-Euro zone policies?

Mr Tucker: I was saying that I thought first of all that the ECB alongside others had an important part to play in the analysis through their unique position as a Central Bank of one of the world's biggest currency areas. I think what can be done at either the EU level or at the global level is recommendations borne from analysis—global analysis, EU wide analysis—bringing all the different perspectives and expertise together. That is something—we have benefited enormously as a Central Bank conducting monetary policy from reading the analysis of the Federal Reserve, of the ECB and Central Banks elsewhere in the world; and in this field too a lot of good can be done by people publishing their analysis and national authorities learning from it. That is the base minimum, I suppose, and that will be quite a lot in itself. A step beyond that would be for some EU wide body to make recommendations in a non-binding way to national authorities and then national authorities would have discretion to decide, given their own circumstances and objectives, what precisely they did. I am emphasising at each stage the EU level because I think in De Larosière's prescription if this is an EU committee it is an EU committee, not a euro area committee; if it is a euro area Committee then it would be constituted differently and the role of the ECB within it would be different. So I think in terms of the comitology, the role of the ECB depends on whether it is a euro area committee or an EU committee. If it is an EU committee, whether or not the ECB chairs it, it (the ECB) is one voice.

Chairman: Lord Moser, you wanted to come in.

Q590 ***Lord Moser:*** Chairman, it is when you asked about instruments rather than institutions. I have had a worry all the way through our discussions on this about a very central element—how to measure risk. I have been shocked by how bad all the institutions seem to be at measuring risk, which is at the centre of supervision regulation. I just wondered whether you saw any future from the Central Bank point of view at getting better at this central bit of technique.

Mr Tucker: I have two points, if I may, Lord Moser. The first is that you are right, if I may say so, that humility is needed in this area and the greatest mistake has not been to have flawed measurements of risks, it has been to have flawed measurements of risk but to be rather confident about them. I was on a panel a few days ago where an academic interestingly described financial risk as more like a liquid than a solid. And yet both the private sector and the official sector had proceeded as though risk is like a solid; and you can draw lines across it and carve it up, and in fact of course it slightly slips out of your grasp all of the time. So I think humility is important to this. The second and separate point I would make is that we need to distinguish—and Andy may want to say something about this—the measures of risk that are appropriate during what I call peacetime, when conditions are relatively normal and, if I may be slightly technical about it, the underlying stochastic process is contained in some way. Yet of course when we slip into a full blown crisis, things are completely different. And the most obvious way of putting this point is that banks are highly leveraged—they are highly geared in the language that we used to use—and so, whatever the cause, if bad events occur that put the capital adequacy of banks into question then we lurch from those normal conditions into a completely different type of environment in which risk measures go off the dial in almost every dimension. Andy has written papers on super systemic risk and he may want to say something about that. But I do not think that we are going to get terribly good at measuring that kind of risk during probably my biological lifetime. I think what that underlines is a rather old-fashioned notion, which is that the safety and soundness of banks is absolutely vital and that bank supervision is about more than consumer protection; it is about people having so much confidence in our banking system that they can withstand very large shocks indeed—larger than the shocks that we endured during 2006 and during 2007, remembering that this began with the US sub-prime market, which is a relatively small market to bring down the world's financial system. But Andy has thought about measures of risk much more than I have.

Mr Haldane: Maybe I could make one point, which really goes back to where we started this micro/macro prudential distinction, because in essence that boils down to: do we think about risk institution by institution—node by node, if you like, to use the network analogy—or do we think about the risk within the network as a whole? To date the approach has been to draw our data, to reach our conclusions and to regulate looking at this node by node. If the objective is to be the stability of the network rather than any one node that begs some rather basic questions about the data we collect, which of course is a pre-condition to any measure of risk.

Q591 ***Lord Moser:*** That is my point, yes.

Mr Haldane: So if I could caricature the situation to date we have sampled each of the nodes, if I can use that language, and not sampled the links between them, which makes lots of sense from a micro prudential perspective, but as soon as your perspective switches to thinking about the stability of the network that makes no sense. If we looked for analogies in other disciplines, be it engineering or ecology, one would need to think about this as a system and to seek information on the whole of that system. One way of interpreting what happened last September/October, at the time of the Lehman's failure, in some sense was no surprise to us because Lehman's had been in a weak situation for many, many months; yet the consequences of that node being knocked out took all of us by surprise and brought the network to a grinding halt. I think had we known more about the joins between the institutions that would have put us in a slightly better position when figuring out ex-ante what might have happened if that big interconnected node had been knocked out. So in alongside the important points that Paul makes about short memories, about the inherent fluidity of risk, I think there are some rather basic, some rather arid points about our information base which in the financial sphere falls well short of that in other disciplines, and I mentioned one or two of them.

Lord Moser: If anything is available to us that is not confidential some of us would find this very helpful reading. Thank you, Lord Chairman.

Q592 ***Lord Jordan:*** A world of free flowing capital has resulted in an interdependent banking system and the hallmark of this crisis has been the global consequences to the banking systems and economies. Does this imply that there is a need for an international system of macro prudential supervision and, if so, what role should the IMF play in such a system?

Mr Tucker: I think it definitely does imply that we need macro prudential supervision assessment at a global level. Your Committee has focused on the EU but the EU, with the best possible institutions and instruments in the world, will not get it right without taking account of what happens in the United States and Asia and, no doubt, over time in Latin America as well. We are in a position where if someone catches a cold in almost any part of the world, it will reverberate through London to a greater or lesser degree and therefore back into our economy. As you say, in a world of international capital flows which I and my institution dearly hope we will maintain—we think that the citizens of the world and our country have benefited enormously from that over time—it does mean that we need to assess the resilience of the system at a global level. We need to do it at every level—the national level, the regional level and the global level. What role does the IMF have to play in that? The IMF's expertise is essentially macroeconomic. In answer to the Lord Chairman's first question I emphasised how this was a crisis where global macroeconomic imbalances had interacted with the intricacies of the financial system. The IMF's contribution is in the first part of that: in identifying and being courageous in their proclamations about global economic imbalances. One of the things I dearly wish they had done more of in their assessment of national economies is to concentrate more on national balance sheets, on the external position, on the debt position of national economies. This was a lesson from the 1990s, the emerging markets crisis, and an awful lot of work was done in the late 1990s and the early zeros about that and the IMF needs to carry across some of those lessons to the industrialised world. So, in short, the IMF ought to stick to its core expertise of macroeconomics but apply that expertise in a more ambitious way to global imbalances and national imbalances. The other thing it needs to do—and it takes two parties to tango—is to interlink better with the Financial Stability Forum, which is where I think the expertise will lie on the intricacies of the financial system. Those two bodies, the FSF and the IMF, working together has to be a priority and that is something which I am sure will be emphasised by the G20 and already has been by our Prime Minister and by other leaders.

Q593 ***Lord Jordan:*** This Committee has been looking at the difficulties of establishing powers great enough at a European level. Eyebrows will not cut much ice across a global setting.

Mr Tucker: No, and I do not think it is realistic to have global powers in that sense. Powers are ultimately in this area going to be applied at a national level because there is no divorcing the fact that the ultimate support for a banking system is the national fiscal authority. That is why this all ultimately comes back to national authorities. But if the instruments and powers lie at their most important and basic sense with national authorities, none of us will apply those powers in a sensible way unless we take account of the broader environment. What the global authorities can do is share analysis and prescription and then national authorities in some areas, regional authorities can take forward the actions.

Q594 ***Lord Jordan:*** You said that the IMF along with yourself had given warnings earlier on that had gone unheeded, so how do you make a warning go heeded?
Mr Tucker: The most obvious reason is that this crisis is costing our citizens, not only in this country but elsewhere, so much that surely our national authorities will be more determined in the future to do something to prevent the build up of over indebtedness and imbalances and features of the financial system that reduce its resilience to shocks. So there need to be improvements at global level in analysis and prescription, but the core improvements that are needed throughout the world are going to be at national level in terms of correcting imbalances in our economies and ensuring that our financial system is resilient. The global element is a necessary condition but it is by no means a sufficient condition.

Q595 ***Lord Steinberg:*** I wanted to ask one question in relation to that. Whilst we all accept that this particular crisis is a different one from many others it has been the history of the world that crises occur at every 15, 20-year period, very often for reasons that we do not even contemplate. Are you looking to try and foresee—we will not be able to foresee how and when the crisis might come—to put in place building blocks that will attempt to try and stop those, and is this something that the rest of the world is also looking at or are they just putting their finger in the dam at the moment?
Mr Tucker: I think this is where institution building does matter; I think it is where mandates matter. As you say, we have had dreadful crises, as it happens it seems, every 50, 60, 70 years. Most of them come out of a protracted period of peacetime when all sorts of bad practices develop in the private sector and in the official sector. In the official sector it essentially amounts to giving other things priority, and the importance of mandates—and that is part of institution building—is ensuring that the official sector cannot take its eye off those long cycle problems that we confront. I do not think anybody on earth can tell you what will be the features of the crisis in 50 years' time, other than perhaps two things—that it will involve excess leverage and maturity transformation, and that they will come dressed up in incredibly, not necessarily complex but relatively novel forms. It is too often said that all crises are alike; they are alike in the sense that they are about leverage and maturity transformation. The 1920s crisis was to do in part with leverage in investment trusts and crossholdings of investments trusts—Galbraith writes about that. But one would not have spotted this crisis by looking at investment trusts; here one needed to look at CDO squared and SIVs and all of the alphabet soup to which my Lord Chairman referred. Our successors are capable of spotting these crises provided they have a mandate and are held to account to concentrate on these issues all the time including, most importantly, during the benign periods. If I may say so, I think the great role that can be played by Parliaments—in this country in both Houses but your opposite numbers overseas—is to ensure that bodies like mine and the FSA stick to that knitting, even when we go through decades of not apparently being threatened by the worst, because it is the easiest thing in the world to move resources on to apparently more pressing matters.

Q596 ***Lord Trimble:*** When you were talking about global macro supervision and all the rest of it where do you see the Financial Stability Forum? Do you see a role for it?
Mr Tucker: This goes back to Lord Jordan's question. I think the Financial Stability Forum in big picture terms has two major roles to play: one is in bringing together at a global level the financial system analysis with the macroeconomic analysis of the International Monetary Fund—that is a big contribution that it could make. I would include BIS, of which the FSF is a twin in that endeavour. The other thing that the FSF can do and has been doing is ensuring that the standard setters in different fields—in bank supervision, accounting, insurance, securities regulation—take account of what each other are doing and take account of the broader global goals of stability. So although I do not think that standard setters should report to the Financial Stability Forum in some formal sense, there is a very important role to be played in ensuring that standard setters do not pursue their particular standard in a vacuum and not take account of other things. Probably the most topical example of this would be accounting standards. This crisis comes in part through the interaction of accounting standards and bank regulatory standards, and I think the FSF behind the scenes has already been performing a tremendously important role, starting to build bridges between the ways that these two different

standard setters think about the world. I think that is a tremendous role that it can play and it can also at times force the pace a bit as well, and I think we have seen that in recent months and I hope that the G20 will take that further over the next few days.

Q597 ***Lord Trimble:*** I am interested in what you say there about accounting standards because one of the things that strikes me about what has happened is the way that the alphabetic soup was all kept off balance sheet.
Mr Tucker: Yes.

Q598 ***Lord Trimble:*** So then people did not know and what was one of the basic tools for finding out what was going on just simply did not work.
Mr Tucker: Yes and I think it would be a good example of the kind of thing I am describing, where the FSF say that if you have accounting rules like this where it is all off balance sheet but for bank regulatory purposes you want them taken into account—and surely for systemic purposes you want to—"Hold on, how do we make all of this fit together?" and keeping people at the table talking rather than thinking, "I have finished with my little bit of global standards—I am off; it is for other people to look after the consequences."

Q599 ***Lord Moser:*** Going back to the earlier discussion on the main institutions for regulation and supervision, Lord Turner in his review made a great point of having a single institution replacing all the other bits at European level for macro supervision and regulation. I would like to ask not so much what you thought of Lord Turner's review but what the Bank's position is on that key issue?
Mr Tucker: Again, I would like to separate the prescription about supervision from rule making. I think on his particular remarks about rule making I should say two things. First of all, the Bank of England has not been involved in EU rule making in this sphere for a decade now, so we cannot claim to have any expertise or great insights borne of experience into how rule making at the EU level has worked. The second point I would make is that whatever the comitology, whether it is one committee or three committees, it is important that within the structure it is recognised that there is a different expertise to being a bank supervisor to being a securities regulator to being an insurance supervisor and regulator. In an echo of my response to Lord Trimble, these things can be connected and so one needs to recognise the connections; but equally it is different being a bank supervisor from being an insurance regulator. So whatever the comitology, if it is three committees then they need to ensure that they work together because of the connections; if it is one committee then the supporting structure needs to ensure that these separate areas of expertise are recognised. And those two things I think actually matter rather more than whether it is one committee or three.

Q600 ***Lord Moser:*** That is very interesting. Could you, for my benefit, explain even more what the different expertise is that is required for each of these roles?
Mr Tucker: In my view—and Andrew and Andy may want to add to this—a very large element of banking supervision is to do with liquidity risk because banks take short term deposits and lend long term, so in a sense they are on the edge of the precipice all the time in terms of liquidity risk unless they are recognised to be safe and sound. An insurance company issues long term liabilities and buys long term assets and an insurance supervisor does not need typically to think about liquidity risk at all. Another distinction would be—and I am going out of my own zone of competence here—insurance companies can get into difficulty partly because of the nature of the insurance products that they have sold. A bank will get into difficulty not because of the nature of the service it has provided to its customers but rather because of whether or not its borrowing customers will repay it. One needs capital to manage over the short term; another needs capital to manage over the long run. So there are some similarities—these are not separate universes but they are perhaps different chapters in the same book. My point is not that this means they should be in separate institutions or separate rules committees, but that however you organise the deckchairs one needs to recognise the connections and one needs to recognise the differences. But Andrew and Andy may want to add something about the differences between these three areas.
Mr Bailey: I would only echo the point about supervising banks. I think that there are a number of important skill areas and judgments and I think it comes back to your earlier question, Lord Moser, which Paul and Andy answered on the question of risk. The other point I would add to Andy's answer to that is that there is a second phase to this, which is getting those who are actually running these businesses to understand and accept the risks that they are running and how they respond to them because quite often—and I have had this in my own dealings, as was mentioned at the introduction, in resolving banks that get into trouble—people say to you, "I know you can paint this picture of a risk but that will never happen." That is a fundamentally wrong judgment because we know that we live in a world of probability distribution of outcomes and we are precisely talking about judgments around what probability distribution we should be protecting the system against. So that is a key judgment you have to make as a supervisor and of course you have to make

a key judgment about what distribution of risks you want this institution to cover and then how you get them to actually do it. The second thing I would say about liquidity—Paul is absolutely right about liquidity—is that in the international and domestic structure of regulation, too little attention has been paid to liquidity and it is quite remarkable how much the focus has been put on capital adequacy, which of course is important as the relative to liquidity. It is quite remarkable and this goes right back to Basel I in the 1980s. So this goes for 20 odd years now—quite remarkable.

Mr Tucker: And this is nothing to do with the 1997 split really.

Lord Moser: Thank you very much.

Q601 ***Lord Steinberg:*** My question is a pretty short one: should early intervention, for example the UK's Special Resolutions, be harmonised at EU level?

Mr Tucker: You can only harmonise when you know sufficient about something to know how to harmonise it and the truth is that we are all starting off on these resolution regimes. It is a great breakthrough that this country now has a Special Resolution Regime for banks, rather than applying the standard corporate insolvency regime. Other countries? Some have them, some do not. I think there will be a debate elsewhere about how they develop them and there is active work about how these regimes connect across countries. The Basel Committee of Supervisors has work on that. The Financial Stability Forum has been encouraging work on cross-border resolution. Cross-border resolution requires at least two things: it requires understanding each other's regimes and it requires a lot of information transfer and there has not been enough information transfer. I think that we need to do a great deal more on all of those fronts before we can talk about harmonisation. Andrew mentioned Basel I and I was involved at a very junior level in the Basel I Capital Accord. The Basel I Capital Accord came out of the fact that most of the countries had a capital adequacy regime for the banks; they had been using it for a while but they realised that they needed to learn from each other and if not harmonise then have some common components. The Basel Capital Accord probably happened at least 10 years after most countries had been doing that. In Europe we are now only embarking on having Special Resolution Regimes for banks. The US and Canada are miles ahead of the rest of us in that and yet even they have discovered that having a Special Resolution Regime just for banks and not for non-bank financial institutions has been a problem—it was a very big problem for them with Lehman. So my short answer is I fear that we do not yet know enough to harmonise.

Q602 ***Lord Steinberg:*** Can I just go on a stage further, particularly from an EU point of view. As you know, the EU is composed of a vast miscellany of different countries—some are reasonably strong and some are very weak. From your perspective in the Bank of England do you think that there is a possibility that some of these weak countries may drag down the proposals that you are all trying to put forward the situation, do you think it is possible that some of them could in fact upset the applecart?

Mr Tucker: I am probably not best positioned to answer that. I rather doubt it. The crisis is sufficiently grave and is affecting all countries that the impetus behind progress of some kind is quite great. I think that there is something else that comes out of your question, if I may, which Lord Turner has talked about amongst others, which is that if one is going to have passporting—and there are very good reasons for having passporting for banks—and access across borders without the host having strong regulatory powers, then it really does matter that the home supervisor can cut the mustard. That should not just be taken for granted, "we have passporting, we are all in the EU, we are all good at this". But instead there should be some peer group review or external review. Going back to the IMF, the IMF can perform a great service through its reviews of national financial systems to ensure that the quality of home supervision meets if not a defined minimum standard one that is decent, is okay. I think the other question in this area is whether more needs to be done to make clear to the citizens of the UK or France or Belgium or wherever, whether they are engaging with a domestically regulated institution or a passporting institution, and of course all of these issues have been thrown up by Iceland.

Q603 ***Lord Haskins:*** We are picking up a great tension between those who want to put more regulation at the top of the agenda and those who say, "No, we must take our time about this"—the Anglo-Saxon tensions. At what sort of pace do you think we should be approaching regulatory reform in that these bankers are not going to misbehave in the short term; on the other hand, the climate is right for making changes—the public opinion climate is right for making changes—at the present time?

Mr Tucker: It is not binary; there are easy wins. The domestic community and the international community should take the easy wins and there are easy wins and they can be done quickly. Indeed, there were easy wins before this crisis and it is a tragedy that they were not taken. At the other end of the spectrum there are grand questions about, can we have a macro prudential authority with instruments to tame the credit cycle, and anybody would be foolhardy if they rushed into that. So we can have both and we need to be clear about which is which.

Q604 ***Lord Haskins:*** What are the easy wins?
Mr Tucker: Redefining the composition of bank capital over time, encouraging dynamic provisioning; as Andrew and Andy have said, giving much greater emphasis to liquidity regulation of banks. It will not be enough for the international regulators to come up with a woolly standard for international regulation; we should be aiming for banks throughout the Community and throughout the world to hold some minimum level of government bonds—this is something that we at the Bank feel pretty strongly about.

Q605 ***Lord Haskins:*** And deposit guarantees?
Mr Tucker: The most important thing about deposit guarantees is that first of all it should be clear what their terms are and it should be clear who is guaranteeing what. We have moved—I have moved personally and the institution has moved—to favouring 100% insurance, up to a minimum level, partly because that helps to take politics out of bank resolution. I think a degree of greater conformity in that area across the European Union would be a good idea, but—and this next bit will be harder, as it has proved domestically—we, for example, at the Bank of England believe strongly that that means the premia paid by banks into the deposit insurance fund should be risk based. There is not even a unanimous view on that domestically let alone internationally; so even within deposit insurance there are some things that are controversial, there are some things that are uncontroversial.

Q606 ***Lord Renton of Mount Harry:*** Mr Tucker, we have talked for the last hour about all the difficulties. Are you optimistic about these financial difficulties being worked out at the European and at the global level?
Mr Tucker: Do you mean in terms of making the system more resilient in the future or in terms of getting out of the current crisis?

Q607 ***Lord Renton of Mount Harry:*** Both but more resilient in the future.
Mr Tucker: I am optimistic that over time we will build a more resilient financial system. We will not be able to prevent crises in the future in 60, 70 years' time, or whenever it is. I give you my pledge that my institution will do its damndest to prevent it but there will be a day in the future when it will occur again. But can we have a more resilient system that we had during the 1990s and into the zeros? Yes we can and I think we will.

Q608 ***Lord Trimble:*** You have mentioned the use of instruments. There is little problem within the Euro zone as to where the instruments lie in the event of a crisis—we have had a couple of countries outside the Euro zone that have had to have bailouts. If that situation occurs within the Euro zone have you any view about how it should be conducted and who should be doing what?
Mr Tucker: Not really. What one has to come back to—and I have made this point once but of course in fact it is a massive point and I know that other witnesses have emphasised this—is that ultimately when things become bad enough it is fiscal authorities, it is taxpayers that put up the money. For a century or more we have talked about Lenders of Last Resort, which is my role, our role, the Central Bank's; but when one gets beyond that one talks about Capital of Last Resort and that is a fiscal authority, and that means that there is always a very important national dimension to this and that is no less so in the Euro area where of course it is national governments cooperating in a single currency monetary policy.
Chairman: Mr Tucker and your colleagues have been admirable in staying with us and answering our questions patiently but also with great assistance to us. I would like before we close to thank our stenographer for going beyond the call of duty; we are very, very grateful and I would like that to be on the record.

WEDNESDAY 29 APRIL 2009

Present	Haskins, L	Steinberg, L
	Hooper, B	Trimble, L
	Moser, L	Woolmer of Leeds, L (Chairman)
	Renton of Mount Harry, L	

Examination of Witnesses

Witnesses: Lord Myners, a Member of the House, Financial Services Secretary, and Mr Clive Maxwell, Director for Financial Stability, HM Treasury, examined.

Q609 ***Chairman:*** Good morning, Lord Myners and Mr Maxwell. How nice to see you here again. Thank you for sparing us your time. My Lord Chairman Baroness Cohen is indisposed; she is poorly. She conveys to you her apologies but she is not able to be here. You have a list of questions and you have a declaration of interests note from the Committee on the desk in front of you. The questions were slightly amended yesterday for which I apologise; I hope that has caused you no inconvenience. Before we start, is there anything that you want to say as an opening comment? I should say that this session is being videoed as well as there being a written record.
Lord Myners: I welcome the opportunity to come before the Committee again to answer your further questions on the EU's response to the financial crises. Obviously, I would like to convey my best wishes for a speedy recovery to Baroness Cohen. Before we turn to you detailed questions, I would like to start by briefly outlining the Government's position on the issue you are currently addressing. I would also welcome the opportunity to make a point on the terminology used in the debate. I hope this may help in setting the framework within which we can then address your detailed questions. Firstly, on the Government's position, you will have no doubt seen the Chancellor's letter of 3 March to European colleagues on EU financial regulation and supervision. In his letter, he welcomed the report of the de Larosière group as a good basis for further discussions. The letter set out a number of principles for EU supervision and regulation, in particular firstly that prudential and conduct of business issues cannot be separated and need to be considered together as an integrated whole. Secondly, that supervisory and crisis management arrangements need to be consistent and aligned. Thirdly, that EU arrangements need to fit within global practice. Fourthly, through all of this, governments must continue to support the development of open global markets and arrangements should be independent and accountable. In this context, the Chancellor made four proposals to form the basis for the EU's response which the Government will take forward in European meetings over coming months. First, the need for an effective EU macro-prudential early warning system; secondly, a new independent rule-making body which should become a regulatory authority and a forum for reviewing national supervisors, but importantly should not have supervisory powers over firms or over supervisors. Thirdly, the development of rules for clearing and settlement systems need to improve operational and prudential standards. Finally, a fundamental review of the risks and safeguards around cross-border branching models in banking to consider issues such as home-versus-host responsibilities and effective co-operation between national deposit guarantee schemes. My second point, as I said, relates to terminology. Why it is important to clarify the distinction between supervision and regulation which often gets blurred when these issues are discussed. Regulation refers to the making of rules. Supervision on the other hand refers to the processes that implement the rules and apply them to individual firms and markets. There is therefore a clear distinction between the European level rule making and European supervision engagement. That is why the Government supports better and more detailed EU regulation but not a single EU supervisory body. I note in this context that de Larosière has not himself proposed an EU supervisory body. I look forward in light of those comments to engaging with the Committee on detailed questions. Thank you very much for giving me the opportunity to say a few words at the beginning; I appreciate that very much.

Q610 ***Chairman:*** That has been extremely helpful. May I begin on the macro level. The de Larosière report suggests the institution of a European Systemic Risk Council. As a specific proposal, how do the Government view that proposal? What should be its role and should it operate under the auspices of the European Central Bank?
Lord Myners: The Government agree that we need a new EU body to act as part of the architecture of effective early warning systems. This body could usefully identify regional risks to our economies and therefore complementing the international role proposed for the IMF and the new FSB which is the

enhanced FSF. It could provide early warnings to finance ministers on the risks identified. Effective macro-surveillance requires any new body to be independent of those over whom it exercises some element of surveillance and it needs to include the most appropriate people within its membership in order to support good analysis. It is therefore important in the view of the Government that the body is sufficiently independent to ensure that it can provide effective analysis.

Q611 ***Chairman:*** Independent of which bodies?
Lord Myners: I think in particular independent in the context of the de Larosière report of the ECB. We are not persuaded that the new macro-prudential surveillance group should fall under the auspices of the ECB because after all the actions of the ECB might in part be an element of the surveillance process and the comments that the independent body might wish to bring forward.

Q612 ***Baroness Hooper:*** To whom would this body be accountable—the European Parliament, the Council of Ministers . . . ?
Lord Myners: That is still being developed in the response to the de Larosière report, but we see it as an enabling and informing agency which would analyse independently and draw attention to areas where risk was accumulating and pressure was building up and could possibly set out the scope of possible responses and possibly in due course comment on any decisions that were taken, but I think that it is primarily there as an informing agency.

Q613 ***Baroness Hooper:*** A sort of advisory committee?
Lord Myners: Yes.

Q614 ***Chairman:*** So, you do not think that there should be a recording structure into the ECOFIN Council as Mr Trichet suggested to us?
Lord Myners: I think that there is merit in reporting into ECOFIN. I think that it would be odd for it to be stranded and isolated without an accountability and ECOFIN would seem to be a good forum that would benefit from the advice of this agency if it is doing its work well.

Q615 ***Chairman:*** To be clear, your view is that it should not be, in the word used to us earlier, the aegis of the European Central Bank?
Lord Myners: That is correct.

Q616 ***Lord Steinberg:*** We saw you on 27 January and I want to ask you to reconfirm that you said, "I am not at all convinced that the ECB has the necessary skills in place to become a regulated body".
Lord Myners: Yes.

Q617 ***Lord Steinberg:*** Are you reconfirming that situation again?
Lord Myners: I think skills and capacities would include whether the issue of independence could be met by the ECB. I would not for one minute be suggesting that the ECB do not have a lot of very competent analysts and economists, but whether to be effective they can be seen to be independent and are able to assure an external audience that the fact that they are both part of the ECB but possibly commenting on actions taken by the ECB is quite a tall challenge.

Q618 ***Lord Steinberg:*** So, really it is the independence issue that you are more concerned about rather than the competence?
Lord Myners: Yes. If there was a competency issue in the sense of skill that could easily be rectified. That would not be an impediment to ECB if that was the issue alone. I think that it is rather whether the ECB could be the host of an agency which would be exercising some surveillance over the ECB.

Q619 ***Chairman:*** I am sorry to press you on this but, when we had the pleasure of discussing these matters with you previously, your words in answer to Lord Renton were, "I think that there is a very important role for the ECB to create a macro-prudential supervision to look at the broader systemic risks and the ECB could play an important role there". On further consideration, is it a different position that you are taking today from the answer you gave to us then?
Lord Myners: No. I think that the ECB, given its considerable standing, can play an important role and indeed is obliged to play an important role in this respect. It cannot turn its back on issues of what we now regard as macro-prudential risk. The question is not whether it cannot play an important contributory role, it is a question of whether it should be the agency that leads European macro-prudential surveillance and the Government's position is that there are better ways of handling that in order to ensure clear independence.
Chairman: We will be coming back to the European Central Bank because there are a number of questions that Lord Renton wants to lead on, but I turn to Lord Haskins and then we will move on.

Q620 ***Lord Haskins:*** I want to make a point about your introductory comments regarding the distinction between regulation and supervision, which I think I understand reasonably clearly. The regulation is about laying down rules. Assuming that the ESRC has a responsibility for laying down rules, it is more than warnings that it will be issuing therefore, it will be a responsibility to make sure that the supervisors actually apply those rules. How is that going to happen?

Lord Myners: I agree with de Larosière that the body needs to include central banks of all Members States and, to be really effective, this body needs to cover all sectors in an area where for instance we are not aligned with at the moment. De Larosière's thinking is that we would expect the FSA to have a significant role in the ESRC. I think that the membership of the ESRC needs to take account of national structures and procedures. Much of the debate about the composition of the ESRC reflects the debate on the role of the whole body of what it does and whether it gives recommendations on what and to whom, and a number of important questions on this still need to be thought through. The answers will likely influence the debate on the composition of the body and how that body accounts for its effectiveness.

Q621 ***Lord Renton of Mount Harry:*** I am holding back on the European Central Bank for a little longer by agreement with My Lord Chairman but, going on the question of Lamfalussy Level 3 Committees, we know that many people have recommended convergence of EU supervisory standards and enhanced co-operation between national supervisors, but what we do not want is for this to be just good words or nice words. Do you think that the upgraded committees, to use the technical term, should be given binding powers over macro supervisors in interpretation of the EU regulations and supervisory standards and dispute settlement? Do you think that that is a necessity in order that they should run effectively?

Lord Myners: There is a clear need to ensure that cross-border financial institutions are properly and effectively supervised and this is something the Government have been very aware of and indeed promoting and we are very pleased to see that there is now increasing support for the Government's position on substitution as evidenced by the G20 and the most recent IMF meeting. I agree with de Larosière that we need more harmonised rules globally and in the EU and I also agree that we need to replace the Level 3 Committees and that is why the Chancellor, in his letter of 3 March, to which I suspect I will refer several times this morning, proposes an independent EU rule-making body to replace the Level 3 bodies. This new body would replace the Commission's role in making technical rules under Level 2 and this will facilitate the removal of certain national discretions. It would also remit to focus on removing derogations and exceptions and so secure a harmonised set of core standards. I also agree with de Larosière that the standard setter should undertake strong peer review to improve standards, set binding regulations and undertake mediation. However, the Government are more sceptical on binding powers such as those in the current debate about binding mediation given the importance of aligning supervision and crisis management arrangements and this again is a point I may find myself coming back to on several occasions this morning. The Government do not see how we could have EU bodies overruling national authorities where national taxpayers can be asked to fund firms that have failed. In the absence of crisis management arrangements that would support EU level decision making including arrangements for fiscal support of firms, the Government believe that it is not possible to agree binding EU powers including binding mediation or over colleges. That is why the Government support regulatory and not supervisory powers at the EU level.

Q622 ***Chairman:*** May I press you on the question of the independent rule-making body and the standard setting rule-making power a little. Is it not the case at the moment that regulations at European level have to emanate from the Commission and the Council of Ministers and Directors and so on? If this body is independent, I assume you mean it to be independent of the Commission? Does that mean that the Commission is effectively delegating powers to another body? If that is correct, I ask you two questions. Would the Commission be happy about delegating powers to an independent body? Where does that leave the Commission? Secondly, where does that stand in terms of the treaties?

Lord Myners: May I ask, with the Committee's agreement, Mr Maxwell to lead in answering your question—he has been working with these issues for far longer than I have—and I will come in possibly with a political complement to his initial more fact-based answer.

Mr Maxwell: You are right that European law at the moment is usually created through a process that involves the Council and the European Parliament and the European Commission making proposals. In the area of technical rule making that very often fits underneath individual directives, there are often arrangements for what is described as Level 2 legislation or comitology arrangements which allow the Commission itself with these Lamfalussy Committees to create more detailed forms of binding rules, so that you have a second tier of more detailed regulation. The Council is in effect consulted on that and there are arrangements for it to vote against it by unanimity, but otherwise those things go through. These committees at the moment are also in effect fulfilling a quasi rule-making power. Even below that sort of level, very often they are working to try to agree standards which they as individual national authorities will aim to follow in their deliberations and how they handle things. So, you have a hierarchy of different sorts of rule-making processes currently under way within the Community on these particular sorts of issues. If you were to change that system, I think that would presumably involve changes to the role of the Commission in that process. I do not know what the Commission's view would be on that, actually. If it were about technical rule-making powers on quite detailed issues, I suspect that that would not necessarily be a huge problem. There would be a question of scope and remit and things for the body as to exactly what areas it was allowed to make rules in and it is possible to see comparisons with the UK's Financial Services Authority which operates under the Financial Services and Markets Act. The scope of the organisation and its rule-making powers is controlled by Parliament by the democratic process through the Regulated Activities Order and through other controls for example on the sanctions and arrangements like that. So, it is possible to imagine an arrangement where the Commission and perhaps the Council and the European Parliament have a role in defining that sort of framework for regulation and setting the powers of that rule-making body but then leaving it to make some of the technical rules within that space. There is a spectrum of options here. This is a proposal that I think sets out some ideas and, as Lord Myners said, we will see where this debate goes on this issue. As to what sorts of changes will be needed to introduce these sorts of arrangements, I think that it will depend very much on the detail of those arrangements and the willingness of countries to go along with something, and we have seen the creation of the Lamfalussy arrangements to date. There has been a very large degree of flexibility on the part of countries and the Commission and the Parliament actually in coming up with arrangements that can be made to work in practice within existing treaty arrangements. So, we are not at the moment calling for any sort of treaty change to facilitate these sorts of changes.

Q623 ***Chairman:*** The European Parliament has been for a long period very unhappy about comitology and the Level 2 Committees cutting them out of the process and, as I understood it, that was going to change.

Mr Maxwell: You are right that the European Parliament has had some reservations but I think that you have to ask yourself what the alternatives are and to recreate pieces of primary European legislation often takes three years. It then has to be implemented in Member States. When you have fast-moving financial markets, one of the benefits of a system like this would be that you could make changes to technical regulation far more rapidly to deal with innovative markets in much the same way that the FSA can change its rule book relatively speedily. It has certain due processes to go through to consult the markets and it has certain types of accountability arrangements around it but, as long as it follows those arrangements, it can make changes quite rapidly to deal with the market change. I think that a European system of regulation that requires the European Parliament and the Council to be involved in very long debates about these issues every time you want to see a technical rule change would not allow regulation to keep up with the pace of market development.

Chairman: I am going to press you further but Baroness Hooper wants to come in at this point.

Q624 ***Baroness Hooper:*** May I ask who you propose should appoint members of this body and would you follow the Doha principle or would you follow a representation of all the Member countries of the European Union? Who makes that decision?

Lord Myners: I think that that is still open for debate and discussion. There is a broad range of views on this. The most important thing is to ensure that an effective body is created which has the competency to fulfil the task and whose decisions are respected. Given that the conclusions of the group and the advice or recommendations that it makes will of necessity pose questions to national governments, I think it is important that its membership commands respect, but it still needs to be a group which is workable in terms of the breadth of membership. So, I think that there is a neat balance that one has to seek to achieve there.

Q625 ***Lord Haskins:*** This is really a big fudge, is it not? Creating an independent body when the accountability is not clear does not seem very good regulation to me and then saying that there is rule making but, on the other hand, the rules that are set out are not binding. Is it not really that this is a very sensitive political area which the ECB and the British Government want to avoid almost at any cost becoming involved with? What is being proposed sounds to me like an unworkable fudge.

Lord Myners: I think that "fudge" has very negative connotations.

Q626 ***Lord Haskins:*** Certainly.

Lord Myners: I think that there is an altogether more positive way of saying that these are complex issues which require recognition of national governance and national sensitivities whilst also recognising that economic and financial pressures would tend not be limited to a single country and therefore does require a European nay global perspective. So, there will be a need for achieving a workable compromise. That is why I emphasised in my earlier answer the importance that this group commands respect both for its independence and for its competence because, if it is seen to be a wholly wise and respected group, its recommendations and conclusions are likely to be taken much more seriously.

Q627 ***Chairman:*** May I press you on two different points in this proposal. I am sure that it would be helpful to the Committee and to the wider audience if you could give one or two examples over the last two or three years that this body has existed. What important rules, not minor technical but important rules, do you think they would have reviewed because there is the impression that these are very minor things and nothing to get too worried about, but I would like some examples of important issues? Then I would like to turn to the question of the body itself. As I understood you, Lord Myners, you said that it would replace the Level 3 Lamfalussy Committees—I think you said that—so it is not really putting in an independent rule-making body, it is actually replacing/getting rid of Level 3 Lamfalussy Committees that operate, have a certain composition and operate in a particular way. The proposal is that there be an independent rule-making body and they themselves would, through this, influence the activities of the national supervisors. What would be the composition—I ask this again because I am not entirely clear—of this rule-making body and would they take decisions by qualified majority? Quite how would it operate? If it is an important body, I do not think that it is just the European Parliament, I think the UK Parliament would want to know quite what it is doing, who it is comprised of and who it is responsible to.

Lord Myners: My Lord Chairman, you ask a number of very detailed questions there and I think the answer is at the moment that those issues are still being debated and discussed by national governments and within Europe, that is to say the make-up and accountability of the two bodies that we are referring to here, the macro-prudential surveillance body and the rule-making body. You ask for examples of areas on which these bodies might have focused had they existed. I certainly think that from a macro-prudential perspective, the build up of leverage in the system both through recognised banks and through quasi-banking institutions, SIBs, hedge funds and others, would have been an area where one would be most surprised if this group had not been seized by that phenomenon and asking questions about it. Indeed, the increased dependence of banks on wholesale funding as opposed to conventional deposit funding. I would have also expected a body, if it existed, to have probed a little more about the move of the banking system from developing assets through loans which the bank serviced and maintained on its own books to the originate and distribute model which certainly has played a part in some of the difficulties which we have seen. So, I think that there are a number of areas there where a macro-prudential facility, be it domestically, regionally or globally—and we are talking through the FSB, through the de Larosière proposal and through some of the issues which Lord Turner has raised in connection with the FSA on which we will be saying more in due course when we publish a White Paper on this area in the next two weeks—would all have informed the policy-making decisions. I think that those in turn then lead on to some of the issues around rule making because there will be a natural follow through.

Q628 ***Chairman:*** That is interesting but not entirely quite what I asked. I am trying to understand the kind of role that this independent rule-making body could have played. After all, a lot of this is in response to a perceived combination of financial and real economic crisis and this is an important proposal which the Government have put forward involving considerable changes. I am trying to understand for the Committee the kind of rules that it might have looked at now looking back over the last couple of years in order that we can understand the role of this body which helps us to understand its independence, its independent role, how it fits into responsibility and so on.

Mr Maxwell: May I mention a couple of areas that I would expect. The first category would be types of changes to regulation that might have avoided or minimised the risk of some of these difficulties occurring and I think that would include issues around capital regulation and around liquidity regulation, for example in the banking industry, and it may be that this body would have had that responsibility, and maybe dealing with rather more technical levels such as the definitions of capital being used in different countries and the way in which they are treated in different countries' regulatory systems to try to find more converged arrangements, and that may have helped deal with some of those risks—it may have done. The second category is about enabling regulators to respond quickly to events when they develop and I think one example of that has been around the regulation of short selling within the European Union. Irrespective of your views about whether it is a good thing or not to regulate short selling, I think we have seen different regulators follow a different approach within the European Union. Given that many banks have shares in other countries, there is a case for looking at that sort of development on a cross-border basis and being able to respond to those sorts of things quickly, as I say irrespective of where you come on the final judgment.

Q629 ***Chairman:*** This body would have made rules which national supervisors would have to implement.

Mr Maxwell: Yes. I give that as an example that could have been considered. I know that for example the Level 3 Committee looked at short selling issues and found an interest amongst the national authorities to act, but it did not have the ability to make that happen in a more co-ordinated way.

Q630 ***Chairman:*** To whom would this body report? I apologise as you have probably told us that already.
Mr Maxwell: The rule-making body would need some form of accountability and governance arrangements like any other body, but I do not think that we have hard and fast plans for that. You would expect it to be accountable publicly and through the democratic institutions of the European Union, so the Parliament and the Council in some form or another.

Q631 ***Chairman:*** And the legal basis for its ability to set the rules and those that would have to be followed?
Mr Maxwell: Would need to be sorted out.

Q632 ***Lord Renton of Mount Harry:*** Lord Myners, it is almost exactly 100 days since you appeared before us, so it is not only President Obama who is celebrating his 100 days at the moment. Do you think that in that time your thoughts about the supervision of regulation of the European Convention have changed at all? Looking at all the things that have happened during that time—the G20 meeting, the considerable strength of the IMF, the difficulty that has obviously been found in European countries and how one actually manages the regulation supervision of banks et cetera—has that changed your view?
Lord Myners: I will step back a little and maybe come to that.

Q633 ***Lord Renton of Mount Harry:*** Yes. I do not say it in a critical sense.
Lord Myners: No and, given that I was relatively new into my job 100 days ago, it would not be surprising if, informed by more experience, one refined one's views. I do not think that they have fundamentally changed. I think that there is some good news around what has happened over the last 100 days. I think that considerable progress has been made to further strengthen the British banking system; we are not alone in doing that; other countries have taken further steps forward. However, there is still a great deal to do and there is still a great deal of risk in the banking system which needs to be very carefully managed. I think that we can take some encouragement from the fact that whereas 100 days ago we would have said that the critical problem was banks' ability and willingness to lend, that pressure/concern is not as great now as it was then. There has been some improvement. I think through bodies such as the G20—an the G20 has clearly been very important—and in the leaders' meeting here in early April in London but also the finance ministers and Central Bank Governors' meeting in Horsham in the middle of March have achieved a high degree of consensus about the need for international action around both economic management and around financial regulation and supervision. There is new impetus to the Financial Stability Board in that respect, more expectations from the IMF and a willingness to commit more resources to the IMF and to update the IMF's governance, and considerable support for the concept of colleges to address cross-border institutions, which I think is a continuing area that needs attention and I think, in that respect, the colleges appear to be working well and, at those companies where colleges have not yet been created, there are clear plans to establish them. So, I think that there has been considerable progress over the last 100 days but I suppose that, in terms of my own feeling about it, having been very seized from the time of my appointment at the beginning of October with the challenges facing a number of major UK banks and therefore tending to see it very much in national terms, my own focus has now broadened to looking at what we need to do within the EU and globally to address issues which require global and European responses.

Q634 ***Lord Renton of Mount Harry:*** Thank you, and I have to be honest with you. I read the evidence that the European Central Bank gave us some weeks ago—I could not be here for the meeting but I read it—and I see that Mr Trichet does say quite clearly in that, "We are ready and able to stand into the position of regulation supervision" without trying to draw a specific line between macro and micro, really definitely saying that he feels they could do it and I must confess that I came to that conclusion myself because I think that there is otherwise a danger that we go on talking about creating new committees and new colleges and this can take an infinitely long period of time and we do not know at the end whether it is going to work or not. I am reminded of the old Latin saying *quis custodiet ipso custodes*. I do realise the problem of us not being in the euro which is a major problem and international problem for us and it is very difficult to see how it is going to go away. Is it not worthwhile your team looking further at the role of the ECB in this and see whether it is actually giving them regulatory and some major supervisory advisory powers that could actually move matters forward much more quickly than is happening at the moment?
Lord Myners: As you say, Lord Renton, Mr Jean-Claude Trichet is a good European and a good public servant who stands ready to take any responsibilities and powers that people believe or European entities

believe it is appropriate for him to take having discussed this at some length when I was at the ECOFIN meeting in Prague earlier this month. I think the concept that the ECB should be the macro-prudential surveillance body and that the chairmanship should always rest with a central bank or representative of a member of a euro country does raise issues for those who are in the EU but who are not in the euro, and I think that we are being entirely pragmatic and liberal in saying that issues such as the chairmanship should not be prescribed to exclude people from certain countries and whether the ECB is the right body to play this role I think is a matter of whether it would be able to criticise itself and I think that that is something which we all on the whole find easier to do in private—I suspect that we are all quite critical of our own behaviours and performance—but to do it in a more public manner and to publish criticism would I think be a tall order as I said earlier on.

Q635 ***Lord Renton of Mount Harry:*** Is there not a real possibility that as the question of exclusion of the de Larosière report drags on, some of the major other European countries such as France, Germany and Italy will come to the conclusion that the ECB should play a really important part in the regulation and supervision of host banks?
Lord Myners: I think that there are certainly people in Europe and it seems in European governments who are moving to that view and we are of a different view. This is a matter for further debate and discussion at ECOFIN and through other fora to work towards a common ground. I think that one of the ways one does that is that you help others appreciate the shortcomings of their preferred solution as indeed others will no doubt seek also to persuade us, as some of the arguments this morning have done, that perhaps building on an existing institution is preferable to creating another institution, but at the heart of our view about the ECB here we do ask questions about whether central banks should be involved in financial regulation. Our own model for instance does not involve the Central Bank in financial regulation.

Q636 ***Lord Renton of Mount Harry:*** Arguably, that has not been a success.
Lord Myners: This is a debate on which I do answer questions at various points in the Chamber of our House including in connection with the Banking Bill and my responses tended to be to remind those who believe that everything would be a lot better if the Bank of England was still responsible for banking supervision that firstly the business of banking has become infinitely more complex, secondly that we have a proliferation of regulators before the Financial Services Act which many people tend to forget now, the SIB period with IMRO and the PIA and other regulatory bodies which I can remember from a practitioner point of view was an absolute nightmare, and of course the Bank of England's history does include BCCI and the secondary banking crisis of the early seventies, Johnson Matthey and Barings. I think that before one sees a simple solution there, Lord Renton, one needs to remind oneself that it was not always as good in the past—

Q637 ***Lord Renton of Mount Harry:*** I think this has probably already been reviewed in the Chamber!
Lord Myners: Yes, but I think that there is a model in this country, which is followed in one or two other sectors, of having a specialist regulatory or supervisory agency which is separate from the Central Bank.

Q638 ***Lord Moser:*** I feel very much the same as Lord Renton on the ECB. In fact, when this Committee started on this inquiry, at the very first meeting when the crisis was still sort of developing, I remember saying, "Where has the ECB been all this time?" and My Lord Chairman reminded me that the ECB under the Treaty does not have general economic responsibilities and therefore it stood back a bit. Leaving that on one side because you have answered Lord Renton, one thing that struck me as we were talking about a supervisory agency, whichever it is, is that you have talked quite rightly and understandably about macro-supervision and I have always felt uneasy in our various meetings of this Committee about this sharp division between macro and micro, not least because most of the problems stem from micro, not least risk assessment stems from micro, and I gained the impression that most of our witnesses have supported the idea of rather tough micro- and macro-supervision, whoever does it, and that, yes, we should keep an eye on micro and, to my mind, micro is the essence and I wonder, in your own mind talking about these issues, how sharp this division and how black and white this division between macro and micro actually is and whether the micro role of the supervisory body, whichever it is, could not get tougher.
Lord Myners: I am much focused in my own mind on those issues as well. Wherever I go, I now hear the argument that macro-prudential focus is the answer to the problems and that, if we had had more of that, we would not have had the difficulties and they could be avoided in the future. My own experience as I work with colleagues in the Treasury in preparation for the White Paper that we propose to produce in the next few weeks is that macro-prudential initiatives are much more complex to actually set in train than the rather simplistic argument that, well, that is the answer, and, when you actually get into the detail of,

what do you do when you see a problem emerging and what the response is and what if there is not a response to the perceived risk, becomes very difficult or much more difficult than some people perhaps assume and that is an issue on which we will no doubt have to give very careful consideration in the drafting of the White Paper. I do think there is a danger that focus now on macro-prudential because that seems to be the child of the moment might lead to overlooking the micro issues and, on the whole, individual companies fail not because of a macro issue but because of their own deficiencies in terms of their strategies and their people. At the heart of banks, we may well have regulatory shortcomings which we note, but banks that have failed have failed largely because of policies they were pursuing and the people who were in place to set those policies. I think that we need to continue to ensure that micro receives a lot of attention. I was with the FSA down in Canary Wharf yesterday morning speaking with, amongst others, the head of the unit at the FSA that deals with large complex institutions and it is very interesting how the FSA is now redefining its approach to regulating such institutions, which I think is placing less reliance on data capture and much more on getting to the heart of the company's objectives, its strategy and its culture. I think that it is a different form of micro-supervision as well.

Q639 ***Lord Trimble:*** A moment ago you were referring to the FSA as being as it were the model you would be advising Europe to follow in terms of the new institution you are instructing, but the FSA eschews any serious role in terms of macro-supervision. Insofar as we can define it, macro-supervision means looking at the health of the economy as a whole and is intimately bound up with the policies of the Government, and I can understand why the FSA is reluctant then to get too deeply into that. How could a European institution function if what it has to do is to consider whether the policies adopted by some or most European countries, advised or ill-advised, because it is located within the institutions and it would be a problem? In any event, part of the problems, as we are constantly being reminded, are global and who is going to tackle the real underlying global problem of global imbalances because we would not have the same asset price bubble were it not for those global imbalances? So, I am left rather puzzled and am rather inclined to agree with my colleague here that there is a considerable amount of fudge going around here.
Lord Myners: I think that you are absolutely right to say that the issue of global imbalances is very important here and I often say to myself when I was asking that question, how did all this happen? You think that you have found the answer and then you have to start asking, how did the issue of sub-prime arise and what caused what we know to be the American sub-prime problem? As you go further back, I think that you are driven to the conclusion that global imbalances are very important here and so there is a need to address that and the G20 has identified that.

Q640 ***Lord Trimble:*** My main question was, how is this new institution going to tackle the problem of advising governments that they are following the wrong policy and whether they should adopt different ones?
Lord Myners: I endeavoured to answer that question earlier but, in the end, it is the quality of the thought processes, the independence of the people managing it and the clarity with which they articulate their conclusions. I think that we have all had the experience of groups who fight above their weight for those reasons, but there will no doubt be pressures to emasculate such a body from being too clear in its expressions of its conclusions.

Q641 ***Chairman:*** Before we move on to question four, may I apologise for returning to the topic we discussed at question two, the independent rule-making role. May I clarify, is the Government's proposal at this stage for discussion that that body would cover the ground currently covered by all three Level 3 Committees, that is banking, insurance and securities markets? So, all Level 3 Committees would disappear, the new independent rule-making body would deal with banking, insurance and the securities markets? Is that correct?
Mr Maxwell: Yes. The plan would be that they would take on those roles over time from those three organisations.

Q642 ***Chairman:*** So, by any stretch of the imagination, a very important body indeed.
Mr Maxwell: Yes.

Q643 ***Chairman:*** Very important, but we are not entirely clear on what legal basis or what its common issue will be or how it will take decisions or if it would have binding powers and so on.
Mr Maxwell: It would have rule-making powers. Those rules would need to be put in place in all countries and, in that sense, those rules would be binding. What it would not become involved in is supervision of individual firms and the application of those rules to firms or indeed determining the mediation between the different supervisors and how they were doing that job.

Q644 ***Lord Trimble:*** I am now coming to the IMF because we have had people suggesting that the IMF could work together with the Financial Stability Forum to provide a global early-warning system and

it sort of follows on from what I was suggesting earlier that we need to look at things globally rather than regionally and nationally.
Lord Myners: The early-warning exercise proposed by the UK was actually launched last weekend at the spring meeting of the IMF. The early-warning exercise will provide a global framework to analyse risks, vulnerabilities, cross-border distress, dependencies and spill-overs across markets and the exercise will bring together the IMF, the Financial Stability Forum, to be renamed the Financial Stability Board with increased resource and broader membership, standard-setting bodies and national authorities which is designed to ensure better responsiveness and strengthen the accountability between those monitoring the global economy and those with the powers to take decisive policy actions.

Q645 ***Lord Trimble:*** I am interested that recently when there have been individual members of the European Union who have got into this problem or who are distressed that the assistance, however that comes, is not coming through European institutions but has been channelled through the IMF and I am thinking of situations where the IMF has been used. I presume that the reason why that has been done and has been suggested is that it is so much easier for someone who sits outside Europe to take the responsibility of giving some straight talk to someone as to what they should be doing and imposing conditions and that does not create that ill-will continuing within European institutions if the European institution were doing that. So, does that practice which has been going on and developed not point towards using global institutions in this context rather than regional ones?
Lord Myners: I have to confess that I am not as clear as I would like to be on why that has been the case, but I think that you have given a very plausible and logical response to why it might be that the IMF is better able to do this than European bodies.

Q646 ***Chairman:*** Lord Myners, if we make haste, can we at least try to deal with a few more questions?
Lord Myners: Yes.

Q647 ***Baroness Hooper:*** In terms of the home host responsibilities and the balance of regulation, I think that on the previous occasion when you spoke to us you suggested that there should be more power given to the host supervisor. I think that we are all agreed that, in terms of the European Union, the single market is extremely important and many other witnesses have suggested that if power were to rest with the host country in this, it could lead to fragmentation of the single market. What are your views on that?
Lord Myners: I raised this when I last had the pleasure of coming before this Committee three months ago and, subsequent to that, the Chancellor also raised the issue in his letter at the beginning of March and the Commission has committed to reviewing the safeguards and powers related to cross-border EEA branching by June of this year. A key principle for us is that branches should in principle pose no greater risk to host country taxpayers and financial stability than an equivalent size and type of subsidiary and, as part of this, there are a number of issues which are important. Firstly, the supervisory standards must be equivalent or higher in terms of quality, prudential liquidity and conduct of business regulation and resoursing levels and quality. Putting in place a new, tough supervisory peer review programme, as the Chancellor has proposed, will be key in addressing this. Secondly, the deposit guarantee schemes need to be of equivalent standard and have access to sufficient national funding and have co-operation arrangements between the home and host country schemes. The European Commission's review of the EU deposit guarantee schemes directive will need to address these issues and, alerted by the Chancellor's letter, that is clearly going to be done. Thirdly, there must be strong supervisory co-operation and information sharing and there again the concept of the EU supervisory colleges has an important role. Finally, the home country should have sufficient resources to fund a resolution and its resolution regime is capable of delivering the same outcomes as the UK regime. Set against those four role tests, our experience with the Icelandic banks does not match up to the standard I have just articulated and that is clearly an unsatisfactory situation and one where we are calling on our colleagues in Europe to recognise the reality of the situation and develop a framework which does not place host country taxpayers at risk because of a deficiency of capital regulation, supervision or deposit protection in the home country.

Q648 ***Baroness Hooper:*** So, you are saying that there is a risk of fragmentation of the single market and that therefore safeguards have to put in place to minimise the risk or to avoid it even.
Lord Myners: I am not sure that it is a fragmentation. I think it is an issue where we must ensure that the quality of financial regulation, supervision, capitalisation and deposit protection are of the same standard that we would expect from the FSA when applied to EEA countries—I have used the word "expect", Lord Trimble, as I see your jaw dropped—in respect of home countries.

Q649 ***Lord Trimble:*** You know what I am thinking.
Lord Myners: I do know what you are thinking, my Lord.

Baroness Hooper: I am not sure that I do.

Q650 ***Lord Trimble:*** It should have the same standard of regulation applied throughout the United Kingdom.
Lord Myners: I think that there is broad recognition not least of all by Lord Turner and the FSA that they need to significantly enhance the quality of their game and they are doing that.
Lord Trimble: It failed on that too.

Q651 ***Lord Haskins:*** I slightly broke your point, hedge funds. The evidence that we have had as far as I can see is that hedge funds and short selling have not really contributed very significantly to the crisis. Nevertheless, the media, the politicians and indeed your good self have joined the "something must be done" syndrome about the hedge funds and the question first of all is, does something have to be done about hedge funds and, secondly, if something has to be done, how do you intervene in a market and decide when a medium sell becomes a short sell and how do you regulate the activities of the market in that way when these transactions are perfectly legal?
Lord Myners: I am actually not sure that I am in the "something must be done" camp about either hedge funds or private equity and I think that we are due to see an announcement from Brussels today in this area—and we must await the precise terminology and I have obviously spoken to Mr McCreevy earlier this week in connection with his announcement—but I have a fear that we are going to see something coming from Europe later on today which leaps at hedge funds and private equity as a source of instability in a way which is not as necessarily as well informed as it should be. I think what is striking in respect of hedge funds is that there have been very few failures in the hedge fund area. Of course, the taxonomy of hedge funds is very broad and not all hedge funds use shorting strategy and some hedge funds have failed but their failure has been managed without too much damage. That said, there are a small number of hedge funds which, because of their approach, which again uses the word "macro", they are described as macro funds, taking very highly leveraged bets in liquid markets, could potentially pose systemic risk and G20 has said that they must come within regulatory oversight and from the perspective of their threat to financial stability and I think that is right, but I would not sign up to say that hedge funds or private equity were instrumental in any significant way in the global financial crisis. As far as short selling is concerned, I have debated this in the past in the Chamber. There are certainly sound economic arguments why short selling provides a valuable role in price discovery. At the same time, the FSA has clearly been mindful of the risks of aggressive short selling which might be linked or could lead to market abuse and that is the sort of issue that again Mr Maxwell was talking about earlier on which needs more debate.

Q652 ***Chairman:*** Suggestions have been made that the Commission have not really followed the kind of consultation careful process that was set out in your own principles for better regulation in coming forward and getting to the point where they are making proposals to regulate hedge funds, private equity funds and other alternative investment funds, and one of the concerns of the Committee has been whether or not in some areas proposals have been brought forward rather more speedily than perhaps makes sense, tempting though it is. Do you think that the principles of better regulation have been really appropriately followed in this particular area with the proposals coming forward?
Lord Myners: I think one would probably be better able to address that in the light of the recommendations that are brought forward and any explanation which is offered about the consultation process, but it does seem to have been approached quite rapidly and, in my discussion with Mr McCreevy earlier this week, we covered a wide range of issues including the need for a clear recognition that private equity for instance was one form of business ownership and there were many others such as public listed companies, partnerships, family firms. One needs to better understand what is at the heart of the issue which is exercising some people about private equity and are there concerns, for instance leverage treatment of employees, generic to private equity or could they also apply to other forms of business ownership? There is a risk that the way the Commission is thinking at the moment could have some quite serious unintended consequences for a source of risk capital which could be enormously helpful in supporting companies which at the moment are experiencing difficulties. There are many companies which are fundamentally sound but which have inappropriate capital structures and one of the features of that inappropriate capital structure is too little equity and too much debt, so the private equity industry can play an important role there as indeed can the other four institutional funds such as insurance companies and pension funds. You find something where you think, gosh, this has dragged on for a long, long time and they have still not reached their conclusions, but I do not think one is going to be saying that about the EU's approach to private equity and hedge funds. If anything, it has been too speedy, but let us judge that more fairly in the context of what they publish later today.

Q653 ***Chairman:*** It is important that proper and due process is followed when proposals are coming forward to regulate important areas of economic activity.

Lord Myners: May I interrupt you to say that time after time in financial markets—and clearly it is not just limited to financial markets—the unintended consequence of something which on the whole seemed entirely sensible and rational but a failure to think through the consequences can have very harmful repercussions which I think tends to support the view that a proper process, careful consideration, evaluation and broad debate based on a consultation with published responses is the right way to handle this.

Q654 ***Chairman:*** Finally, on the question of unintended consequences, is this an area where you think adequate careful thought has been given to spill over or extraterritorial consequences in this area? It is very important for us in London, is it not?
Lord Myners: Yes. I want to be careful about saying something which relates to a document which is going to be published within, as I understand it, a matter of hours, but certainly in the discussions I have had with both Baroness Ashton and with Mr McCreevy, there have been extraterritorial aspects that I have touched on. The original thinking about the new directive on private equity for instance would impose restrictions on a private equity fund based in Europe but investing in China. That would seem to me to lead to somebody who was running a global private equity fund to query whether Europe was the right place to base the fund or the manager. Likewise, we completely failed to miss the consequences of a major European company being owned by a Chinese private equity fund and, let us be clear, that is going to happen. The Chinese do not have a private equity industry that is global at the moment, but that will occur over the next 10, 20 or 30 years. At the moment, they would be free of certain obligations including reporting. So, extraterritorial global consequences here need to be taken into account otherwise we do end up with a lot of inconsistency, some of which could be damaging to Europe in general and to London in particular.

Q655 ***Lord Renton of Mount Harry:*** Is there not a point in this where one can say that the world has changed hugely partly because it is global as you have just said, Lord Myners? Hong Kong has always invested in markets around the world, so why should the rest of China not do so too? Also, because of the internet as e-trading is so easy and so quick, that has actually fundamentally changed the markets. In the old days, you went on the floor, held up your hand and someone said, "It's yours". All that has changed. You can do a huge amount very quickly. You can get in and out of the market in huge quantities within seconds. That gives a different view of the equity market to that which perhaps both you and I were both brought up with.

Lord Myners: Yes. I do not think that there is much that I can add to your question other than to express my complete agreement. I welcome the day when China and surplus countries develop a greater competency and confidence in equity investment because one of the problems we have had in the balancing issue to which Lord Trimble referred earlier is that those balances have largely been kept in short-term liquid monetary instruments and we are, I am sure, going to see much more cross-border global equity-type investment. As far as the instantaneous nature of markets now, I started working in the City as a blue button for a jobber and that was very much about a manual exercise on the floor of the Stock Exchange where you were allowed to make prices after the market closed at four o'clock, otherwise you just had to go and save your senior partner's place in the Long Room in the restaurant opposite the Stock Exchange so that nobody sat at his table.

Q656 ***Lord Renton of Mount Harry:*** When I started we had a different view which was that, if you made the wrong bid or excessive, you sorted it out in the pub afterwards!
Lord Myners: Yes.

Q657 ***Chairman:*** This is getting extremely interesting!
Lord Myners: I also have experience of the Lloyd's Market. I was a member of the Lloyd's Market Board and there were mechanisms in the Lloyd's Market in which problems were worked through which just do not sit comfortably with a global multi-cultural more litigious environment combined with technology.
Chairman: I now know the clear difference between the select committees in the House of Commons and the House of Lords. You could never have that conversation in the House of Commons!

Q658 ***Lord Steinberg:*** I am a great believer in prevention being better than cure. A lot of people do not necessarily agree with me. We have been talking about hedge funds and now I am going to talk about over-the-counter and we are talking on a more gambling nature and that suits me very well because I spent my whole life in that industry. I think that the OTC is a next-to form of gambling and in fact I have to declare an interest in that I am Chairman of an over-the-counter company based in New York. The question that I want to ask is, is there a need for an EU-based clearing house for CDSs and an over-the-counter market which I know that we have in London at the moment? If I may draw a very tiny comparison which is not hugely relevant. We have an AIM market in London which is a very weak market. In fact, in the last three months since 1 January, I appreciate that conditions are very poor. It only raised £3 million which shows the weakness of these kinds of markets.

Lord Myners: I may say a word about AIM markets but on OTC I will ask Mr Maxwell to lead.

Mr Maxwell: I think that there are benefits in having central counter-parties for clearing credit default swaps and other forms of OTC contracts. I think that clearly some of those forms of contracts are more amenable to being processed through some form of centralised clearing system, those that are more plain and straightforward commoditised forms of contracts. Using some form of central counter-party system I think helps manage prudential and operational risk which otherwise sits on the books and the balance sheets of the institutions doing the trading and it provides a sort of fire break within the system. So, there are some quite significant potential benefits and that is why I think internationally all the major jurisdictions have supported over the last couple of years the development of that sort of infrastructure. Given that these markets themselves are international in nature and that firms are dealing in contracts that originated all over the world and with counter-parties that may well be elsewhere in the world, it would seem strange to re-invent a whole series of national CCP arrangements in every single country where there are some participants in these markets. So, I think it is to be expected that we would see the development of some central infrastructure within the European Union and no doubt within the United States and maybe in one or two other jurisdictions. I think that there are potential benefits in competition in having a handful of these sorts of arrangements in place. On the other hand, the smaller the number of systems and the more netting off that can be done between those centralised systems, the more efficient they will be for the users of those systems. So, there is a balance to be struck around that.

Lord Myners: As far as AIM is concerned, clearly the AIM market is at the moment going through a difficult time with an increasing number of company failures and a number of companies delisting because they have judged that it cannot be sensible to continue to be members of AIM and new listings and fresh arrivals into that market or additional capital raising by existing companies is very low. In some ways, that is not surprising. Financial economists would expect the AIM market to exhibit high beta features which would mean that, at a period of high economic confidence and a high propensity to take risk, you would expect the AIM market to be active and, when the reverse applies, namely when the focus is on caution and risk aversion, that the AIM market would be a lot quieter and Dame Clara Furse, the Chief Executive of the London Stock Exchange, wrote a rather good letter in *The Financial Times* on the subject of AIM earlier this week I believe, which was essentially saying that the reports of our death are incorrect.

Chairman: Greatly exaggerated!

Q659 ***Lord Steinberg:*** I know that it is not strictly relevant, so may I move back to the EU and the OTC. I am suggesting, Mr Maxwell, that what you were saying is that it is better to have an EU control of it which to some extent would affect the City of London.

Mr Maxwell: It depends on what the counter factor is to this. The first thing is that it is better to have some systems there that can do the job effectively. It is not normally the Government's approach to intervene in commercial markets and say that there must be bits of infrastructure built here and here and here, but rather to support competition between potential providers and see where that ends up with them being provided. I think that for financial stability reasons it is sensible that, if these systems are being developed, they are subject to reasonably high prudential and operational standards to make sure that they fulfil their role and I think that from the UK's perspective, if there is a possibility that UK firms will be using systems in other countries which, if we support open markets, must be a possibility, then those systems in other countries are also subject to high standards and that is probably best done through using international standard setting organisations like IOSCO for example, working with the US authorities where I am sure infrastructure will be developed but also working within the European Union to support the establishment of standards which would cover systems wherever the work within the European Union. I think that it is preparing for those cross-border arrangements just as in other areas of these markets we try to have rules that are set and international standards that are set internationally.

Q660 ***Lord Steinberg:*** But these markets are much more of a gambling nature than a lot of the other markets that we have and, as such, we have to be more careful about the way that we regulate and supervise them.

Mr Maxwell: Yes.

Q661 ***Lord Moser:*** Some people have commented to us, people who know the Treaty in more detail than I do, that there is a risk with one of the articles, Article 100, can be used as a bail-out clause and that there is a danger or risk that it could be used for Member States to bail out. Is this a real worry from your point of view? Should we be worried?

Lord Myners: There is no question of any EU Member State receiving a bail out from either the EU or any other Member State under Article 100(2) or indeed any other article. Bail outs are defined in Article 103 of the Treaty establishing the European

Community, the Maastricht Treaty, which clearly states that the European Community or any other individual Member State shall not be liable for or assume the commitments of governance of another Member State. Nevertheless, there are existing Treaty provision under which the Community can provide financial assistance to non-euro Member States—I hear the word "fudge" whirling around Lord Haskins's mind as I say that—experiencing difficulties with their balance of payments under Council Regulation 332/2002 which establishes a facility for medium-term financial assistance and is pursuant to a Council decision under Article 119 of the Treaty. The EU balance of payments finance facility allows the Community to borrow on financial markets currently up to a cumulative total of 25 billion euro to pass on to Member States in need in the form of a loan. This assistance comes with policy conditionality attached which is set out with a view to re-stabilising the balance of payments situation and is often in conjunction with IMF support. The Government's interpretation of the Treaty is because of Article 103 such financial assistance cannot be used to transfer the commitments of the Member State concerned to the Community or to another Member State. I hope that answers your question, Lord Moser.

Q662 ***Lord Moser:*** I think it answers it more fully than I could ever hope for. I am quite incapable of asking you more questions!

Lord Myners: I am so pleased because I was fearful that there would be a supplementary on it and I would grievously disappoint!

Q663 ***Chairman:*** You do not often leave Lord Moser speechless! Lord Myners, thank you very much, indeed. You have been, as before, extraordinarily patient and, along with Mr Maxwell, we thank you for your responses. We are most grateful to you.

Lord Myners: Thank you. My Lord Chairman, if I on reflection on reading the transcript feel that I have given the Committee a less than full or complete answer, I would welcome the opportunity of being able to write to you with any further comments that I think might be helpful to your good work.

Chairman: That normal courtesy will of course be conveyed to you.

Supplementary letter from Lord Myners, Financial Services Secretary, HM Treasury

FOLLOW UP TO EVIDENCE SESSION HELD ON WED 29 APRIL 2009

It was good to have the opportunity to appear in front of your Committee again on 29 April. As I promised during the meeting, I am writing to provide answers to the questions we did not manage to cover fully during the evidence session due to lack of time, on the subject of the ECB.

Before I turn to the particular questions, it is worth noting that Larosiere does not propose to put supervision in the ECB. The report proposes an extended role for the ECB in macro prudential oversight, in the form of a macro-prudential early warning body under the auspices of the ECB and chaired by the ECB President. The report does not however propose any role for the ECB at the micro supervision level.

In response to your particular questions:

Could the European Central Bank undertake a supervisory role, given the possibility provided by Article 105.6 of the EC Treaty?

While there is a clear need to improve supervisory cooperation, for example through the use of supervisory colleges, I do not agree that a European body should have supervisory powers over firms. A key concern here for me is that national governments remain responsible for crisis management, and that only national governments can, for example, provide fiscal support to individual institutions. I note that the Larosiere report did not propose the ECB have this role.

You will remember from my evidence session that I do however believe that there is a role for a EU macro-prudential early warning body, to provide analysis of cross-border risks to our economies. That is why the Chancellor proposed such a body in his 3 March letter. Such a body would complement the early warning work of the IMF and FSB.

This body will need to be sufficiently independent of the current EU institutions to provide effective analysis. Clearly the ECB will need to play a significant role in this body, as will the Bank of England and the FSA.

Regarding the specific Treaty legal base, we will have to wait and see under what legal basis a proposal is made. I understand the article suggested, which requires unanimity in the Council, is one that might possibly be used to establish a macro-prudential early warning body, but that there are good arguments in favour of using Article 308 instead. Article 308 also requires unanimity.

If the ECB takes a role in supervision through its General Council rather than the Governing Council, will this prevent the UK from being disadvantaged by it not being a member of the eurozone?

As in the previous question, I would not support an ECB role in EU supervision. In terms of the macro-surveillance body, as I also mentioned above, effective macro-surveillance requires any new body to be independent and to include the most appropriate people in it putting together its analysis. While the General Council includes non-eurozone central banks, which is important, the new macro-surveillance body will also benefit from input from national supervisors, particularly from the main financial centres. Therefore the policy response should be wider than that just a debate between the General Council and the Governing Council.

Should the ECB play a role as an arbitrator between national supervisory authorities on supervision of cross-border banks?

I do not believe that the ECB should have powers over national supervisors or over individual firms. I note that Larosiere's report did not recommend a role for the ECB in arbitrating between supervisors. You will remember from my evidence session that I also do not believe that the Level 3 committees can become supervisors themselves. Similarly therefore I do not consider that binding mediation powers over individual firms are appropriate, nor supervisory decisions over firms or infrastructure.

I hope that these thoughts are helpful and thank you again for the opportunity to clarify the Government's position on these issues.

11 May 2009

Written Evidence

Memorandum by the Association of British Insurers

The Association of British Insurers (ABI) is the voice of the insurance and investment industry. Its members constitute over 90% of the insurance market in the UK and 20% across the European Union. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. And through the ABI they come together to improve customers' experience of the industry, to raise standards of corporate governance in British business and to protect the public against crime. The ABI prides itself on thinking for tomorrow, providing solutions to policy challenges based on the industry's analysis and understanding of the risks we all face.

Executive Summary

Insurance is not at the centre of the financial crisis. A sound business model and conservative asset management means that insurance has weathered the crisis relatively well.

Lessons need to be drawn from the financial crisis, and limited regulatory change will be needed to provide new powers in some areas. We look to Europe to play a leading role in developing these new powers.

Insurance is not banking. Different supervisory techniques are needed. There is no need to apply to insurance the restrictions intended to reduce the systemic risk in banking. Europe has already set out most of the changes needed to the prudential regulation of insurance in the Solvency II Framework Directive.

There is a risk of regulatory overreaction. New regulation should be targeted at the genuine causes of the crisis, rather than applied indiscriminately to poorly understood corners of the financial markets. It is paramount to the recovery of capital markets that regulation is proportionate to the problems they are meant to address. Proper cost-benefit analyses and consultation are key to the construction of proper and effective legislation, even during a crisis. We welcome Commissioner McCreevy's measured approach to regulation. The new Commission will need to continue to show restraint.

New regulation is only one part of the answer to the financial crisis. Above all, we need better quality supervision. Much of the crisis could have been prevented by better decision-making using existing powers. Better quality supervision will be needed to prevent the next crisis.

A key element in better quality supervision is greater convergence between supervisors. The financial crisis has led to a serious failure of trust between national regulators. National regulators appear to feel safe only when the regulatory powers are in their own hands. Regulators must not respond to the crisis by retreating to isolated national positions and introducing protectionist measures. There is a real risk of market fragmentation and de-globalisation.

In Europe, the Lamfalussy architecture has proved inadequate to the task. There is not enough pressure on national regulators to cooperate. The regulatory framework at EU level needs to be strengthened, at first by giving the Level Three committees powers to mediate in cases of differences between national regulators. We can believe it is time to exercise the case for a single EU prudential supervisor.

Globalisation has brought significant benefits allowing more efficient use of capital, diversification of risk, greater competition resulting in more choice and lower prices, good ideas and best practice travel more quickly. We expect Europe to play a leading role in an international context. Unlike the G20, the EU does have legislative powers and is therefore in a stronger position to react to the financial crisis. But just as we expect national regulators to cooperate in Europe, so the European Commission should reach out to the new administration in the US, and to supervisors in the major energy markets and in India and China. It must continue to promote open competition across the globe. We look to G20 leaders at the London Summit in April to assert a greater degree of cooperation at the international level.

Questions

1) *Current Commission Proposals: Will enforcing a prudential financial regime be an effective method of preventing a repeat of the financial turmoil?*

1. We agree that tackling the financial turmoil is primarily a prudential issue and that a limited range of new powers may be needed. But new powers are only part of the answer. Better cooperation is also needed between the EU and national supervisors. Writing rules is the easy part; effective enforcement is much more difficult. Much could have been prevented by more effective decision-making using existing EU legislation. Better quality prudential supervision is key to avoiding another crisis.

2. The ABI strongly supports the robust prudential approach outlined in the European Commission's Solvency II proposal (COM 2008/119). Solvency II fundamentally updates the capital adequacy requirements for the insurance industry. Insurance companies across the EU will be required to identify fully their risks and hold the corresponding capital.

3. Solvency II places a significant emphasis on the risk management framework. The insurer is required to demonstrate that the same analysis is used for its own business decisions as is being presented to the regulator.

4. In addition, qualitative measures will be put in place through greater supervisory oversight. Insurance companies can expect supervisors to be more fully engaged. The framework of group supervision in Solvency II will enhance cooperation and require a better exchange of information between supervisors. This will support a more complete picture of the financial health of a pan-European insurance company.

5. Insurance is peripheral to the financial crisis. The lessons that can be drawn from the crisis (better risk management, accurate valuation of all assets and liabilities etc,) will best be met by early adoption of the Solvency II Directive.

Will Commission proposals amending the Capital Requirements Directive and introducing rules on credit rating agencies prevent a future crisis? What dangers are presented by these amendments?

6. These proposals do not target the prime causes of the crisis which lie in excessive leverage and loose credit standards. These new rules may help at the margins but will not prevent another crisis, and some elements may be counterproductive.

Capital Requirements Directive (CRD)

7. As investors ABI members have been supportive in principle of the proposal that issuers should retain on their books a proportion of each instrument they originate, as stipulated in Article 122a of the review of the Capital Requirements Directive (CRD). The requirement for the originator to hold a minimum 5% material net economic interest, provided this is 5% of each relevant tranche, would provide some assurance to investors that their interests are—and continue to be—aligned with those of originators/sponsors. The principle of retention also provides a positive link between the borrower and the lender and ensures that it is not severed in complex transactions. However, we question the practical implications of the proposal.

8. First, it is questionable whether investors' interests are best served by the proposal as it stands. The Directive proposes to restrict the ability of investors to invest in securitised products from issuers that are not subject to the CRD requirements. In other words it would prevent UK investors from investing in products originating from outside the EU, effectively limiting investor choice and opportunities for diversification. The notion that instead of this, it would in fact mean that even originators not subject to CRD would keep a portion of the risk seems to us at best optimistic. And even in cases where this would happen, obtaining commitment via legal agreements would be a complex and costly process.

9. Second, it is neither practicable nor feasible for investors to monitor and enforce compliance of originators/sponsors with the retention requirement as described in Art122a.5. This additional layer of due diligence would simply add to costs, without necessarily achieving its intended objectives. The costs are likely to be significant—both the initial ones such as legal fees for contractual agreements with originators, and ongoing costs such as monitoring compliance with the retention rules for the duration of the holding. It is important to emphasise that it is ultimately the ordinary savers and investors who pay for this.

Proposal on Credit Rating Agencies (CRA)

10. The ABI maintains its opposition in principle to the regulation of Credit Rating Agencies (CRAs). The Agencies may have made errors during the crisis but regulating them is not the answer. For major institutional investors ratings are only one consideration when making an investment, and can never be a substitute for proper due diligence. We fear that by regulating CRAs, ratings may be given more credibility than they deserve. This may perversely result in encouraging reliance on ratings.

11. We have serious reservations with the proposal as currently drafted. Similar concerns of protectionism arise to the CRD. Currently the Regulation inhibits investors' ability to invest in paper rated by a CRA outside the EU. In addition, we do not believe the ramifications of withdrawing the registration of a CRA, or the suspension of ratings, have been properly thought through. Changes in ratings, including withdrawal, could destroy asset value, especially if fund managers are forced to sell paper before the scheduled end date of an investment. The impact on the financial stability of markets must be considered.

12. We consider that any regulation should focus specifically on the conflicts of interest facing CRAs, and should not refer to ratings used for regulatory purposes, as this will reinforce their use in regulation and therefore reliance on them. We believe the regulation should apply to ratings paid for by the issuer.

13. The ABI remains a strong supporter of robust corporate governance but we question the need for detailed statutory governance requirements for CRAs. Apart from setting a precedent for other sectors, these measures will conflict with domestic national law. We would propose that the regulation focuses on the key areas where it could add value—to strengthen measures to combat conflict of interest and to improve the availability of the information used by CRAs in their ratings.

14. A worrying theme that runs through both of these proposals is the restriction placed upon investors in investing in financial products in countries outside the EU. The conservative and nationalist response of national regulators is understandable, but the result is protectionism. These proposals, if left untouched, are likely to result in UK and other European markets becoming less competitive in the global marketplace, less attractive places to do business, and poor value for investors and the pensioner who rely on those investments.

Are changes needed to International Accounting Standards?

15. The International Accounting Standards Board (IASB) has already made changes in response to the financial crisis, notably amending IAS39 to allow for the reclassification of some financial assets from fair-value through profit and loss (when it has hitherto been compulsory to use this treatment) to amortised cost. While we welcome the additional flexibility that this change allows during this difficult financial period we believe that there remains further scope for adjustment to allow reclassification from fair value through profit and loss when this is an option. As things stand the lASB's changes, while bringing IFRS more into line with US GAAP, will mainly benefit banks and cannot be used by insurers. We are looking for some other changes in the lASB's rules, for example to those on impairments of available for sale debt assets, as they have led to very significant charges to the income statement which are not expected to be realised if the assets are held for the long term.

16. As global investors our members want to be able to use accounting standards that are comparable across continents. We thus supported the European Union's endorsement of the revised IAS39 in November. However, we do not support any moves by the European Commission to act independently of the IASB thereby creating an EU carve out from IFRS. We were opposed to such action when it was discussed in the autumn of 2008 for IAS39, despite our enthusiasm for additional change via the IASB.

17. The independence of the IASB from political interference and its due process must be fully respected. We can see arguments for improvements to the governance of the IASB, which could be done through an international treaty.

18. We also want to emphasise strongly that the primary purpose of International Accounting Standards being to ensure that accounts meet the needs of investors. We do not consider that accounting standards should have financial stability as a primary objective. Financial stability is the direct responsibility of regulators, not of investors. Regulators and investors have different objectives, and so their information needs are not the same. Further, regulators do not depend on accounts—they can normally obtain directly any information they need that is not given in accounts.

How effective are current proposals to protect bank deposits?

19. The UK insurance industry supports the Financial Services Compensation Scheme (FSCS) and believes it an important factor in providing consumer protection and maintaining the industry's reputation. We do believe some changes are needed to the funding structure of the FSCS, which currently calls for each financial sector to pay (ex-post) into its own sector's pot up to a certain level, and then into a general pot should the pay-outs exceed that level. This will lead to the insurance industry having to finance the failure of banks, despite insurers' sound business models.

20. The UK has operated an Insurance Guarantee Scheme (IGS) for over 30 years, and many other Member States have such a scheme in place. We believe that the absence of a scheme, or where the scheme has been limited, in other Member States has been a barrier to the development of a Single Market in insurance. We in principle would in principle welcome an EU Directive in this field, although we understand the difficulties and technical complexity of trying to coordinate so many varying national structures. We would also not want to damage the FSCS.

2) *Further Legislative Opportunities: How can we achieve a coherent set of rules on last resort assistance, deposit protection and bank insolvency proceedings? Should a revised directive on the reorganization and winding up of credit institutions include a system of prompt corrective action, with intervention triggers tied to a leverage or liquidity ratio?*

21. No comment.

Do rules on state aid to the banking sector need to be clarified?

22. The Commission has worked swiftly to approve national bank recapitalisation packages under the State Aid rules, and came forward with guidelines on the assessment of recapitalisation under State Aid rules in December 2008. The Commission will monitor and review measures taken by Member States, who in turn will report to the Commission after six months on how they have used state capital. The ABI is confident that the six-monthly reviews of recapitalised companies will unearth any anti-competitive impact on insurance.

What other rules are needed to ensure financial stability in Europe?

23. As major institutional investors and holders of long-term investment capital, insurers are well placed to participate in an economic recovery. Investor confidence in capital markets is key to financial stability, and measures must reflect the need to restore this confidence while permitting the markets to innovate and allocate capital efficiently. This means the focus should be more on developing transparency, rather than prescriptive regulation of hedge funds, short-selling and stock lending etc. Non-legislative measures must also be given consideration.

Corporate Governance

24. As guardians of the Company Law Directives and the accompanying Recommendations, the EU institutions have an important role to play in encouraging and enhancing robust corporate governance structures within companies. But in doing so the EU must not call into question the fundamental principles of corporate governance that have been developed over decades, and have on the whole served well the needs of Europe's industrials and service companies.

25. Europe needs to re-affirm the principles of comply or explain, and proportionality over the longer term. Within this overall context, British insurers have identified a number of issues for consideration in the light of the financial crisis.

Holding executive directors to account

26. British insurers wish to contribute constructively to the debate about the role of shareholders in the run-up to the financial crisis. Some stakeholders have suggested that institutional shareholders should have mounted a more robust opposition to the executive remuneration structures in investment banks, or to the investment policies that allowed financial institutions to take on the level of leverage and risk they did. We need Boards and management to increase their focus on risk management.

27. Recent events suggest that more could be done to improve dialogue with company management. A particular focus should be given to improving mutual understanding between independent directors and shareholders, how they interact at times of corporate stress, and on ensuring that dialogue appropriately addresses key issues such as risk management.

28. Analysts have tended to place great stress on the impact of short-term developments, including quarterly financial statements. It is now clear that the desire for short-term profit encouraged some financial institutions to take excessive risks, which subsequently led to serious losses. We need to shift the culture away from this. This objective will not be achieved through regulation, but introducing a longer-term perspective should be an important priority for dialogue between shareholders and companies.

29. The issue of remuneration is already on the EU agenda. Legitimate questions have been raised about the separate issues of the remuneration of banking executives and of directors. On banking remuneration crude caps will not work. However, we see merit in a more sophisticated linkage between remuneration and prudential supervision. Prudential supervisors should examine the remuneration structure—particularly of banking executives—with a view to determining its impact on the risk carried by that institution. We understand that the issue may in due course feed into the revision of the Capital Requirements Directive. On the remuneration of directors, further consideration is needed of the role played by Remuneration Committees and Remuneration Consultants. We understand that some thought is being given within the Commission to revision of the existing Recommendation.

Removal of barriers for cross-border shareholder activism

30. Shareholders cannot properly take a more active role unless the EU institutions do more to bring down the cross-border barriers that exist within the EU. We urgently need improved voting systems to raise participation at general meetings and to allow cross-border voting. Voting at general meetings is the key method by which shareholders can hold management to account. A single market for investment would make a major contribution to the depth of Europe's capital markets, and this will only become a reality if it becomes as easy for a Milan-based institution to vote at a General Meeting in Stockholm as it is in Milan. The Shareholder Rights Directive (2007/36/EC) took important steps in the right direction, but there are further improvements to be made, particularly in the operation of the chain between the legal holder of the voting rights and the ultimate beneficiary.

31. We remain concerned by the continued existence of barriers to shareholders exercising their rights in Europe. These devices serve only to entrench the power of management, and make these companies less attractive as investment opportunities. The issue acquires particular significance when many of Europe's major companies will need to be recapitalised. We urge the Commission to revisit their approach especially in the context of the forthcoming review of the Takeovers Directive (2004/25/EC).

Transparency

32. We also need more transparency about the ownership of companies. It is very difficult for management to engage in meaningful dialogue with their major shareholders if they are not certain who they are. The widespread practice of stock lending and the increasing use of derivatives and contracts for difference has complicated the issue. There have been occasions recently when, in the run-up to a controversial vote, company management have found that their share register bore very little relation to those actually empowered to vote. There is nothing wrong in principle with stock lending or with the use of derivatives, but there should be clearer and quicker obligations on those holding voting rights through those routes to declare their interest. We would support a review of the Transparency Directive (2004/109/EC) to extend the rules of disclosure.

Hedge Funds

33. There have been some calls in Brussels for the regulation of hedge funds. Putting aside the difficulties of regulating something that is difficult to define, we should not forget that general rules already apply. Hedge fund managers are subject to market abuse laws just like other fund managers. Any market manipulation is illegal. We suggest that more attention is given to the enforcement and policing of existing legislation.

3) *EU Supervisory Reform: Do we need a European System of Financial Supervisors or a central European authority to supervise pan-European financial institutions?*

34. Over the last decade the European single market has opened Member State borders allowing capital and wholesale financial services to flow more freely, efficiently and swiftly.

35. It is equally fair to assert that the supervisory architecture has lagged behind this progress. Member States are still learning to trust each other, and to allow greater convergence between supervisory regimes. But it is here where much of the problem lies. The Lamfalussy regulatory framework has done much to aid cooperation and convergence. The Level Three committees, made up of representatives from national supervisory authorities (in three separate bodies for banking, insurance and securities) advise the Commission on preparation of legislation, act as a forum for exchange of information and to support the consistent application of EU legislation across Member States. They have brought national supervisors together like never before, but in light of the recent turmoil we must question whether this has achieved enough.

36. We have always argued that convergence is key and we have watched the Lamfalussy process unfold and given it time to settle down in the hope that greater convergence will be achieved through evolutionary steps, while recognising that should this fall short then more radical steps may be needed. We believe the time has come to consider further steps and to take a new approach to supervision. The manner in which national supervisors reacted to the financial turmoil, by pulling back and retreating nationally, has shown the need for change. We therefore support the work currently being under taken by the de Larosière group in looking at the future of the supervisory architecture.

37. The ABI believes that in the long-term a more centralised coordination for prudential supervision may be necessary. This is a long-term vision, which should not be taken lightly, but it must be explored. We wish to stress this must not be to the detriment of a number of measures already being developed, such as the use of Colleges and group supervision (which we expand upon in the following questions). Such measures are not mutually exclusive.

38. In the medium term, more powers and resources should be given to the Level Three committees. Their roles and responsibilities should be clearly defined, giving them the ability to act as a mediator should disagreement between national regulators arise. It should also be made clear when their decisions act as a binding decision or simply as guidance. An enhanced role will require more resources to be given to the Level Three committees, which are already severely underfunded. In the longer term, the time has come to exercise the case for a single prudential regulator. This is not a step to be taken lightly. We may never get there. But the failure of trust between national regulation means that Europe should start now to exercise the economic and political conditions necessary for a single regulator, and the timetable.

39. What we fear is that national regulators will take a retrograde step by responding to the supervisory failures with inward looking measures. This is a mistake and insurers with cross-border operations would not be safe in such a world. We do not believe that the financial crisis shows a need to retreat into national fortresses by rebuilding old walls but rather to identify the cross-border supervisory failure and to tackle it. It is only through more coordination.that supervisors will be able to identify and manage risks effectively.

What type of fiscal resources should such an authority have access?

40. No comment.

How effective would group supervision be in creating a unified system of supervision across the single market? Would group supervision assert the primacy of large supervisors to the detriment of the supervising bodies of smaller Member States?

41. Solvency II is well advanced and should not be derailed by current debates on the future of supervision. The opportunity to make substantive improvement now must not be missed.

42. Negotiations in the European institutions are ongoing. Despite a solid proposal and continued commitment by the European Commission for group supervision, and an excellent and supportive report by the Economic and Monetary Affairs Committee (ECON) in the European Parliament, the Council of Ministers unpicked much of supervisory elements that make Solvency II so valuable. An immediate priority for the insurance industry, in the UK and across the EU, is to see these elements reinstated.

43. The group supervision mechanism envisaged in Solvency II gives a lead role for the home supervisor of a group (known as the lead supervisor), that will act in close cooperation with host supervisors (known as the solo supervisors) that have subsidiaries/branches in their jurisdiction. It should not be denied that in most instances the pan-European groups have their headquarters located in one of larger member states. This means that most lead supervisor roles will be held by one of the large supervisors.

44. However, it would be wrong to be distracted by the debate of large versus small member state. What is most important is that the lead supervisor has the best view of the overall financial health of a group, regardless of whether that supervisor happens to be from a large or small member state. It will have a thorough understanding of the group as a whole, through close contact and coordination through the group structure, via colleges. The group supervisor when approving internal models is genuinely best placed to make a judgment. The group supervisor role ensures greater security of consumers.

45. There are a series of crisis mechanisms already in place in Solvency II. Solvency II stipulates how group procedures work should an insurance company drop below its Solvency Capital Requirement (SCR) (first warning level) and then its Minimum Capital Requirement (MCR). There is also a commitment by the parent company to assist a subsidiary. This goes further than what is currently in place, and gives greater security than would be possible independently.

46. The local supervisors remain best placed to oversee the qualitative risk management practices, as developed under Pillar 2 of the Directive, and the MCR of the subsidiaries located in its territory. Full and proper coordination as a group of supervisors with regular exchanges on information, as envisaged under Solvency II, is essential for having true oversight of an insurance group across several member states in the EU.

47. In addition, Solvency II includes a number of safeguards should disagreement within the group occur—including the opportunity to refer to CEIOPS (the insurance Level Three committee) which would be given an unbinding mediation role. In most instances the lead supervisor is left with the final decision on a comply/explain basis because it is best placed to have a clear view of the complete picture of the group.

48. Colleges of supervisors are long running in practice for cross-border groups but are only now being seen in a more formal light, perhaps an indication of their value. By bringing together the supervisors who have a particular responsibility for a part of the group, they can collectively consider the financial soundness of a company and co-ordinate any required action to ensure more effective oversight.

49. There is currently no formal procedure as to how a College should organise itself. However, current convention is that the home member states (known under Solvency II as the group supervisor) would take the lead in the College, being well positioned to have a good understanding of the entire group. In order to avoid too wide a variation of how Colleges work from one group to the other we would favour more formal guidance on the operation of Colleges, to introduce some consistency and certainty as to their scope and remit. However, it will be important to ensure that some flexibility remains as group structures will vary and there needs to be an ability to reflect this in developing the most effective supervisory arrangements. We therefore welcome the publication of the "10 principles on the functioning of supervisory colleges" jointly produced by CEBS, CEIOPS and CESR on 27 January 2009.

50. There has been considerable debate as to which supervisors should be involved in a College. We agree that all Member States that have a direct link to the group, by way of a branch or a subsidiary, should be involved—this is the only way that a full picture can be maintained. However, in order for the Colleges to function properly and effectively it is important that at certain meetings only the essential member states are present—perhaps where subsidiaries are vital to the local economy. At others they could be opened to all, and even to third countries for international groups. This is where flexibility is needed.

51. What is important is that Colleges make a more concerted effort to formulate a procedure during a time of crisis. So far, as identified by the collapse of Fortis, coordination at the most crucial of times has been found lacking when it is most needed.

52. For international groups where they conduct significant operations and/or where their business is primarily established in third countries, we would support moves to involve them in group discussions.

53. In short we believe Colleges of supervisors are essential to proper oversight of a cross-border group, they should be placed on a more formal footing to provide greater clarity about their role and functioning, but this should maintain a degree of flexibility to enable supervisors to manage the supervision of different group structures.

Do we need a rethink of the home-host country divide with regard to supervision and crisis management in the EU?

54. As stipulated above, Solvency II is already well under way. Dependent upon the final outcome of negotiations offers a more than adequate solution to the home/host divide. We are aware that there is a different home/host division of responsibilities for the banking sector under the Capital Requirements Directive (CRD). Insurance is different from banking. The insurance industry has weathered the storm well through its solid business models and risk management practices. We remain concerned that while the focus, quite rightly, in the financial crisis has been on banks that any measures introduced as a consequence will be simply read-across to insurance. There is no reason why the supervisory arrangements should be identical across the two sectors.

4) *Working Practices: Do EU institutions need to amend their working practices on financial services? How effective are current working practices in providing a rapid response to a crisis?*

55. There are no lessons to be drawn yet—it is too early to tell if the responses have been successful or not.

5) *Global Supervisory Reform: Does the turmoil signal the need for a global supervisory system? If so, what role should the EU and existing financial institutions, such as the IMF, take in this system? Is a new Bretton Woods agreement necessary?*

56. The current financial turmoil does indicate a genuine need for a greater degree of cooperation at an international level, to combat the current and any future crisis.

57. The importance of global cooperation has already been recognised through the establishment of a series of international bodies, such as the International Monetary Fund (IMF), International Organisation of Securities Commission (IOSCO), and the Basel committees. However, we would now look to see their roles enhanced and the International Association of Insurance Supervisors (IAIS) is in need of more resources. We look to the leaders of the G20 at the London Summit in April 2009 to bring forward robust proposals for convergence at global level.

58. Globalisation has brought significant benefits allowing more efficient use of capital, diversification of risk, greater competition resulting in more choice and lower prices, good ideas and best practice travel more quickly. These should not be sacrificed lightly. It is essential that the European Commission and national governments do not respond to the crisis by retreating to isolated national positions and introducing protectionist measures.

59. This said, for EU Member States, Europe has to play a leading role in this process. EU legislation is binding on national governments and market participants alike. Until recently Europe was playing a leading role in developing global regulation for insurance through the Solvency II project. This lead position has now been put at risk by the opposition of a large minority of national regulators to group support. The principles of Solvency II are also under attack from the US, rather as an innocent bystander caught up in the intense US dispute over state and federal regulation.

60. We look to Europe to take back its leading international role by reaching early agreement on Solvency II, and taking an agreed European approach to the London Summit in April.

9 February 2009

Memorandum by the Association of Chartered Certified Accountants (ACCA)

1.0 Introduction

1.1 ACCA is the largest and fastest-growing international professional accountancy body with over 122,000 members and 325,000 students worldwide, whom we support through a network of 80 staffed offices and centres around the world. ACCA has its headquarters in London and 54,000 of our members and over 60,000 of our students are based in the UK.

1.2 The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; pensions; education; and corporate governance and corporate social responsibility.

1.3 Our staff around the world have been working with members and others in the financial services sector to develop the network necessary to understand the credit crisis from the perspectives of governance, remuneration, regulatory and accounting stances.

2.0 Context

2.1 Data released in January 2009 confirmed that the eurozone officially slipped into recession in the third quarter of 2008[1] and the EU as a whole now faces a prolonged period of little or no economic growth. Consequently, confidence in the EU economy sank to a record low in December 2008, according to the European Commission's Economic Sentiment Indicator.[2]

2.2 Implications of the financial crisis are likely to be prolonged and far-reaching. In the short-term, with tax revenues diminishing, unemployment rising and many governments having to bail out ailing banks, public budgets across the EU will come under pressure. It is likely that countries will exceed the Maastricht budget deficit limit of 3% of GDP, in some cases, by a significant margin. All of this will provide the first real test of the eurozone's sustainability.

2.3 In the medium to longer term, it is inevitable that 2009 and beyond will see greater regulation of the financial services industry in the EU and globally, with the implementation of further steps to enhance transparency and stability of financial markets being an important goal. Germany's Chancellor, Angela Merkel, has gone further, outlining the need for better regulated financial markets across the world, saying that she would "react very strongly" if attempts were made to block tighter regulation and calling for the creation of an economy body at the United Nations, similar to the Security Council, to judge government economic policy.[3]

2.4 This submission explores some of the impacts of the financial crisis on the EU, recommends key areas that decision-makers need to be aware of, suggests priorities for immediate actions and suggests issues of relevance for the financial services sector.

3.0 Summary of Key Points

3.1 The crisis has exposed weaknesses in both the EU's and wider Europe's regulatory systems. As a result, it is inevitable that the EU will adopt tighter rules for the financial sector. However, the priority should be to ensure that existing legislative and regulatory measures are implemented and enforced effectively across the EU, rather than reactively rushing through new legislation.

3.2 The financial crisis has reinforced the case for a serious reform of the institutions of global economic governance. The EU should take a lead here in shaping the new global governance around progressive values.

3.3 If the Recovery Plan is to be successful, member states will need to ensure that banks, especially those receiving support, make lending available and ensure that interest rate cuts are passed onto borrowers.

3.4 Although the option of a single European regulator is being discussed, we should avoid any option that creates too much centralisation and bureaucracy, or that risks a one-size-fits-all approach.

3.5 The bail out of Europe's banking sector will make it harder to resist state support for other industries, while weaker economic growth may lead to greater calls for protectionism.

3.6 There will be a debate around the push to get banks lending to business again. Some businesses will have become "bad" as a result of the lack of credit and are now a greater risk than they might otherwise have been. It will be come more difficult to provide "good banking".

4.0 The EU's Role

4.1 In 2008, Europe's central banks, led by the European Central Bank (ECB), injected large amounts of liquidity into money markets and encouraged banks to borrow against an increased range of collateral, in order to thaw the frozen markets and shore up confidence in the financial system. This tactic had little impact after the initial bounce where share prices rebounded around the world and frozen interbank lending markets showed some signs of thawing. Banks remained reluctant to lend to each other and confidence remained low.

[1] Eurostat, 8 January 2009
[2] European Commission, http://ec.europa.eu/economy_finance/indicators/business_consumer_surveys/2008/bcs_2008_12_en.pdf
[3] Speaking at the "New World, New Capitalism" symposium, Paris, 8 January 2009

4.2 This began to improve, however, towards the end of the year, after various EU governments, including Germany, France, Italy and a further 12 countries, adopted the main points of the 13-point action plan outlined by Gordon Brown.

4.3 Although the EU did not have a direct role in the bank bail-outs and the small upturn in confidence in the money markets, the coherent response and unity of the EU Heads of State or Government to the financial crisis has been a key factor for responsiveness and effectiveness, with the Summit of the euro area countries resulting in a declaration on a concerted European action plan of the euro area countries[4] confirming their commitment to act together in a decisive way to restore confidence and proper functioning of the financial system.

4.4 It is vital that governments increase cooperation and that they work together at EU and global levels to devise ways of bringing the financial crisis to a conclusion.

5.0 The Economic Recovery Plan

5.1 The two-year recovery plan, which is equivalent to 1.5% of the EU GDP, is made up of a fiscal stimulus of €170 billion from national stimulus budgets and €30 billion from the EU budget and the European Investment Bank. European Commission President José Manuel Barroso has not ruled out raising the amount if the crisis escalates.

5.2 The programme is aimed at breaking the vicious circle of loss of jobs, the economic slowdown and bringing back confidence in consumers and in the business sector.

5.3 The thinking behind the co-ordinated approach is that the fiscal measures will be much greater if they are part of a co-ordinated European response that will create multiplier effects. A co-ordinated approach will also avoid the effect of individual countries going it alone and running into problems, such as getting punished by capital outflows and seeing some of their stimulus leaking into imports from other countries.

5.4 If it is implemented fully across the EU, the Recovery Plan will shore up the real economy, help increase consumer confidence and restore stability to the financial markets, thus boosting lending to businesses and individuals.

5.5 However, if the Recovery Plan is to be successful, member states will need to ensure that banks, especially those receiving support, make lending available and ensure that interest rate cuts are passed onto borrowers. Community policy, structural reform, monetary policy and budget reform also need to be addressed to immediately stimulate economic growth in a co-ordinated manner.

6.0 Regulation

6.1 After the initial crisis, thoughts are now inevitably turning to the regulatory response, especially as leading banks in several EU member states have been part nationalised and the overall bill for the various national schemes across the EU could reach as much as €2000,000,000,000.

6.2 The risk in situations such as this is that politicians will be tempted to bring in "knee jerk" regulation in reaction to calls for action to prevent a recurrence of the situation. However, we caution against reform of the regulatory regime being seen as the only solution, as the inadequacy of the regulatory regime far from being the only cause of the crisis.

6.3 Regulation brought in in this manner is rarely well designed and has often not had the benefit of rigorous and transparent impact assessment. This can result in legislation having unintended consequences and actually damaging the businesses it aims to protect. ACCA, as a representative of many SMEs across the EU, is extremely concerned at this possibility.

6.4 The better regulation principles and the Commission's aim to cut down on unnecessary legislation by 25% by 2012 are both good steps. However, the financial services industry has been subject to far-reaching regulatory reform in the past five years and we now await the comprehensive overhaul of the Accountancy Directives, with Barosso having put pressure on the Commission to introduce liberalisation of the 4th and 7th Accounting Directives by October 2009.

6.5 The priority now should be to ensure that existing legislative and regulatory measures are implemented and enforced effectively across the EU, rather than reactively rushing through new legislation. The body of EU financial services regulation must also be reviewed to ensure that it is appropriate and enforceable, before its transposition into national legislation.

[4] EU Presidency, http://www.ue2008.fr/PFUE/lang/en/accueil/PFUE-10_2008/PFUE 12.10.2008/sommet_pays_zone_euro_declaration_plan_action_concertee, 12 October 2008

7.0 A single European Regulator?

7.1 Financial services is becoming increasingly pan-European, and cross-border activity continues to grow. In the light of the current turmoil, calls for greater cross-border supervision are likely to increase. This may take the form of a single, pan-European regulator, (which would involve changing the treaty to create a single regulator or system of European regulation, replacing the 27 individual regulators); a single regulator for the eurozone only; a European system of financial supervisors; a common rule book, whereby all national financial regulators would have to enforce a single set of rules; or a central European authority to supervise pan-European financial institutions.

7.2 In October 2008, the European Commission appointed a committee led by Jacques de Larosière, to establish what this cross-border supervision might look like. Individual member states have submitted views and an option is likely to be chosen in spring 2009.

7.3 Before any decision is taken however, a number of questions need to be addressed, including: what type of fiscal resources should any pan-European regulator or system of financial supervisors have access to? How effective would group supervision be in creating a unified system of supervision across the single market? Would group supervision assert the primacy of large supervisors to the detriment of the supervising bodies of smaller Member States? Do we need a rethink of the home-host country divide with regard to EU supervision and crisis management?

7.4 Whatever is decided, we should avoid any option that creates too much centralisation and bureaucracy, or that risks a one-size-fits-all approach.

7.5 What might be a more palatable option to some member states rather than the establishment of a single European regulator would be to strengthen the powers of the three "Lamfalussy" committees.[5] This would increase harmonisation, although not as much as the creation of a single, EU regulator, would avoid the costly creation of a new body, and would improve communication between regulators.

8.0 Accountancy

8.1 In response to political criticisms that fair value accounting rules caused some of the of the market volatility, the International Accounting Standards Board (IASB) has revised its rules on fair value accounting. Some countries now want the EU to seek exemptions from the international standards. This would be a serious step backwards.

8.2 The EU decision to use IASB standards (IFRS) as the basis for EU accounting standards, together with the Securities and Exchange Commission's (SEC) decision to allow foreign SEC-registered companies listed in the US to use IFRS without reconciling to US GAAP, were major milestones for EU listed companies and more generally for the development of IFRS as the global accounting language.

8.3 Rather than reverting to disparate sets of regional rules, the focus should now be on ensuring that IFRS continues to be a high quality, largely principles-based accounting language. An essential requirement for this is that the governance and process arrangements for the IASB (as the standard setting body), and its parent foundation, the IASCF, are in proportion to the global reach of its standards.

8.4 The EU authorities should engage from the beginning of the standard setting process to ensure that the IASB is aware of their views on accounting issues. The EU should also encourage EU companies and others to contribute to that process. As more and more countries adopt IFRS, it becomes ever more important that those with IFRS experience share their views and knowledge.

8.5 If this can be achieved through the consultative process, it should be possible for EU public and private sector parties to contribute to the evolution of individual standards, from the initial standard setting phase. In most cases, the EU authorities should then be in a position to give their support to new standards, as they are issued by the IASB.

9.0 Global Governance

9.1 The financial crisis and other issues such as climate change, are too big for individual nations to tackle on their own. Governments are looking more and more to global agreements and solutions. However, while the problems are global, financial regulation is national. Moreover, the so-called Bretton Woods institutions, the World Bank and the International Monetary Fund, have proved insufficient at spotting, preventing or controlling global financial crises, especially the current one.

[5] The Committee of European Banking Supervisors (CEBS), the Commitee of European Insurance and Occupational Pensions Supvisors (CEIOPS), and the Committee of European Securities Regulators (CESR)

9.2 The financial crisis in particular has raised issues of global governance which need to be addressed. These include, for example, the need to improve co-ordination at global level and to review the role of international financial institutions such as the World Bank and the International Monetary Fund.

9.3 The Commission has already outlined its support for international efforts to provide a consistent framework for addressing investment issues at global level, including on the IMF General Agreed Principles and Practices on Sovereign Wealth Funds.

9.4 However, in areas such as accounting, being too prescriptive with global measures could backfire. Issuing guidance that results in mechanical rule-following would be a recipe for disaster. Principles-based standard setting and professional judgement have a vital role to play and should not stifle recovery.

9.5 While the crisis has revealed some flaws in Europe's own regulatory system, the EU is still well placed to play an active role in designing new global structures and ensuring that they are transparent and accountable and that developing countries as well as others are represented, in order to increase the legitimacy of the decision-making process.

9.6 Europe should make sure that it plays an active part in shaping the new global governance around progressive values.

11 February 2009

Memorandum by the City of London Corporation

Introduction

1. The City of London Corporation aims to promote and reinforce the competitiveness of the UK-based international financial services sector by tackling issues which may impact upon the open, efficient and competitive environment for doing business in the City. The City Corporation welcomes the opportunity to contribute to the Committee's inquiry.

2. The European Union's current legislative term is drawing to a close at a time of extreme uncertainty in global financial markets, which has now spilled over into the wider economy. In the last 12 months or so, governments and central banks have been forced to make unprecedented interventions in support of markets and of financial institutions. Despite these attempts to restore market stability and limit the negative impact on the wider economy, the outlook continues to be bleak and, on most expert forecasts, it will probably last for the remainder of this year at the very least. The City of London Corporation believes that industry must seek proactively to improve the situation and not wait for the authorities to impose solutions. In this regard, the City Corporation has entered into a dialogue with Paris EUROPLACE[6] to promote a joint Anglo-French industry response to the challenges posed by the current situation.

3. In the short-term, the authorities and the industry must work together constructively to address the pressing needs of the current turmoil. Confidence in the financial services sector's ability to generate growth has understandably been dented and policy reactions to this crisis will be crucially important to the European financial services industry. Maintaining the status quo in the financial markets is no longer a realistic option and clearly some adjustment to the regulatory framework will be required. The industry accepts the need for change but in preparing future proposals, the financial services industry would urge the EU institutions to consult widely and to be rigorous in making and applying impact assessments so as to avoid prejudicing industry's competitiveness and innovative capacities. Regulators must not disregard the reality that not all parts of the financial services industry have been similarly affected and that, in the medium and long term, the industry can help deliver real gains to citizens.

4. In preparing for the future, however, policymakers need to be aware that existing financial markets legislation remains unevenly implemented across the EU, hindering the construction of a true level playing field for financial services and so hampering the industry's vital contribution to the renewed Lisbon growth and jobs strategy. Accordingly, the City of London Corporation believes that in the 2009–14 period, the EU institutions should not overlook the importance of the implementation of current rules, while consulting carefully to ensure that any new proposals help achieve greater competition, more innovative and better quality services and a lower-cost economy.

[6] Paris EUROPLACE is the organisation which promotes Paris as a financial market representing the major stakeholders in the French financial services industry.

Current Commission Proposals

5. It is arguable that the current crisis arose in an already well regulated prudential environment (Basel II and Capital Requirements Directive etc) and, therefore, the mere harmonisation of rules is unlikely to prevent future crises. There is a case for institutions to assess, monitor and control their liquidity risks much better than they have done in the past. The Commission Proposal for amendments to the CRD mainly comprises important technical improvements that the industry supports. However, some amendments of a more far-reaching impact have been shoehorned into the revision. For example, changes to the large exposures regime would result in more restricted lending to some sovereign states and the quantitative restrictions on securitisation would seriously harm the market function. The Council is proposing some amendments to the Commission proposals, including one on securitisation (Article 122a) that would exclude credit default swaps from the scope of application of the 5% retention requirement.

6. The CRD proposals on "EU colleges" aspire to formalise college arrangements within the EU. There is a danger that such legal formalisation might be counter-productive in the global context so, in order to avoid this, attention should be focused on ensuring that college arrangements in the EU are consistent with, and do not cut across, global collegiate cooperation.

Credit Rating Agencies—impact on European Investment Funds

7. As originally drafted, the Commission Proposal for a Regulation on Credit Rating Agencies (CRAs) would prohibit the trading of any debt instrument unless it was rated by an EU-based CRA, and certain debt instruments would become ineligible for UCITS or investment firm balance sheets. The key impact for fund managers was Article 4 which prohibited two things:

i. any EU regulated firm or UCITS fund from using a rating "for regulatory purposes" unless it has a rating from an EU licensed CRA (this affects firms wanting debt instruments on their balance sheet and UCITS' eligibility criteria);

ii. any EU regulated firm purchasing/selling a debt instrument unless it has a rating from an EU licensed CRA.

8. This would mean that no rated financial instrument anywhere in the world (including for example US Treasuries, Japanese sovereign debt or Indian corporate debt) would be able to be purchased or sold in the EU unless it was rated by an EU-based CRA subsidiary. It is not, however, realistic to expect EU licensed CRAs to carry out ratings on non-EU instruments nor are they necessarily best placed to perform such tasks. There is a risk of retaliation by the US and others which could have serious repercussions for EU companies wishing to attract US and other international investment. The Council and European Parliament are considering amendments to alleviate the situation.

9. There are many UCITS and other funds based in Europe that invest in the bond and other debt instrument markets outside Europe which would then become ineligible. Such a provision would require either the closure of such funds or relocation of such funds and/or their investment management outside the EU with potentially massive investor detriment and dislocation. An unintended consequence for the proposals might be to turn Europe into a "debt ghetto" with its financial institutions and retail investors locked into investing in the regional market with no access to non-EU capital and with EU companies not able to access flows of capital from outside the EU.

10. There are clear arguments that any response to this issue needs to be co-ordinated globally, as IOSCO indicated in its response to the Commission proposals. In the current state of affairs that would imply at least some form of mutual recognition with ratings of non EU-based CRAs. This is the approach favoured by Jean-Paul Gauzes MEP who is currently reviewing the European Commission Proposal for the European Parliament.

Further Legislative Opportunities

11. It could be argued that the greatest failures revealed by the crisis have been in the area of financial stability and crisis management. Options for supervisory reform have, therefore, focused on systemic stability as the main objective, which also make the EU as solid a place to do financial business as possible. To enhance the EU's financial stability oversight, consideration should be given to the development of a mechanism for EU financial stability coordination, based on prudential supervisors and central banks. Its remit would be to identify and consider the macro economic threats to financial stability within the EU, but it would need to mesh with global financial stability coordination. For the foreseeable future, however,

last resort assistance appears likely to be the responsibility of individual Member States but, perhaps, with greater coordination.

12. In addition, the City Corporation would argue that better coordination at the macro prudential level is essential. One option might be to consider the application of a counter-cyclical leverage ratio that would ensure the building of financial reserves in the economic upturn which could be used to cushion the impact of the down turn.

EU Supervisory Reform

13. Practitioners recognise that the current market situation, with widespread Government interventions to support the finance industry, has changed radically the political climate for financial services and its regulation and supervision. Improvements are, therefore, needed to the previous arrangements. In this environment it is important that the considerable progress made on the development of the Single Market for Financial Services over the last years is maintained. There should be open mind to all possibilities for supervisory reform, but any change should deliver a higher quality of supervision and financial stability management.

14. Issues relating to supervisory reform are quite complex. Whilst swift action in changing the EU's supervisory model may be justified politically, in some circumstances it is clear that many of the issues will require a longer time frame to allow an appropriate level of study, consultation and finally implementation over a realistic transition period, particularly in relation to the issue of lender of last resort and who ultimately pays when firms fail. In its response to the high-level review by Jacques de Larosière, the City Corporation has made some suggestions regarding a short-term solution, which can be implemented more immediately, with the thought to consider further study to some of the more radical changes, which might be more effective if implemented over the longer term.

15. An urgent part of the solution must be to enhance systemic stability by reinforcing colleges of supervisors, at EU and global levels. Colleges must be made to work efficiently and deliver more effective and coordinated supervision of cross-border groups, and should be complemented by the establishment of a strong lead supervisor role in the EU and a robust system of peer group review.

16. In addition, the City suggested that the three Lamfalussy Committees, CESR, CEBS and CEIOPS, should be given enhanced roles in supporting, with third country authorities, the organisation of colleges and (within the EU) the operation of the lead supervisor model. To do this, they should be provided with additional resources to carry out their tasks, delivering more coordination and, where appropriate, convergence. They must be given the means to set supervisory standards and ensure their appropriate implementation.

17. The establishment or reinforcement of colleges for financial groups operating in more than one Member State through branches or subsidiaries in the EU is already in progress. Moreover, the G20 proposed that by March 2009 colleges should be set up for all major cross-border financial institutions. These are radical steps in which the EU should take a leading role, and that must be supported and allowed time to work.

18. Reinforced college arrangements must be given time to demonstrate their utility. Colleges can facilitate a holistic view of a group's activities and risks, reducing regulatory duplication and inconsistencies, enhancing dialogue, cooperation and trust between regulators and supervisors. The G20 action plan emphasised colleges as an essential element in reinforcing international cooperation. The EU has a vital role to play in making sure that this action plan is a success and that we do indeed achieve a globally consistent approach to financial groups. More specifically, colleges can cope with EU group structures that do not fall under a single EU parent company (ie parallel subsidiaries or branches of 3rd country firms) and they can also cope with EU structures in which not all significant branches and subsidiaries are located in the EU (ie related to the issue of legal powers).

19. Colleges will remain relevant within the EU for as long as national regulators continue to exist (and beyond, with respect to international groups with material 3rd country regulators), so they need to be considered in parallel to other options. For colleges to be effective, greater thought needs to be given to prescribing "outputs"—ie what public policy objectives regulators and firms seek from them.

20. In the longer term, there may be a case for more integrated EU approaches. The City would argue, however, that any more radical approach would only be justified if it demonstrably delivered a higher quality of supervision and financial stability management. Some of the key issues identified include the quality of

staff, appropriate resources, independence, quality of outcomes, openness to dialogue with industry, and compliance with better regulation principles. It would also be vital to ensure that any more integrated EU approach worked well with global supervisory cooperation. The focus of the work therefore should not be on structures *per se* but rather on outcomes. If a superior outcome necessitates a structural change then consideration should be given to how to make that change efficiently and safely.

Working Practices

21. There is a need to address the issue of crisis management in the EU. The roadmap to further elaborate on financial stability and crisis management as put forward by the ECOFIN in October 2007 (based on a report from the Economic and Financial Committee, August 2007) is a useful starting point, but the issues identified there may need to be further developed in light of the lessons from recent market developments and the evolving work, at global level, of the Financial Stability Forum.

22. EU institutions and policymakers need to recognise that the industry has set up centralised functions for risk, capital and liquidity management. It is essential to the effectiveness of the single financial market that regulatory practices lives up to aspirations voiced by politicians at the EU level for a truly integrated financial market.

23. Considering that the EU financial system is continuously evolving and keeping in mind that markets continue to integrate the EU institutions must ensure that the structure of the EU's supervisory system is commensurate with the level of market integration, safeguarding financial stability in the EU, ensuring cost-efficiency for financial firms, and providing the EU with a strong voice in international financial diplomacy.

Global Supervisory Reform

24. There is, in the City at least, broad consensus that there is no need for new global institutions. It is however important to ensure that the governance of the existing institutions is accepted globally. Recent events have shown that a more globally coordinated supervisory system is needed, both of prudential supervision and financial stability management. Any solution will need to be sufficiently flexible to reconcile national accountabilities and prerogatives (such as the lender of last resort function) with effective mechanisms for international coordination and information sharing. The EU institutions' role in this system should be to ensure that regional cooperation and coordination arrangements within the EU contribute to global coordination. Leadership in international standard-setting and coordination of financial stability and supervision should be taken by global bodies.

February 2009

Memorandum by the Confederation of British Industry (CBI)

1. The Confederation of British Industry (CBI) is the national body representing the UK business community. It is an independent, non-party political organisation funded entirely by its members in industry and commerce and speaks for some 240,000 businesses that together employ around a third of the UK private sector workforce. The CBI's membership includes 80 of the FTSE 100, some 200,000 small and medium-sized enterprises (SMEs), more than 20,000 manufacturers and over 150 sectoral associations.

2. The CBI welcomes the opportunity to respond to the House of Lords EU Committee inquiry into EU proposals to deal with the financial crisis.

3. The CBI believes that the changes proposed by the EU should be aimed at restoring confidence in the financial system within the EU and globally.

4. The current proposed changes only go so far and have been established outside of the developments of improvements to the international frameworks. We recognise that given the rapid change in circumstances within the global financial system it is not possible to propose changes in all areas simultaneously. We therefore set out our key concerns with respect to the proposals identified to date with a focus on areas where additional proposals should be targeted.

5. One fundamental aspect of any proposed changes must be to ensure the functioning of a robust pan-European supervision framework. We outline our opposition to a single EU regulator and support for a enhanced college of supervisors approach with well-resourced level 3 committees.

Capital Adequacy Regulation Requires Further Reform…

Basel 2 and the EU's Capital Requirements Directive was not the cause of the financial crisis…

6. The development and implementation of the Capital Requirements Directive has been a lengthy and resource-intensive process for firms, advisers and regulators. It has resulted in the current approaches to capital adequacy, and to some improvements in the core infrastructure for managing risks.

7. Basel 1 was widely acknowledged to be inherently flawed and arguably encouraged some of the creative financial engineering that was a contributory factor to the crisis, such as off-balance sheet financing, a shift from banking book exposures to lower capitalised trading book exposures, and an increase in securitisations and risk transfer products. Basel 2 sought to address some of these flaws, including a more detailed focus on significance of risk transfer, liquidity facilities and risk-based lending.

8. Given that Basel 2 was not in operation for much of the time leading up to the global financial crisis it is wrong to say that it was to blame for the crisis. But it has since been found to constrain firms' ability to respond to the crisis, and in some cases has reinforced the downturn.

So the capital adequacy rules need to be reviewed and amended to address these flaws…

9. Further improvements that are required to capital adequacy rules include:

— The need to tackle the pro-cyclicality of capital requirements…

10. The Basel 2 prudential capital has been known to be pro-cyclical for a long time. This was a prominent issue during the development process, and certain adjustments were made to soften the impact of changing economic circumstances. The difficulty is to develop an approach that is counter-cyclical in spite of the natural human tendency of bankers to be pro-cyclical anyway (ie the boom/bust cultural mindset encourages certain forms of lending).

11. It should be possible to learn from the experiences of Spain which has operated a form of dynamic provisioning since 2000. This system is not counter-cyclical in that it did not prevent the build-up of excessive lending (Spain still had an extensive exposure to property lending and a big property crash). However, it has left the large Spanish banks seemingly in a better position to withstand some of the impacts of the financial crisis.

— The need to separate fair value treatments from prudential capital…

12. Fair value is simply a better measure than the alternative mechanisms for accounting, namely cost accounting. Given the issues with establishing fair values over the past 18 months due to the illiquid markets, then the clarification and guidance on valuation issued by the IASB[7] is welcome. Future developments and examination of fair value accounting should be done in a considered manner, with international co-operation and consistency to reach international standards.

13. There is a need to separate accounting treatments (prepared for the capital markets and owners of businesses) and the prudential regulatory requirements associated with firms operating in the banking system. For banks, given that the natural human tendency is to exacerbate the boom/bust cycle, a prescriptive mechanism for allowing capital buffers to be built up during the good times to allow them to be eroded in the bad times is necessary.

14. It is very difficult to determine the state of an economic cycle and to judge one's position within the cycle, and therefore the mechanism for introducing counter-cyclicality should be determined analytically and automatically to avoid undue dependence on management judgement. Reducing capital during bad times will be difficult to convey to analysts and will require increased confidence in the competence of regulators.

— Improvements to capital requirements for the trading book…

15. It is generally accepted that the internal models based approaches to the calculation of trading book capital requirements have been shown to be inadequate during the crisis of the past 18 months. The Basel Committee has been working on improvements in this area,[8] particularly on the calibration of a so-called "incremental risk charge" to capture the risks associated with illiquid markets.

[7] IASB Expert Advisory Panel "Measuring and disclosing the fair value of financial instruments in markets that are no longer active", 31 October 2008

[8] Basel Committee on Banking Supervision " Guidelines for computing capital for incremental risk in the trading book", and "Revisions to the Basel II Market Risk framework", 16 January 2009

The Future Regulatory Capital Treatment of Securitisation Structures needs to be Considered in a Co-ordinated Manner…

Securitisation and other forms of off-balance sheet financing had become incredibly important sources of finance, which regulation did not keep pace with…

16. The securitisation markets had become increasingly important to the financing of corporate and consumer credit in the EU. Securitisation is an important funding source for SME and other corporate loans, residential and commercial mortgages, consumer loans and credit cards and so on. Arguably the regulation and prudential capital requirement regimes have not kept up with the importance of this mechanism and its impact on the financial stability of the system.

The EU has tried to close some of the principal gaps in the regulatory treatment of the "originate to distribute" model…

17. The capital requirements in the current CRD regime are principally based on external credit ratings (see later). Whilst there were requirements on the originator to demonstrate significance of risk transfer, there was historically no focus on the quality of the original underwriting activities or the ongoing exposure management.

18. The main aim of the proposed EU changes to the CRD is quite rightly to get "skin in the game". The aim is to ensure effective underwriting at source by the originator and effective ongoing monitoring and management of the exposures, together with appropriate oversight and due-diligence by investors. We support these principles.

The EU's response should aim to eliminate unintended consequences…

19. The CBI supports the shared objective of the Commission and the European Parliament of restoring confidence in credit institutions and investment firms through improvements to the prudential regulatory capital regime under which they operate. In achieving this objective, the CBI's key concern is that any amendments are introduced in a considered manner with regard to the principles of better regulation, with holistic cost benefit analyses and which do not introduce significant unintended consequences for financial services providers or businesses which rely on a properly functioning financial system.

The Role of Credit Rating Agencies in the Crisis needs to be Examined, and this should be done on a Global Basis…

Regulation on credit rating agencies should focus on the calculation of capital requirements for structured credit product positions…

20. The Commission has proposed the introduction of a Regulation[9] on Credit Rating Agencies (CRAs) and on the use of external ratings produced by CRAs.

21. CRAs have been criticised for the part they are perceived to have played in the financial crisis and, linked to this, the capital requirements regime has been criticised for its dependency on the ratings produced by the CRAs.

22. There are two principal areas in the CRD which rely on external rating agencies:

— Calculation of capital requirements for firms on the standardised approach with exposures to corporates, banks and sovereigns, where it is not generally considered that these "issuer ratings" have been the source of particular problem.

— Calculation of capital requirements for structured credit product positions (eg Asset Backed Securities, Mortgage Backed Securities) in both the trading book and the banking book, where the ratings of these products are considered to have been at fault and to which the CRA Regulation is principally directed.

[9] Given the speed with which the European Commission has sought to introduce the proposed requirements, it has proposed a Regulation rather than a Directive as this does not need to be transcribed into National legislation.

And should be addressed in a global context…

23. A big concern over the proposed Regulation on CRAs is the extra-territoriality impact that is introduced and the danger of moving out of step with the global approach which is still being introduced.

The EU has helped to Facilitate some of the Government Intervention Required to Deliver a Co-ordinated Response to the Financial Crisis…

The EU changes to the depositor protection schemes are a welcome effort to restore some comparability and to eliminate opportunities for beggar thy neighbour action

24. One of the triggers of the October banking bail-outs was the indiscriminate announcements from various Member State governments on the details of the deposit guarantees that were to be introduced. Some degree of harmonisation across the EU is essential in an open market to avoid significant capital flows and arbitrage activities causing fundamental harm to the stability of the financial system.

25. The proposed EU Directive is a maximising directive with the aim of moving to a €100,000 common limit across all countries. This is arguably too high for the "widows and orphans protection" that it is generally considered to cover. Moving forward the removal of the "co-insurance" elements of the depositor protection schemes (all now cover 100% of deposits up to a certain limit) removes any element of consumer responsibility. If we are to encourage a long term savings and investment culture we need to ensure financial education and financial capability of consumers coupled with responsibility.

Need to move to a position where the government intervention can be unwound as efficiently as possible…

26. Moving forward it is essential that we are able to move back to a less interventionist approach from Government. There needs to be a road map for exiting the current intervention to avoid beggar thy neighbour issues within the single market over the coming months. As the impact of the financial crisis extends beyond the financial system into ordinary businesses, the extension of state aid implications becomes more relevant. We must be wary of throwing away all the rules around state aid with long term structural implications from directed investments and lending.

Reforms to EU Supervision should Focus on Enhanced Co-operation, but not a Single Regulator…

The CBI is not in favour of a single EU regulator

27. A single EU regulator would need access to a single EU Treasury function to provide the capacity for monetary and other forms of intervention. It is only national Governments that currently have the capacity and the money to carry out bail-outs and to rescue financial systems. At this point we question the appetite for a central European treasury function to co-ordinate and carry out such activity.

Given the difficulties with establishing global form of formal co-operation, a collegiate system is the next best thing

28. Improved co-operation is essential, and one needs to recognise the challenges in a model of informal cross-border supervision through collegiate structures. There are many global financial organisations operating in the EU, for example Citigroup, HSBC, Standard Chartered, Aviva, which have significant interests in the supervisors of 3rd country operations. Any supervisory model needs to fit with such global operations. Therefore a European form of colleges will need to align with closer 3rd country supervision.

Enhanced co-operation and communication should allow for improved supervisory function both in times of business as usual and crisis mode

29. Any reforms proposed to the EU supervisory structures need to be designed to cope with business as usual as well as crisis modes—informal co-operation works well in the good times, and it needs to be able to work well in the bad times as well. The dangers with informal collegiate approaches are that they rely on too many "memoranda of understanding" and non-binding links which break down at times of crisis. The focus of the EU proposed changes so far are on greater co-operation and information sharing, cognisant of the fact that at times of crisis, firms and individuals will look to National State Governments to co-ordinate action. Until such time as there is a single European treasury and single European regulator (which we do not support) there is no feasible alternative.

Conclusion

The future shape of financial regulation must be robust and internationally consistent…

30. In determining the future shape of the European financial regulatory architecture, and banking regulation in particular, the overarching objectives should be to develop robust regulation to restore confidence in the system, to ensure it is within a consistent international framework, and that it does not damage the EU's historic strength in the global financial system. Our key recommendations are to:

- Ensure that the amendments by the European Union (for example to the CRD and the CRAs) are proportionate and do not damage the functioning of markets to the detriment of our corporate and financial members.
- Focus on delivering a counter-cyclical mechanism to provide automatic stabilisers to the natural tendency for over-exuberance in lending behaviour and to position firms more effectively to cope with future downturns and crises.
- Examine the future issues of competition and the unwinding of Government intervention in a timely manner when the financial crisis has passed.
- Drive the improvements to the "college of supervisors" approach to achieve a robust pan-European financial supervisory framework. This approach should be supported by better-resourced level 3 committees and should not include a single financial regulator.

9 February 2009

Memorandum by the Council of Mortgage Lenders

Introduction

1. The Council of Mortgage Lenders (CML) welcomes the opportunity to submit evidence to the House of Lords European Union Committee Sub-Committee A (Economic and Financial Affairs and International Trade) inquiry into the role of European Union regulation in the financial sector.

2. The CML is the representative trade body for the residential mortgage lending industry. Its 137 members currently lend over 98% of the residential mortgages in the UK mortgage market.

Current Commission Proposals

3. We recognise the efforts being made by the European Commission, as well as by a range of other governmental bodies at a national and international level, to address the serious crisis that is facing the financial system. It is absolutely proper that these bodies should examine the regulatory framework to see how it can be improved to reduce the risk of future systemic crises in the financial system. However, it is most important that the authorities at a national and international level do not rush to put in place regulatory changes until adequate consideration has been given to the impact of the changes.

4. The CML, together with bodies representing the securities industry, are concerned over the Commission proposal in the amendments to the Capital Requirements Directive (CRD) to require CRD regulated investors in securitisations to obtain confirmation from the issuer or arranger of the securitisation that they will retain 5% of any bonds with the same risk profile of those purchased by the investor.

5. We believe these Commission proposals would delay the re-emergence of new securitisation issuance and have been introduced without adequate impact assessment. Given the international nature of the securitisation market and its investor base, we favour an attempt to find consensus on policy measures at an international level. But, if the European Union insists on imposing retention requirements they should be more flexible, for example, by allowing the issuer to retain an equivalent stake through the highest risk tranches. We believe that the capital charges under this proposal are also disproportionate.

6. The CML is also concerned about Commission proposals to regulate credit rating agencies (CRAs). The work of CRAs is truly international, supporting cross border investment, so any new regulatory framework should be discussed and agreed upon at a global level. To have different regulatory regimes for CRAs in the main regions in which they operate (Europe, North America and East Asia) would be a significant source of confusion, which rather than enhancing global transparency for investors could have the opposite effect.

EU Supervisory Reform

7. We support enhanced regulatory co-operation at a European and international level. The current crisis has demonstrated the extent to which problems in one country can spill over into others. However, we do not believe that it logically follows that a system of European financial regulation is required to supersede the current system of national regulators.

8. In their dealings with their customers, banks work within a national legal framework. Indeed, even European regulatory arrangements require an element of national discretion to allow for the myriad of structural and cultural differences between national markets. National regulators are best placed to operate within this existing framework. Moreover, while many large banks and other financial institutions are truly transnational in their operations, their activities are rarely restricted to the European Union, so regulation at a European level is not necessarily a logical step for these institutions.

9 February 2009

Memorandum by Deutsche Bank

EU Supervisory Reform

Do we need a European System of Financial Supervisors or a central European authority to supervise pan-European financial Institutions?

1. Yes.

2. The case for full integration of EU financial supervision is compelling. The largest EU banking groups hold the majority of all EU banking assets. These pan-European groups have developed group-wide integrated and centralised ways of doing business and managing risk. In an integrated EU market they rely upon increasingly integrated infrastructures.

3. Policymakers over many years have been calling upon the financial sector to embrace and drive the process towards EU financial market integration. The industry has done so but has struggled and continues to struggle with the piecemeal complexity of now 27 harmonised, but still distinct, national supervisory regimes many of them with two or more regulators. The duplication of internal. systems and processes for group-wide risk management and for local regulatory and reporting requirements creates significant costs and risks.

4. The financial crisis has demonstrated again the deficiencies of today's scattered landscape of supervision in the EU. Deutsche Bank believes that ultimately only full institutional integration can remedy these deficiencies. Efficient and effective supervision of the largest pan-European banking groups requires a European System of Financial Supervisors, or a central European supervisory authority. An integrated supervisor is much better placed to ensure the stability of the European financial system and to prevent and where necessary manage and resolve large-scale crisis. As the financial centre of Europe, London has much to gain from overcoming the current fragmentation of the supervisory landscape in the EU.

5. Full institutional integration will be a significant challenge in terms of both the organisational set-up and the necessary legislative reforms. However, it would not be the first time that the EU embarks ona vast change project. Institutional integration of supervision can draw on the successful example of the establishment of the ECB and the European System of Central Banks.

6. The necessary legislative reforms underpinning the institutional integration of supervision are far-reaching. A single prudential. rulebook has to be written and among a number of other things insolvency laws and deposit protection schemes need to be harmonised. Moreover, institutional integration of supervision has to go hand-in-hand with the integration of related functions and processes. It requires not only a lender of last resort but also swift access to fiscal resources if and when necessary to support, on a pan-European basis, individual financial groups in trouble. Developing workable burden-sharing mechanisms between Member States will be difficult.

7. High quality integrated supervision comes at a cost. A pan-European supervisor will have to deliver on the demanding task of supervising the largest and most sophisticated pan-European banking groups. The resources, expertise and skills needed to live up to this challenge require an adequate fee-based financing by the industry itself. Funding, the organisational and statutory set-up including the operational independence of a pan-European supervisor or supervisory system must be such as to attract highly qualified, experienced staff not least by payment of competitive salaries.

8. We expect immense benefits from a pan-European solution. A more resilient financial system, more efficient and effective supervision and more clout of the EU-voice in international negotiations on banking regulation can be achieved. Given these benefits we are willing to bear our share of the cost.

Do we need a rethink of the home-host country divide with regard to supervision and crisis management in the EU?

9. Yes.

10. As set out above, institutional integration has to be the long-term objective.

11. In the meantime operational integration ie much enhanced day-to-day cooperation and joint work between home and host authorities is crucial. The fully integrated and group-wide approach to banks' risk management, which recent public and private reports call for, does require a commensurate group-wide and cross-border approach to supervision.

12. In the absence of full institutional integration near-term operational integration of the supervisory activities of home and host authorities is urgently needed. Operational integration requires smoothly functioning colleges of supervisors under the full process leadership of the consolidating supervisor and on this basis consistent decision-making across the involved home and host supervisors. For banking groups with extensive international operations outside the EU the supervisory colleges would also have to involve the most relevant third country host supervisors.

13. A level playing field, based upon consistency and convergence across the different supervisory colleges can only be achieved if the Committee of European Banking Supervisors (CEBS) is appropriately strengthened. CEBS must be vested with the necessary powers and must be appropriately resourced and funded to ensure delivery of operational integration.

Current Commission Proposals

Will enforcing a prudential financial regime be an effective method of preventing a repeat of the financial turmoil?

14. An effective prudential framework for the EU which is aligned with the evolving risk-based Basel II framework is a key element of financial stability.

15. However, a reformed micro-prudential regime and its effective enforcement must be complemented by a more macro-prudential approach to regulation and supervision. The analysis of systemic risk and market-wide trends must be translated into effective line-side supervisory action.

16. For that reason, a much enhanced cooperation between central banks and supervisory authorities is essential. The long-term institutional integration of supervision in Europe must be implemented in such a manner as to ensure a close line-up of the central bank and the supervisory function.

17. Improving the resilience of financial firms through the economic cycle is a key aspect of a more macro-prudential approach to regulation and supervision. The current crisis demonstrated the need to develop and implement measures that counter or smooth the pro-cyclicality of the financial system. It is the merit of the European Parliament to have put the issue on the legislative agenda of the EU. The report of Rapporteur Karas on the pending reform of the Capital Requirements Directive calls on the European Commission to review how the directive should take into account the effects of the economic cycle and assess in particular how capital, provisioning, leverage and valuation may exacerbate cyclical trends. Deutsche Bank welcomes this request.

18. The crisis triggered undeserved criticism of the use and regulatory recognition of risk-based metrics and saw revival of the debate on simple measures, in particular of the so-called leverage ratio. This ratio is used in the US (and more recently introduced in Switzerland) to impose a nominal cap on the ratio of banks' total non risk-weighted assets to their capital. Introducing a mandatory maximum leverage ratio for banks will not counter pro-cyclicality, will be of no value in enhancing financial stability, and will further encourage regulatory arbitrage (as already evidenced by experience where some banks moved assets off their balance sheets and onto those of firms or entities that could hold them with much less capital). Deutsche Bank believes that strengthening risk-weighted Pillar 1 requirements and minimum capital ratio is a far more effective way to improve banks' resilience.

19. We are keen to contribute to the emerging debate on effective counter-cyclical measures. Given the reach of the crisis such measures will have to be taken at pan-EU and global level with the aim of making the financial system more capable of enduring systemic shocks.

Further Legislative Opportunities

20. Crisis management and resolution were mostly driven by national interest and national taxpayers' money at stake, with insufficient cross-border coordination and inconsistency which resulted in competitive distortions and examples of fall-back into uncoordinated national regulation even within the EU.

21. If more policymakers follow the many examples of pre-empting national and regional regulations and legislation with extra-territorial reach, cross-border banks will find it increasingly difficult to operate in such an environment.

22. Successful implementation of policymakers' calls for integrated risk management at firms is dependent on legislators' and supervisors' own ability to cooperate across borders. If the trend towards legislative fragmentation is not stopped, regulation and supervision will become more prescriptive and localised both within and outside the EU.

23. Legislation and regulation drafted to suit narrow political agendas not only promote an uneven playing field internationally and provide opportunities for regulatory arbitrage but also impede cross-border economic development.

24. In drafting new regulation, EU institutions must take into account that international financial markets and the participants in them do not operate in silos. There is a strong interconnectedness among them and hence close coordination from a legal and regulatory perspective is needed.

25. Deutsche Bank is ready to contribute to EU legislative initiatives aimed at promoting financial stability and an international level playing field for financial services.

20 February 2009

Memorandum by the Financial Services Authority (FSA)

1. This memorandum is submitted by the FSA in response to the specific questions raised by the Committee.

Question 1—*The report of Mr de Larosière suggests a new supervisory architecture in the EU. How does the FSA view the report?*

2. We welcome the report. It is a thoughtful response to some of the issues thrown up by the crisis. There are a large number of recommendations with which we agree. For example:

- Recommendation 1—a fundamental review of Basel 2 rules.
- Recommendation 4—a wider reflection on mark-to-market principle.
- Recommendation 6—supervisory authorities in all Member States to have sufficient powers, including strong, equivalent and deterrent sanctioning regimes.
- Recommendation 7—appropriate and proportionate regulation of the parallel banking system.
- Recommendation 10—avoidance of future and removal of existing national discretions where these constitute obstacles to the single market.
- Recommendation 11—better alignment of compensation incentives.
- Recommendation 12—enhanced risk management arrangements in firms.
- Recommendation 13—coherent and workable regulatory framework for crisis management. The recommendation calls for legal measures to be adopted to remove legal obstacles to such co-operation. This point needs to be clarified.
- Recommendation 14—host powers over branches to be reviewed.

3. There are a number of other recommendations where further work is needed. In particular, we consider further reflection is needed on:

- The European Systemic Risk Council, where the role is not clearly specified and whose membership is to include all the EU's central bankers, the chairs of the Level 3 Committees and the Commission, but none of the EU's national supervisory authorities.
- The proposed powers that the new European supervisory authorities would have over national supervisors. The key principle which needs to be followed is that fiscal responsibility and political accountability need to be aligned with regulatory responsibility.

(a) *What extra resources and powers would the Level 3 Committees need to carry out the extended functions within the proposed European System of Financial Supervision?*

4. It depends on what role the Level 3 Committees are asked to perform. The de Larosière report suggests a two-stage process. In the first stage (covered by Recommendations 18 and 19) the tasks of the Level 3 Committees would remain broadly the same, though they would have a more active role in Colleges and in overseeing through tough peer review and the standards applied by national supervisors. Additional resources will be needed for this, but they are unlikely to be very substantial.

5. In the second phase (covered by Recommendations 20–22) the Level 3 Committees would be turned into Agencies or Authorities and given powers over national supervisors, including binding mediation, binding supervisory standards, adoption of technical decisions, oversight of Colleges and so on. To do this effectively, the Agencies or Authorities will need significant additional resource.

(b) *Would the proposed European Systemic Risk Council (ESRC) effectively carry out macro-prudential supervision in the EU?*

6. Macro-prudential regulation and supervision needs to entail both analysis of macro developments (eg growth of credit, asset price trends, liquidity risks in the banking system) and the use of macro-prudential levers (eg countercyclical capital or liquidity requirements) to offset emerging risks. Analysis needs to be done at national, European, and global level. Offsetting action could be defined in internationally agreed capital and liquidity rules, but to the extent that it is discretionary will need to be decided by national supervisory and/or central bank authorities. In the Euro zone, this could include a role for the European Central Bank (ECB), but in the UK, any discretionary action would result from Bank of England/FSA decision-making and would be effected by the FSA. The ESRC could not therefore in itself effectively carry out macro-prudential supervision for the EU, but it could play a role in the analysis of the situation, and in discussions with the ECB about eurozone (but not EU wide) discretionary actions.

(c) *How does the FSA view the suggested role of the European Central Bank (ECB) in the ESRC? Lord Myners told the Committee that he felt the ECB "did not have the necessary skills to in place to become a regulatory body"*

7. The ECB will need to play a key role in the ESRC. Whether it should chair the body or be involved in micro-prudential supervision, as suggested in the report, hinges on what the precise role of the ESRC should be.

(d) *What would be the legal basis for the changes recommended in the report?*

8. The de Larosière report contains 30 recommendations. The legal basis for many of the proposed changes will not be problematic. However, recommendations which would have the effect of delegating the Commission's rule-making powers, or which would give the Level 3 Committees binding adjudicative powers over national regulators does, we understand, raise legal issues of some delicacy.

(e) *The ECB raised doubts over the effectiveness of the mechanism proposed in the De Larosière report to handle the potential collapse of a cross-border bank. Does the FSA agree with the ECB's concerns?*

9. The de Larosière report addressed this issue and subjected it to detailed analysis (paragraphs 167–172 of the report, especially 171). The points made there are compelling, and explain why the ECB should not be the prudential supervisor of the largest cross border European firms. As the de Larosière report explains, fiscal responsibility and political accountability need to be aligned with regulatory responsibility. Until the EU has fiscal powers which permit it to raise the funds needed to rescue distressed banks, or until there is a system of mandatory burden sharing between Member States for fiscal support, supervision will and should remain the responsibility of Member States. A two-tier system would also create the potential for competitive distortions in national markets. The most effective way of improving the supervision of cross border firms is therefore through effective College arrangements, underpinned by tough peer review.

Question 2(a)—*Can you explain your preference for one authority instead of three suggested in the de Larosière report?*

10. We believe that the traditional sectoral approach, where insurance, banking and securities issues are treated separately, does not adequately capture the interlinkages between these once distinct areas of the financial services industry. Many banks are heavily involved in securities business, and financial conglomerates can comprise banking, stock-broking and insurance companies. We also believe the "twin peaks" approach,

which is also suggested in the later stages of the de Larosière report proposals, is inappropriate as conduct of business and prudential issues are inextricably linked, as the recent events in the US housing finance market have shown.

(b) *Would the creation of this authority require a Treaty amendment?*

11. We believe that an authority operating along the lines proposed in the Turner Review could be created without a Treaty change, but it is likely to depend on the exact powers which the authority is to be granted.

(c) *In what other ways does the Turner Review differ from the recommendations of Mr de Larosière?*

12. The Turner Review finds much to agree with in the de Larosière group's proposals. There are two main areas of difference. We agreed that an EU macroprudential forum is required, but believe that it should be linked with the ESCB rather than the ECB alone, and crucially, that it should have direct input from national supervisory authorities where these are separate from central banks. This differs from the model proposed by de Larosière, which is an entirely central bank forum, centred on the ECB. We also believe that the de Larosière proposals for an integrated EU supervisory body go too far in proposing that the EU level body should be able to overrule national supervisors. We have proposed instead an approach to supervision which combines standard setting, peer review and challenge, but which stops short of European powers to overrule national supervisory decisions.

Question 3—*The Turner Review states (page 100) that "existing single market rules can create unacceptable risks to depositors or to taxpayers" as evidenced in the failure of Landsbanki (the Icelandic banks) and proposes the reinforcement of host country supervisory powers. How do you respond to comments from previous witnesses that giving more power to the host supervisor will destroy the single market in financial services?*

13. There has always been a tension in the financial services acquis between facilitating the single market in financial services and ensuring that the high level aims of regulation (protection of consumers and maintenance of financial stability) are achieved. What is proposed in the Turner Review is an adjustment to this balance, as recent events suggest that the single market considerations may have been put before the regulatory. Our proposal is that the business of "passported" banks in the host state may be curtailed where there are concerns about the quality of supervision in the home state, or about the ability of the home-state deposit guarantee arrangements to ensure adequate depositor protection. Only in extremis is it suggested that activities might be halted altogether. We would envisage that such action would only be taken where these concerns were very serious and posed a clear danger, in our case, to UK depositors. It is therefore an exaggeration to say that the Turner Review proposals would "destroy" the single market. Any use by regulators of increased powers would need to be fully justified, and any use of such powers to exclude banks from other EEA countries from their host market on a systematic basis would be an abuse.

Question 4—*What further regulatory reforms does the FSA believe should be made at EU Level?*

(a) *How should the problem of pro-cyclicality be addressed?*

14. Chapter 2 of the Turner Review sets out how pro-cyclicality in the overall system of capital, accounting and liquidity should be addressed. For any new system to be effective it will be crucial that the recommendations are implemented internationally. The EU, as a key regional body, will be a vital part of this, particularly as it reflects some international agreements in European legislation (particularly the Capital Requirements Directive). We believe that an EU body with rule-making powers and oversight of national supervisors should be established. We would expect this body to play a key role in addressing procyclicality in the banking system.

(b) *Should hedge funds be further regulated?*

15. The Turner Review recommends that regulation should be about economic substance and not legal form. A coordinated global approach will be crucial to the effectiveness of the way national authorities relate to the unregulated sector, and it will be important for any EU arrangements to complement, rather than undermine, global arrangements. More specifically, the Turner Review sets out that we regulate UK-domiciled hedge fund asset managers, although hedge funds themselves are not subject to prudential regulation affecting their capital adequacy or liquidity. This is because, at present, they are not generally undertaking banklike activities.

However, we do believe that, in aggregate, hedge fund activity could have systemic impacts and therefore improved macro-prudential analysis is needed to assess the overall risks to financial stability. If authorities judge hedge funds (or any other category of investment intermediary) to have become systemically important, they will need the power to apply appropriate prudential regulation or have then become bank-like in their activities. Given that most hedge funds are legally domiciled in offshore centres, any changes will need to involve all the relevant authorities and therefore any EU reforms should be consistent with the approach outlined here.

(c) *What type of regulation does the FSA support with regard to credit default swaps?*

16. The Turner Review sets out our support for a variety of operational enhancements to the OTC derivatives infrastructure, such as robust and resilient central clearing arrangements for the relevant standardised credit default swaps (CDS). To this end we welcome, and are actively contributing to, ongoing international groups working on this goal, both at the global level and including the European Commission's Working Group on Derivatives. Chapter 3 of the Turner Review also explores the concept that some form of product regulation could be considered to restrict the operation of markets such as CDS if they pose unacceptable levels of systemic risk. The Chapter sets out some arguments for and against this form of CDS regulation. We believe regulatory authorities should be willing to actively consider the appropriateness of such intervention as markets develop, with the EU playing an active role in any such discussions.

(d) *The regulation of large complex banks and the distinction you draw in the Review (page 93) between "utility banking" and "investment banking"?*

17. The Turner Review concludes that, although there are a number of theoretical arguments in favour of a separation of "utility banking" and "investment banking", it is unlikely that the best way to achieve the desired objective is through a legal definition of different roles. It is also unlikely that there will be international agreement on such a definition. However, it is important that the use by large commercial banks of the benefits arising from retail deposit insurance, access to lender of last resort facilities, and "too big to fail" status, should not be used to support risky propriety trading. New approaches to capital and liquidity regulation need to be designed to achieve this. Any new regulation will be mainly international in nature (for example, the trading book capital regime) and the EU will therefore play an important role in its design and implementation.

Question 5—*How does the FSA view the current EU proposals for financial regulation? In particular:*

(a) *Capital Requirements Directive*

18. The Capital Requirements Directive (CRD), originally adopted in 2006, is currently undergoing amendment. The final text of the CRD amendments is not yet available. We expect the final text of the amended CRD to reach the Official Journal by end of April or early May 2009. However, we have been closely involved in the negotiations on the amendments package, which we have seen as an opportunity to demonstrate our continuing commitment to strengthening capital standards. Following publication of the final CRD text later this spring, we are planning to consult on various elements of the existing CRD amendments package—such as large exposures, securitisations, hybrid capital and various technical amendments—and we expect intense engagement from the industry. We will continue to be involved in the negotiations for a further package of legislative proposals relating to the CRD, which the Commission is expected to provide over the summer 2009 eg trading book, to deal with further substantive CRD amendments that are already in train. Furthermore, once the Basel Committee on Banking Supervision has reached international agreement on the changes in capital regulations needed to give effect to the principles set out in the Turner Review and agreed by the Financial Stability Forum, it is likely that future CRD amendments will be required to give these changes legal effect.

(b) *Deposit Guarantee Scheme*

19. There are welcome elements in the current EU proposals for deposit guarantee schemes (DGS). We support the increase in protection to €50,000 and the new provisions to increase the speed of payout to depositors. We consider speed of payout a key component to increase consumer protection and market confidence. We also welcome the proposal to increase cooperation among the national DGS but need to see this underpinned by robust arrangements among the schemes, eg to ensure that there is a single point of contact for depositors with a failed bank.

20. More fundamentally, the proposals do not guarantee the ability of the DGS (and ultimately the sovereign state) to provide adequate protection to UK depositors with branches of banks from other EEA countries, either from a funding or an operational perspective. We would like to see serious consideration given to introducing a rigorous system within the EU of peer review to ensure effective home country supervisory regimes and deposit guarantee arrangements, together with increased formal powers for host supervisors in their dealings with the home state (for example, host country power to have more direct oversight of branches and to be entitled to greater engagement with the home country supervisor on whole firm issues).

(c) *Rules on Credit Rating Agencies*

General Comment

21. We support the work already under way in IOSCO and the EU to promote more effective oversight and supervision of credit rating agencies (CRAs) through the implementation of an appropriate EU registration scheme, alongside greater consistency, cooperation and information sharing on CRAs between regulators at a global level. This regulation will focus on addressing weaknesses in CRA conduct of business and is likely to create a more thorough and clear evaluation of their governance, controls and transparency. However, the quality of ratings does not depend solely on the integrity of the ratings process but also on the accuracy of methodologies and assumptions used, as well as the experience and insight of the rating analysts in the determination of ratings. Therefore, while oversight of CRA conduct of business may address a number of concerns about rating agency activities, it cannot guarantee the quality of ratings or the appropriate use of these ratings by market participants. The requirements for greater transparency from CRAs will, however, provide the market participants with greater ability to form an independent view of the relevance of their ratings.

Scope of Regulation

22. The EU regulatory proposals will introduce specific rules affecting a number of areas of credit rating activity. In particular they will focus on removing or mitigating conflicts of interest within the rating process, increasing transparency by ratings agencies, enhancing internal control structures and ensuring that rating agencies are appropriately resourced. The regulation will not focus on assessment of the validity of rating agency methodologies and models. We would not support the broadening of scope to include the regulation of methodologies due to the moral hazard and the potential conflict of interest for authorities when reviewing methodologies. Given the global nature of capital markets, it is important that the European legislation is matched by agreement on compatible global standards, and we are working through IOSCO to achieve this.

Key Issues for EU Regulation

23. The initial proposals from the Commission would have placed restrictions on EU firms, preventing them from investing in or executing orders in securities that had been rated by a CRA not authorised under the Regulation. This would have effectively limited the universe of available securities and had an impact on EU investment firms' ability to access global capital markers. In Council negotiations HMG have successfully had the scope narrowed, however, the ECON committee of the Parliament supports a widening of scope. Therefore, HMG will need to continue to work to ensure the scope of the regulation is appropriate.

24. The original Commission proposal did not include any mechanism for acknowledging the validity of ratings produced outside the EU. This presented a number of risks particularly to market stability, given EU firms' exposure to non- EU debt, and to competition. A workable solution must be reached to allow for the use of non-EU issued ratings. Two possible solutions are for an equivalence regime for other jurisdiction with regulatory regimes, or for EU-based CRAs to be allowed to take responsibility for and endorse ratings produced in non-EU offices. Currently the Parliament is showing willingness to reach a compromise on the issue of non-European EU ratings and we are optimistic over the likely outcome.

25. The proposals from the Commission and discussions in the Council have favoured national authorities having supervisory responsibility for CRAs, with CESR and regulatory colleges acting to create consistent outcomes and approach. The de Larosière report concluded that regulation of CRAs should be conducted by CESR and this has been supported in the ECON committee of the Parliament. CESR is currently not equipped for supervisory responsibility, nor has sufficient consideration been given to how CESR would act and organise itself for this role. Given the timeframes for the implementation of the regulatory regime in the EU we would be concerned if CESR was placed in a supervisory role.

Use of ratings

26. Credit ratings have established an ever more important role in the financial system, particular examples include the inclusion within bank capital rules and also their common use in setting investment mandate risk parameters. Whilst regulation of rating agencies can be used to address the issues of conflicts of interest and transparency it will not ensure that these ratings are used appropriately or that investors conduct appropriate independent due diligence. This means that it is highly important not only to reconsider and monitor the use of ratings but also to consider how the regulatory regime for the rating agencies may impact on this.

Question 6—*What role should the EU play in ensuring that progress is made towards a more coherent global system of financial supervision?*

27. The crucial challenge at global level is to ensure that the development of agreed standards and regulations is matched by effective enforcement in all countries. Fairly effective fora exist for agreeing global approaches (eg the Basel Committee and the Financial Stability Forum (now the Financial Stability Board)) but there is not a treaty-based organisation charged with ensuring effective and even implementation and equipped with any powers of sanction. Further work will be required to equip the Financial Stability Board with sufficient resources and influence to secure implementation, working alongside the IMF. The EU is represented on the Financial Stability Board alongside national authorities and will therefore be involved in discussion of effective implementation measures.

28. A large part of our prudential regulation is anchored in European directives. If we wish to engineer major changes to prudential regulation, we need to ensure that these directives are revised in the right direction. In terms of exercising "thought leadership", there will be some instances where we will want to do this through EU fora and others where we will want to focus on the international debate. In most cases, we will need to harness both to achieve necessary change. It is therefore to be welcomed that the EU is fully engaged in the work of the G20 and the European Commission has recently been invited to join the Financial Stability Board as well as attending meetings of the Basel Committee. Similarly, when we attend EU fora we need to underline the global dimension to most of the market turmoil issues we face.

29. In recent months, the G20 has provided momentum and high-level political accountability for the broad set of policy responses being devised to address market turmoil and to prevent a repetition of this crisis. At a technical level, many of the individual regulatory work streams endorsed by the London Summit (2 April) will be taken forward by the relevant standard setters (eg the Basel Committee, International Organization of Securities Commissions and the Financial Action Task Force) under the guidance of the Financial Stability Board. In their *Declaration on Strengthening the Financial System* (released 2 April), G20 leaders instructed their finance ministers to take responsibility for ensuring that their decisions were implemented. They also asked the FSB and the IMF to monitor progress. Taken together these measures should help to ensure the coherence of the overall package and ensure that the various policy bodies work towards common goals.

(a) *Can you explain the role you envisage for colleges of cross-border banks in the European and global context?*

30. The role of supervisory colleges has been discussed in a number of international work streams, including the EU, the G20 and the Financial Stability Board. There is general agreement that colleges should be established for the largest crossborder firms operating globally. The Financial Stability Board has agreed principles to govern the coverage, structure, role and working methods of colleges. A list of over 30 firms has been identified as suitable for a global college; and a college has been established in most cases. These colleges do not have a formal legal basis and do not affect the relative powers of the home and host supervisory authorities that participate in the college. Their role is to promote supervisory cooperation and information sharing. In the EU, colleges will have a more formal legal basis (under directives). It is likely that they will exist for a wider set of institutions, have a wider membership and more formal procedures. Where firms operate on a global and pan-EU basis our aim would be to avoid duplicative college arrangements, but it remains to be seen whether it will be possible to converge on a single college for such firms. For us, the purpose of the college is to develop an improved understanding of the risk profile of the relevant firm, to develop mitigating action in a way that is coherent and to engage in joint work to the extent that we can in order to target our resources most effectively.

9 April 2009

Memorandum by Fitch Ratings

1. *We have heard concerns from many witnesses that the regulation of ratings is impossible due to the complexity of the ratings system. Can you comment on this suggestion?*

1.1 The answer to this question depends on the specific regulation the witnesses had in mind. We note that we are currently regulated in the US as a Nationally Recognized Statistical Rating Organization (NRSRO). That regulation focuses on our policies and procedures, and addresses the issues of transparency, management of conflicts of interest and treatment of confidential information. The proposed EU Regulation with respect to rating agencies (the "EU Regulation") is intended to address similar issues. This type of regulation is, of course, possible; moreover, we think that appropriate regulation of rating agencies, covering these kinds of issues, can assist us in regaining the confidence of users of ratings.

1.2 We note that the US law that gives the Securities and Exchange Commission the powers to oversee rating agencies specifically provides the following:

> "Notwithstanding any other provision of law, neither the Commission nor any State (or political sub-division thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings".

We agree with this approach to regulating rating agencies/ratings. The current draft of the EU Regulation, as amended by the EU Council, provides for a similar restriction.

2. *The British Bankers' Association, in its evidence to this Committee, argues that the requirement for EU financial institutions to only trade instruments rated within the EU, would "substantially limit the ability of EU regulated financial institutions to make use of non-EU related credit ratings for regulatory purposes". Do you agree with this assessment? Have changes made in European Council resolved this issue?*

2.1 We believe the BBA is referring to the second paragraph of Article 4 of the EU Commission's original draft of the EU Regulation. The Council has deleted this paragraph, and has thus addressed this specific point.

2.2 There is, however, a broader issue. The Commission draft also specifies that EU regulated institutions may only use, for regulatory purposes, ratings that have been issued by rating agencies that are registered under the EU Regulation and established in the EU. Many market participants have objected that this provision will prevent EU institutions from investing in obligations issued and/or rated outside the EU. The Council has addressed this point by introducing the concept of endorsement: a rating agency established in the EU and registered under the EU Regulation may, subject to certain conditions, endorse ratings issued outside the EU by another rating agency that belongs to the EU rating agency's group of companies. Such endorsed ratings will be treated as if they had been issued by the EU-established rating agency registered under the EU Regulation.

2.3 The Council's proposal is helpful in addressing the market's objections. However, we have specific concerns with certain aspects of the proposal that might render it ineffective in actual practice. First, one condition is that the EU rating agency must verify, and be able to demonstrate, that the conduct by the non-EU credit rating agency of its rating activities "fulfils the requirements with are at least as stringent as the requirements set out in Articles 5 to 10 of the EU Regulation. Given that we will apply the same policies and procedures to all rating agencies within the Fitch group, wherever they are located, this provision would not pose a problem for us. If, however, the intention of this provision is that all non-EU countries must have in place regulations that essentially replicate Articles 5 to 10 of the EU Regulation, then no country would be compliant. Indeed, it would seem unrealistic to expect that all countries will (eventually) adopt the specific contents of these Articles. Another condition to endorsement is that the non-EU country has in place an appropriate cooperation arrangement with the relevant home Member State. We can understand the reasoning for this, but we are not confident that such arrangements can be put in place during the two-year time period provided for in the Council's proposal.

3. *A previous witness has criticised the excessive reliance on rating agencies as 'laziness' on the part of regulators and financial institutions. Do you agree?*

3.1 We have always been clear that our ratings address the credit risk of the rated entity or security—that is, the relative ability of an entity (or issuance) to meet financial commitments. We believe that ratings should be viewed as one tool available to investors (or regulators) in assessing an issuer or an issuance. It now appears that some investors may have been using ratings to assess other aspects of an issuer/issuance such as liquidity or price—for which they are not intended.

4. *Many witnesses to the Committee have criticised the speed at which EU legislation in response to the financial crisis has been constructed, raising concerns that this will lower its quality. Do you agree with this criticism?*

4.1 With respect to the EU Regulation, we agree that, given the significance of this legislation, it is important that careful consideration is given to its creation. We note that the Commission consulted with market participants, including rating agencies, prior to issuing its draft in November 2008. We also note that the Council and the Parliament have generally been open to listening to our views with respect to the various drafts.

4.2 The current draft agreed by the Council is generally workable, although we do have concerns as to whether certain specific provisions are actually practical and therefore achieve the goals of the EU Regulation. We will continue to work with the EU Institutions to arrive at a regulation that is both workable and effective.

5. *Some witnesses have expressed concern that the regulation of rating agencies will write ratings into regulations and subsequently reduce the requirement on purchasers of financial instruments to conduct their own due diligence. How do you view this suggestion?*

5.1 The EU Regulation does not, in and of itself, result in ratings being incorporated into regulations, nor do we think that will be the practical result of the EU Regulation. It is also important to note that the EU Regulation (in both the Commission and Council versions) explicitly states the following:

> "The users of credit ratings should not rely blindly on credit ratings. They should take utmost care to perform own analysis and conduct due diligence regarding their reliance on such credit ratings".

We wholeheartedly endorse this position.

23 March 2009

Memorandum by Professor Christos VI. Gortsos, Panteion University of Athens

Executive Summary

The present briefing paper is confined to two of the five questions raised in the Report, given the particularly demanding nature of the issues raised, and the restraints posed on the length of the paper to be submitted. For the same reasons, the answers provided are obviously not as comprehensive and analytical as they would be in a more in-depth analysis. Accordingly, I remain at the disposal of the members of the Subcommittee for any clarifications, as well as for submitting any additional work, should that be requested.

On Question 3 (EU Supervisory Reform, paras. 1–7), I conduct a short comparative assessment of the two existing alternatives for creating a single supranational, European financial supervisory system:

- establishing a "European System of Financial Supervisors"—outside the European Central Bank, and
- activating para. 6 of article 105 of the Treaty establishing the European Communities, according to which the ECB could become, even though under constraints, a European financial supervisory authority.

The assessment is based on specific criteria that have to be met for the establishment of an efficient single financial supervisory authority in the European Union.

My position on Question 5 (Global supervisory reform, which I restate as "Global supervisory and, mainly, regulatory reform", paras. 8–16) is developed around two main arguments:

(a) The first is that, for specific reasons, it is rather impracticable to envisage, in terms of political realism, the creation of an international financial supervisory authority. Accordingly, the main issue that should be addressed in the context of the current dialogue is not that of a global supervisory reform, but rather that of a global regulatory reform.

(b) The second argument is in favour of preserving the existing international institutional framework, due to its adequacy, while enhancing its effectiveness.

By concluding, I assert that the creation of an international organisation, even with powers confined to the adoption of regulatory norms, is not necessary (negating the need for a new "Bretton Woods Agreement"). On the contrary, imperative is the enhancement of the content of the regulatory norms adopted at the international level by the existing standard-setting bodies, as well as the need to ensure their proper implementation by national authorities. It is in this last direction that the IMF should (and could definitively) play an increasingly more substantial role.

Paras. 3 and 9–11 are stated in italics. This is indicative of their supportive role in the briefing paper, since they have been inserted for the sake of completeness of my argumentation. Strictly selected references are put in footnotes.

Question 3: EU Supervisory Reform

1. The option of creating a single supranational, European financial supervisory system has been discussed for years now both among policy-makers and in the academia. The main argument in favor of such a structure is that it represents one of the options to effectively supervise and regulate pan-European, "systemically important" financial conglomerates, due to the threats they are posing to the stability of the European financial system.[10]

2. In this context, two main alternatives can be envisaged, taking as a starting point the current structure of the European monetary and financial system:

— establishing a "European System of Financial Supervisors"—outside the European Central Bank (the "ECB"), based on the existing three so-called "Level 3 Committees" (ie, CEBS, CESR and CEIOPS) established by the Commission according to the proposals of the Lamfalussy Report (see below, under 4), or

— activating para. 6 of article 105 of the Treaty establishing the European Communities (the "Treaty"), according to which the ECB could become, even though under constraints, a European financial supervisory authority (under 5–7).[11]

3. *In principle, in either case decisions need to be taken with regard to various aspects pertaining to the functioning of the European financial supervisory system. In particular, the following eight (8) issues need to be addressed:*

(i) *the necessary extent of amendments of the Treaty,*

(ii) *the institutional structure of the system,*

(iii) *the material coverage of its supervisory powers in the financial system (banking sector—capital markets sector—insurance sector),*

(iv) *the personal coverage of its powers (which categories of financial firms and groups would be subject to supervision and by whom),*

(v) *the extent of its regulatory powers,*

(vi) *its decision-making bodies, their composition and their competences,*

(vii) *the independence of its constituents, the decision-making bodies and the persons appointed therein, and*

(viii) *its overall embedment within the existing institutional structure of the European Union/Community.*

[10] See, among others, Lastra, R.M. (2006): *Legal foundations of international monetary stability*, Oxford University Press, Oxford—New York, p. 324–328, discussing four (4) alternatives in achieving centralization of European financial supervision, of which the creation of a single supervisor is the first.
See also Schoenmaker, D. and S. Oosterloo (2007): Financial Supervision in Europe: A Proposal for a New Architecture, in Jonung, L., Walkner, Ch. And M. Watson: *Building the Financial Foundations of the Euro—experiences and Challenges*.

[11] The current tasks assigned to the European System of Central Banks with regard to financial stability are laid down in article 105, para. 5, of the Treaty.

4. The establishment of a European System of Financial Supervisors (the "ESFS") is, to my opinion, a legally demanding and time consuming option, but still a more straightforward solution for the effective supervision of European financial conglomerates.[12] Based on the just abovementioned list of issues, the creation and design of a ESFS raises, to my opinion, the following considerations:

(i) Establishing an efficient ESFS requires an amendment of the Treaty, in parallel (even though not fully in analogy) to the amendments that were introduced in the Treaty for the establishment of the European System of Central Banks (the "ESCB"), allowing potentially individual member states to opt-out.

(ii) A decision should be taken with regard to the institutional structure of the ESFS, and the delimitation of powers between the European Financial Supervisor (the "EFS") and the competent supervisory authorities of the member states (which are currently structured under four different approaches: institutional, functional, integrated, and "twin peaks").[13]

(iii) It is expected that the ESFS would be responsible for the supervision of firms and groups operating in the entire financial system (banking sector—capital markets sector—insurance sector).

(iv) A decision should be taken with regard to the criteria for determining the "systemically important" financial firms and groups which would be subject to the supervision of the EFS and those who should continue to be supervised by the national competent authorities.

(v) A fully fledged supervisory authority must be empowered to issue binding legal acts and impose sanctions. Accordingly, the Treaty should assign such powers to the EFS. This would, however, render to the potential existence of two, partly different sets of regulations:

— those issued by the EFS and applied to the firms and groups under its jurisdiction,

— those issued by the (other) Community institutions under the existing law-making procedure and applied to the remaining financial firms.

(vi) A decision has also to be reached concerning the decision-making bodies of the ESFS, their composition and their competences.

(vii) Specific provisions should also be implemented to ensure the institutional, personal, functional and economic independence[14] of its constituents, the decision-making bodies and the persons appointed therein.

(viii) Finally, specific decisions have to be taken with regard to the overall embedment of the ESFS within the existing institutional structure of the European Union/Community, by addressing issues such as:

— the position of the ESFS and the EFS within the inter-institutional dialogue,

— the accountability and transparency of the activities of the EFS, and

— the judicial review of the acts of the constituents of the ESFS.

5. Assigning the task of financial supervision to the ECB, renders the exercise simpler with respect to the majority of the abovementioned questions, since its powers in the field of financial supervision would be embedded within the existing structure and institutional setting of the ESCB. In addition, the relevant decision by the EcoFin Council could be taken within a definitively shorter time horizon than if the decision would be taken to create a European System of Financial Supervisors.

6. Nevertheless, in this case as well the following questions require consideration:

(a) According to article 105, para. 6, of the Treaty, whose activation requires a unanimous decision by the EcoFin Council, the ECB could only become a "sectoral supervisory authority", since insurance undertakings are explicitly excluded. Accordingly, the ECB may not become a supervisory authority for some of the most systemically important pan-European financial conglomerates, which are comprising in their structure insurance undertakings.

For the ECB to become a supervisory authority under the "integrated approach" (ie, to become a single financial authority) would, hence, require an amendment of article 106, para. 6, of the Treaty. It is worth noting, however, that such an amendment, if decided upon, would be more flexible than the range of amendments required for the establishment of a European System of Financial Supervisors, as discussed above.

[12] This argument is based on the assumption that article 105, para. 6, of the Treaty would not be amended (see below, under 6a).

[13] On these approaches and a comparative study on their adoption by selected countries, see Group of Thirty (2008): *The Structure of Financial Supervision—Approaches and Challenges in a Global Marketplace*, Group of Thirty, Washington, D.C.

[14] This is actually answering the question (3.2) on "What type of fiscal resources should such an authority have access to". To my opinion, the ESFS should be economically independent, endowed with its own capital, subscribed by the EFS and the national supervisory authorities-members.

(b) A decision should also be taken, in this case as well, with regard to the range of financial firms and groups which would be subject to the supervision of the ECB and those who should continue to be supervised by the national competent authorities.

7. Finally, among all other considerations that may be raised, one should take into account, before deciding to assign to the ECB a supervisory task for the financial sector, the following two aspects:

(a) The first aspect refers to the conflicts arising if a monetary authority is also, concurrently, a financial supervisor. It is reminded that the existence of such conflicts has been the main argument which led several countries around the globe (including the UK) to resort, at a national level, to the separation between the monetary and the financial supervisory functions.[15]

(b) The second aspect refers to the need to reconcile the supervisory powers of the ECB with those of the national supervisory authorities, especially in the case of the member states (which are now the majority within the European Union) which have adopted the "integrated approach". This is a derivative problem arising from the current phrasing of article 105, para. 6, of the Treaty.

Question 5: Global Supervisory (and, Mainly, Regulatory) Reform

8. Even though, in the midst of a very significant level of international financial integration, the "regulation of financial activities and the institutions that conduct them continues to be carried out mostly by national (…) governments",[16] we are definitively not living in an international financial regulatory vacuum. Currently, there exists a variety of agencies making up the institutional governance of the international architecture of the monetary and financial system.

9. *These institutions may be divided, depending upon their legal nature and their composition, into five categories:*[17]

(i) *three intergovernmental fora (Group of Ten (G-10), Group of Seven (G-7), and Group of Twenty (G-20)),*

(ii) *four international economic organisations (International Monetary Fund, Bank for International Settlements, World Trade Organisation (in matters related to the liberalization of the international trade in financial services), and Organisation for Economic Co-operation and Development (in matters of corporate governance)),*

(iii) *various international fora of:*

— *national supervisory authorities (Basel Committee on Banking Supervision, IOSCO, International Association of Insurance Supervisors, Joint Forum on Financial Conglomerates),*

— *experts from national central banks (Committee on Payment and Settlement Systems, Committee on the Global Financial System),*

— *an expanded composition (Financial Action Task Force on Money Laundering), and*

— *agencies managing national deposit guarantee schemes (International Association of Deposit Insurers),*

(iv) *two private professional associations, notably the International Accounting Standards Board in matters of corporate accounting, and the International Federation of Accountants in matters of corporate auditing, and*

(v) *the Financial Stability Forum, composed by the abovementioned international organisations and international fora.*

10. *It is worth mentioning that none of these international bodies has been assigned any supervisory authority over financial institutions. Nevertheless, the majority of the international fora participating in the FSF have issued during the last three decades guidelines and recommendations, most of which have been accepted in broad terms internationally, by both economically developed and developing countries, as necessary in order to preserve the soundness and stability of the globalised financial system. However, these legal acts are "soft law" instruments and, hence, non legally-binding.*[18]

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[15] See on this Goodhart, C.A.E. and D. Schoenmaker (1993): Institutional Separation Between Supervisory and Monetary Agencies, in Goodhart, C.A.E. (editor): *The Central Bank and the Financial System*, Macmillan Press, London, p. 333–413.

[16] See Herring, R.J. and R.E. Littan (1995): *Financial Regulation in the Global Economy*, Integrating National Economies, The Brookings Institution, Washington D.C., p. 1.

[17] See on this Giovanoli, M. (2000): A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting, in Giovanoli, M. (editor): *International Monetary Law—Issues for the New Millenium*, Oxford University Press, Oxford, p. 3–59.

[18] See on this Giovanoli, M. (2000), op. cit., and Norton, J.J. (2001): Pondering the Parameters, of the "New International Financial Architecture": A legal Perspective, in Lastra, R. M. (editor): *The reform of the International Financial Architecture*, International Banking, Finance and Economic Law Series, Kluwer Law International, United Kingdom, p. 3–46.

11. *The current structure is definitively characterized both by specialization as well as by compartmentalization. This is mainly due to the fact that the various aspects of financial regulation are entrusted by countries to different supervisory and regulatory, governmental and non-governmental, authorities. Even where the "integrated approach" has been adopted for financial supervision, there are aspects of financial regulation, supervision and oversight that cannot be assigned to the single supervisory authority, even if this is the central bank (which is definitively responsible for the oversight of payment systems).*

12. On the basis of the abovementioned remarks which are briefly summarising the status quo in the global financial architecture, any proposal for its reform should be based on the assumption that it is rather impracticable to envisage, in terms of political realism, the creation of such an authority (for which there is, anyway, no precedent). In particular, the creation of such a fully-fledged supervisory authority would require the creation of an international organisation with a global participation (in order to avoid regulatory arbitrage), based on an international convention, to which the signatory parties would assign the power to:

— exercise the supervision of their national financial institutions and markets (or, at least, of those considered as "systemically important"),

— issue binding legal norms on their regulation, and

— impose sanctions on these financial institutions.

The difficulties arising in the context of the discussions in the European Union with regard to the possibility of establishing a regional supranational financial supervisory authority, with similar powers, are manifestly reflecting the problems that would arise in the global context.

Accordingly, the main issue that should be addressed in the context of the current dialogue is not that of a global supervisory reform, but rather that of a global regulatory reform (to which I will turn in the rest of the paper). The global supervisory reform should mainly assess the possibility of enhancing international supervisory cooperation, mainly through the effective operation of "colleges of supervisors" for globally active financial institutions (and in particular banking groups).

13. Overall, the design of the current international institutional structure governing financial regulation is, in broad lines, adequate. This assessment is based on the following considerations:

(a) It is of primary importance that rules on international financial regulation be discussed and adopted by institutions with the decisive (and not merely advisory) participation of national supervisory authorities (which are concurrently regulatory ones). The same applies, *mutatis mutandis*, with regard to rules on payment systems oversight (a field of central banks), on the combating of money laundering (a field of governments, judiciary and supervisory authorities), or on accounting.

Accordingly, it is difficult to envisage the substitution of international fora, such as the Basel Committee, IOSCO, the Committee on Payment and Settlement Systems or FATF, by any new constellation. It is open, however, to discuss amendments with regard to the composition of certain of these fora in order to reflect the most appropriate representation of the international Community.

(b) It is a responsibility of these international fora to address the adequate issues and propose the appropriate solutions relating to the problems arising from the current financial turmoil in close cooperation with the Financial Stability Forum.

(c) The Financial Stability Forum is, indeed, an appropriate forum for a comprehensive synthesis and coordination of international financial regulatory initiatives and for taking decisions on the prioritisation with regard to the adoption of new rules. This due to the fact that in its composition participate all the international organisations and fora which are dealing, as mentioned above, with the various aspects related to financial regulation and oversight. It is not by coincidence that the current agenda of the Financial Stability Forum is covering the entire range of the issues which came under discussion as a regulatory response to the causes of the recent financial turmoil.[19]

(d) The International Monetary Fund (the "IMF") plays a significant role within the current international financial architecture, which is based both:

— on its supervisory task over national economies (under the new article 4 of its Articles of Association), under which it is operating its Financial Sector Assessment Programs for all its member states, and

— its role to provide financial assistance, under "conditionality", to less developed economies.

[19] Financial Stability Forum (2008): *Report on Enhancing Market and Institutional Resilience*, April, available in the following electronic address of the Forum in the website: www.fsforum.org.

In that sense, the IMF has the power to induce, directly and indirectly, its member states to adopt a significant sub-total of the rules contained in the guidelines and recommendations issued by the abovementioned international fora, which, as mentioned, are non legally-binding.

14. Nevertheless, the existing international regulatory apparatus should definitively be enhanced. To my opinion, this enhancement should be pursued along the following lines:

(a) The main deficiency of the regulatory structure is the potential it leaves for regulatory arbitrage among institutions, markets and jurisdictions. In order to overcome this, the work of international standard-setters should focus on:

— closing the existing gap between heavily regulated financial entities and markets (such as commercial banks and equities markets) and non-or less-regulated ones (debt markets, OTC derivatives markets, hedge funds, credit rating agencies),

— dealing effectively with the regulation of activities in offshore financial centers.

(b) The rules adopted should pass a thorough "cost-benefit analysis" in order to ensure their effectiveness and avoid unintended negative spillovers. The pro-cyclicality of the existing capital adequacy regulations under the so-called "Basel II framework"[20] is a manifest example, especially under the current adverse economic conditions internationally, of the potential serious negative effects of measure adopted for legitimate reasons.[21]

15. Finally, there is a question about the necessity of a new "Bretton Woods Agreement".

(a) If this question is to be taken literally, the answer is that currently there are no official plans for the international Community to resort to a global monetary system of fixed but adjustable foreign exchange rates, like the one established in 1945 by the Bretton Woods Agreement and then abandoned in the early seventies.[22] On the contrary, the trend is toward creating regional currency unions around the globe.[23]

(b) A second broader reading of this question raises the issue on the necessity of an international agreement, like the one in Bretton Woods, which would lay down the foundations for a new international organisation responsible for preserving the stability of the globalised financial system.

16. The case against creating an international organisation in the capacity of an international financial supervisor has already been discussed above, under para. 12. In addition, I believe that the creation of an international organisation, even with powers confined to the adoption of regulatory norms, is also not necessary for the reasons laid down above, under paras. 13–14.[24]

On the contrary, what is imperative is:

— the enhancement of the content of the regulatory norms adopted at the international level by the existing standard-setting bodies (in line with the proposals made above, under para. 14), as well as; and

— the need to ensure their proper implementation by national authorities, on which the IMF should (and could definitively) play an increasingly more substantial role.

February 2009

[20] Basel Committee on Banking Supervision (2006): *International Convergence of Capital Measurement and Capital Standards: A revised Framework* (comprehensive version), June, available in the following electronic address of the Committee in the website: www.bis.org/publ/bcbsca.htm.

[21] See on this, among others, Swoboda, A. (2008): *Restoring International Financial Stability: Five Guidelines for Regulatory Reform*, paper prepared for the conference "Building an International Monetary and Financial System for the 21st Century: Agenda for Reform", The Reinventing Bretton Woods Committee, New York, 24–25 November (unpublished).

[22] The current financial turmoil has not been a "currency crisis" nor a "twin" crisis, but a pure banking (and more broadly financial) crisis. On this classification, see Brakman, S., Garretsen, H., van Marrenwijk, Ch., and Ar. Van Witteloostuijn (2006): *Nations and Firms in the Global Economy—An Introduction to International Economics and Business*, Cambridge University Press, Cambridge (and elsewhere), p. 217–263.

[23] See on this Vicuna, A. (2008): *Regional Monetary Unions*, International Law Association, Rio de Janeiro Conference (2008), Report of the Committee on International Monetary Law (MOCOMILA), section I, available in the following electronic address of the Association in the website: www.ila-hq.org.

[24] The case against creating an international organisation in the capacity of an international financial supervisor has already been discussed above, under para. 12.

Memorandum by Mr Will Hopper M.A., former Member of the European Parliament

Introduction

1. Thank you for inviting me to comment on the changes to the regulation and supervision of financial markets which have been proposed by the European Commission as their response to the current financial crisis. I understand that there are three reasons why you have asked me to give evidence:

a. Together with my brother, I am the author of a book called *The Puritan Gift* published in March 2007 and declared by the *Financial Times* to be one of the Top Ten Business Books of that year. It forecast the Credit Crunch in some detail, together with the likely consequences of that event.

b. I am an experienced investment banker of an old-fashioned kind. I was a director of, and then an adviser to, the merchant bank, Morgan Grenfell, for the decade before 1986, when Big Bang transformed the structure, attitude and ethos of the London capital market. More recently, I have practiced investment banking through my own company, WJ Hopper & Co. Limited, which is regulated by the FSA. I intend to close this business on 31 March, so that I can focus on writing and broadcasting.

   At Morgan Grenfell and elsewhere, I was a pioneer of the Eurobond market, in which capacity I wrote the first ever prospectus for the United Kingdom in any market. Recently my focus has been on investing in Eastern Europe, particularly Ukraine. I operate there through the so-called "primary market", in which capital is raised for investment in new plant and other facilities. By way of contrast, much recent financial activity by others has been in the "secondary market", in which assets and liabilities are swapped but no wealth is created. Secondary market operators are like the rapacious landlord in the Parable of the Talents (Matthew 25:14–30) who "reaps where he does not sow". As my co-author and I say in *The Puritan Gift*, someone has to "create the wealth that other people exchange".

c. I was a member of the first elected European Parliament for Greater Manchester West from 1979 to 1984 and so have had direct experience of European Community affairs.

Answers to your Questions

2. You ask if enforcing a prudential regime will be an effective method of preventing a repeat of the financial turmoil. The answer is "emphatically, no". A good prudential regime is a necessary, but not a sufficient, precondition for the creation and perpetuation of a healthy capital market. As we say in our book, "you can legislate against vice but not for virtue".

3. Some at least of our present troubles can be attributed to the relaxation in forms of financial regulation which has occurred in recent years. An example of feckless deregulation occurred in the US in 1999 when the Glass-Steagall Act was repealed, enabling both commercial and investment banks to engage in dangerous forms of speculation that had previously been unlawful and have since caused the collapse of major companies, inflicting serious damage on the global monetary system.

4. Or take the case of "short selling". From time immemorial this practice was regarded with suspicion on the New York Stock Exchange, where it was tolerated only in favourable circumstances and only if it took place on a rising market—technically, on an "uptick". In 2007 the "uptick" rule was abolished, leading to recent serious abuses. Underlying the traditional aversion to short-selling was the belief that shareholders, managers and employees should work as one team; short-sellers work against the other two groupings.

5. When I studied for my New York Stock Exchange examinations 50 years ago, I was told that selling something that one did not possess was a crime, unless undertaken on a recognised stock exchange. This leads to an interesting thought: if short selling of securities occurs away from a recognised exchange, is it legal in the US or the UK? If not, there may be some recourse for innocent investors against the money managers who have engaged in this dubious practice.

6. If a good prudential regime is a necessary, but not a sufficient, precondition for the restoration of a healthy capital market, what else is required? The answer is: the recreation of the much healthier managerial culture which existed throughout business and society -not only in banking—before, say, 1970. My co-author and I describe this earlier culture in great detail in *The Puritan Gift*, with particular reference to the United States.

We argue that, in the Golden Age of American Management (1920–1970), business managers including bankers were expected to, and did:

(a) learn what we call the craft of management "on the job" as they proceeded up the ladder of promotion; and

(b) simultaneously acquire what Jeff Immelt, CEO of General Electric calls "domain knowledge" of their company and their industry.

7. After 1970, however, a new concept of management became dominant in the US. Its proponents argued that management was a "profession" like medicine, dentistry or the law, which could and should be learned in an academic setting. It followed that a manager qualified in this way could turn his hand to any task in any industry at any time. This made it redundant for him to learn the craft of management "on the job" or to acquire "domain knowledge" of the company or industry in which he worked. Previously (and simplifying somewhat), engineering companies had been run by engineers, chemical companies by chemists—and banks by bankers!

8. The new class of "professional" managers also became known ironically as "financial engineers" since their object in life was to generate an attractive figure at the bottom end of the income statement, rather than to create genuine wealth in the real world. Citigroup is a case in point: it would be destroyed by its last chairman and CEO, the lawyer and take-over specialist, Chuck Prince, and the last chairman of its executive committee, the economist Robert Rubin. Please find attached to this document the Introduction which my co-author and I have provided for the paperback edition of our book; it develops this point in some detail.

9. The new American model of "financial engineering" has shaped the economies of most other countries to a greater or lesser degree. Curiously enough, one of the countries least affected has been Canada, in spite of its proximity to the US; to this day, the Canadian banking industry is run by old-fashioned commercial bankers, which has enabled it to sail though the current crisis relatively unharmed. The foreign country most affected is the UK. RBS is a carbon copy of Citigroup, with Lloyds and Barclays not far behind. When our building societies converted to limited companies, they too were taken over by American-style "financial engineers".

10. You ask if changes are needed to International Accounting Standards. The answer is "emphatically, yes". These Standards insist that companies "mark to the market", the assumption being that something called "the market" will at any time and place offer us a price which accurately reflects the interplay of supply and demand. This view is supported by the so-called Efficient Markets Hypothesis (EMH), a piece of pseudo-science which has dominated market thought and practice for the last 30 years. EMH treats the price-setting "mechanism" of the marketplace as a bit like a clock which tells us the time. However, the comparison is highly misleading. A clock does indeed tell us the time, but does not in any way advance or retard the hour. The operations of the market "mechanism", on the other hand, can have a devastating impact on price, particularly, but not only, in a thin market. The financier, George Soros, describes this phenomenon as "reflexivity", by which he means that investors' and traders' biases alter the fundamentals that determine prices.

11. For example, a large sell order for a five-year interest-bearing note may lead to a collapse in its market price, even in a good market and even if the fundamentals in relation to that note are sound. Under International Accounting Standards, holders of the security will be obliged to write the price down in their balance sheets, perhaps more than once. If short sellers scent a profit, a "bear raid" may ensue—catastrophic for the holders of the security but highly beneficial for the short-sellers.

12. Market fundamentalists, who believe that the market is always right, love to quote Adam Smith's famous dictum: *It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner but from their regard to their own interest*. They rarely quote another of his observations: *People of the same trade seldom meet together, even for merriment or diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. In the case of a short sale, this should be re-written as: or in some contrivance to lower prices*. Improved regulatory practices, associated with the kind of sound managerial culture described by, and promoted in, *The Puritan Gift*, would offer some protection to the public against this kind of conspiracy.

13. The solution to the "marking to the market" problem involves, in the first place, acknowledging that valuation is a difficult art requiring the exercise of common sense. Auditors must be fully aware of, and take into account, the likely consequences of a valuation for the market price itself. For example, when there is no real market, or only a very thin one, in a given security, it is entirely reasonable to "mark to the book value" instead of "to the market". Even in some good markets, there may be strong arguments for "marking to the book value".

14. Somewhat more controversially, I believe that we should also move further down the road to what I call "multi-dimensional accounting". Under this dispensation, companies would continue to publish one single balance sheet and one single income statement for legal purposes. However, the many assumptions underlying those accounts would be made fully explicit. A simple computer programme could, therefore, be made available to shareholders and others, enabling them to alter these assumptions at will. For example, they could decide to write-off good will arising from an acquisition over five years instead of 10. An elementary form of "multi-dimensional accounting" has been in normal use for many years, in the sense that many companies already publish cash flow statements; these are, essentially, income statements from which non-cash charges such as depreciation have been excised. If it is argued that preparing full "multi-dimensional accounts" would place too great a strain on the resources of companies, my answer has to be that chief executives should already have access to such calculations for their own, internal control, purposes.

15. You ask: *How can we achieve a coherent set of rules on last resort assistance, deposit protection and bank insolvency proceedings?* I believe that, with or without British participation, the EU will be driven along the federal path by the current financial crisis; and that it is in the area of bank regulation that the next major step forward will occur. If I am right, the European Central Bank will be transformed into an equivalent of the US Federal Reserve System and the existing national central banks within Euroland will approximate to regional Reserve Banks. At that point the UK will either have to adopt the Euro or leave the EU. My guess is that we will stay.

16. In answer to your questions (excepting the first and last) under the heading, "Further Legislative Opportunities", my response is a resounding "yes"!

17. In answer to your questions (excepting the first) under the heading, "EU Supervisory Reform," my response is that "group supervision" would be inadequate to achieve the object, although it is obviously better than the present arrangements.

18. In answer to both your questions under the heading, "Working Practices," my response is that effectiveness varies from country to country but in most cases could be improved.

19. In answer to your questions under the heading, "Global Supervisory Reform," my response is that the world is not yet ready for a single regulatory authority. However, there is now a need for an efficient global co-ordinating body which would meet at least monthly, possess its own permanent staff and might eventually involve into some kind of authority. This body could be part of a "college" of similar bodies responsible for co-ordinating a variety international activities, including the response to climate change, all preferably located in one physical space.

9 February 2009

Memorandum by the Banking Commission, International Chamber of Commerce

1°) Introduction

The Banking Commission of the International Chamber of Commerce—the global forum for the trade finance industry, has undertaken a survey of major international trade finance banks over the past three months examining the impact of Basel II on the availability and pricing of trade finance. Its full report is available at http://www.iccwbo.org/uploadedFiles/ICC/policy/banking_technique/Statements/ICC_Recommendations_on_Basel%20II.pdf

Below is a summary of its outcome.

2°) Disproportionate Capital Requirements for Trade Financing

The feedback we have received from ICC members shows a remarkable consistency, and it appears that most banks are facing tougher capital requirements for their trade assets. We believe that the financial crisis has brought into sharp relief an ongoing trend whereby the implementation of the Basel II charter has eroded the incentive of banks to lend trade finance, due to pronounced capital weightings that are not fully reflective of the low risk level of the activity.

The results of our consultations indicate that these increases in capital requirements have had particularly adverse consequences on trade lending to SMEs and counterparties in developing economies. Capital requirements under Basel II will of course vary according to the nature and structure of the transaction, counterparty risk and country risk. As an example, however, the capital intensity of lending to mid-market companies under Basel II is four to five times higher than for equivalent transactions under Basel I.

— *Rigidities in the maturity cycle applied to short-term trade lending:* Whilst trade finance lending is usually short-term in nature, between 0 to 180 days maturity, the Basel II framework applies a one-year maturity floor for all lending facilities. Since capital requirements increase with maturity length, the capital costs of trade financing are thus artificially inflated as a result. All national regulators have the discretion to waive this floor, although many have chosen not to do so.

— *A lack of historical and performance data to assist in validating risk attributes:* Many banks face difficulties identifying and isolating sufficient data to produce validatable estimates of risk attributes for trade lending. This tends to translate into overly conservative risk weightings (particularly as concerns the credit conversion factor (CCF), an essential element of calculating risk equivalent assets under Basel II) for trade finance products—in particular, where banks are required to rely on "standardized" parameters provided by national regulators.

By increasing the amount of capital banks are required to hold against trade finance lending, each of the above factors significantly restricts the ability of banks to lend essential short-term credit to businesses in the current, capital-constrained environment. As such, we believe changes to the treatment of trade finance under Basel II are urgently required to ensure sufficient flows of trade credit during the current economic downturn.

3°) The Grounds for Revised Treatment

The case for revised treatment of trade finance in the allocation of banks' capital rests on the historically low risk profile of the activity. Many banks will attest that they have experienced substantially fewer losses on trade lending over the past few decades compared to other banking activities. This primarily reflects the fixed, short-term maturity of trade finance products, and the fact that exposures are liquidated by cash upon maturity.

In addition, the transactional nature of trade financing allows banks to carefully manage exposures. Unlike products such as term loans or overdrafts, which may be granted on a revolving or ongoing basis, trade financing is not automatically renewed or rolled over on maturity. Moreover, each drawdown by the obligor requires submission of underlying documentation—often based upon standardized codes of practice—for the bank for review. The bank can refuse a new drawdown if it is not comfortable with the credit worthiness of the transaction, or the documentation submitted.

What is more, even in times of severe difficulty companies will generally try to avoid defaulting on trade obligations, as continual access to trade finance is a lifeline for most firms. In a similar vein, it should also be noted that trade-related instruments are generally the last forms of credit to be cut, and the first to be re-established, in debt-distressed economies.

4°) Recommendations

In the context of the above—and having regard to the key role that trade-related finance will play in stimulating a sustained economic recovery—ICC urges policymakers to give consideration to how changes to international capital adequacy requirements might complement other public interventions to boost trade finance flows. Based on our consultations with major trade finance banks, we firmly believe that such changes would have a significant impact on the ability of banks to lend trade credit at the current time.

Specifically, we recommend to:

— *Exempt trade finance products from the one-year maturity floor applied to lending facilities:* Within the national discretion, Basel II allows for the exemption of the one-year maturity floor for "short-term self-liquidating trade transactions". This is because the contractual maturity of Trade Finance products is reflective of the time horizon over which banks are exposed to a credit risk. Such discretion has already been exercised by a small number of national regulators. Our initial analysis suggests that removal of the maturity floor has the potential to cut capital requirements for trade finance obligations of 90 days maturity by around 20–30 percent.

— *Allow key risk attributes to be determined on the basis of industry benchmarking:* As noted above, many banks face difficulties identifying and isolating sufficient data to produce validatable estimates of risk attributes for trade lending. These problems are particularly pronounced in relation to the calculation of "loss given default" ("LGD") and "credit conversion factor" ("CCF") inputs in modelling to determine capital requirements under Basel II.

11 May 2009

Memorandum by the London Investment Banking Association (LIBA)

Current Commission Proposals

Will enforcing a prudential financial regime be an effective method of preventing a repeat of the financial turmoil?

1. Maintaining proportionate prudential supervision is an essential contributor to financial stability. The current turmoil had many causes, which we are all still in the process of understanding. Reinforcing prudential supervision is therefore likely to be one of a range of measures which will aim prevent future crises. It is important to recall that the current turmoil occurred under the Basel 1 prudential regime. The significantly more risk-sensitive Basel 2 regime was in the process of implementation when the turmoil began. The Basel Committee is conducting studies to ascertain what further improvements might be needed to Basel 2 to learn from recent experience, as set out in its recent consultations. It is important to note, as explained below, that no regime, however well enforced, can guarantee to prevent future instability.

Will Commission proposals amending the Capital Requirements Directive (CRD) and introducing rules on credit rating agencies (CRAs) prevent a future crisis?

2. See our answer to the previous question on the role of supervision in "preventing" a future crisis. There can be no guarantees that any prudential or legal changes will prevent any future crisis. Risks may be reduced, but cannot be wholly removed. The Commission Proposal for amendments to CRD largely consists of important technical improvements. Other aspects, in particular on the regulation of securitisations and the formalisation of "EU colleges" and "consolidating supervision" are, like aspects of the CRA Proposal, more controversial because, though they are intended to address weaknesses that the financial turmoil has revealed, they do so in a way which threatens either to introduce significant weaknesses in the supervisory regime itself, or to impede prudent market operation (see our answer to the next question for details).

What dangers are presented by these amendments?

3. The CRD proposals on "EU colleges" seek to formalise college arrangements within the EU. Such legal formalisation may be counter-productive in the global context. Most international groups are global in scope. It is thus vital that college arrangements in the EU dovetail with, and do not cut across, global collegiate cooperation.

4. The CRD proposals on securitisation require the "originators" of securitisations to retain a 5% economic interest in the issues that they originate: this is a crude attempt to create stronger incentives for due diligence by aligning the interests of "originators" with their clients. But their interests are likely to differ, which means that more targeted ways of aligning incentives are preferable; furthermore, the requirement for "originators" to retain risk runs directly counter to other principles of prudential regulation which require firms to minimise market risk exposure in respect of securitisation, and which require that firms create a clean break with securitisation vehicles in order to ensure there will be no "implicit recourse" or financial support by the originator for assets which the regulator has permitted to be removed from regulatory capital calculations. A further major concern is the proposed punitive capital penalties that would apply to regulated investors if they do not exercise continuing due diligence in relation to securitisations: these provisions could cause serious damage to investor appetite for securitised products, the vast majority of which are performing as expected.

5. The CRA Proposal is in certain respects more stringent than international norms; more worryingly, it would require all credit ratings used for regulatory purposes in the EU to be issued by EU-registered agencies' EU offices, and would prohibit investment on behalf of clients in non-EU-rated instruments: these provisions could impose significant barriers, at a time when governments are seekmg to keep protectionist pressures at bay. The danger is exacerbated by the absence of provisions on cooperation with regulators elsewhere in the world to ensure consistent and coordinated supervision of CRAs whose activities, by their nature, have a global effect.

Are changes needed to International Accounting Standards?

6. Many stakeholders may have particular criticisms of International Financial Reporting Standards, but our strong view is that these issues should be dealt with through the IASB's due process and that we should accept the outcome that the IASB process yields: it is important to note that some criticisms of IFRS, or demands for carve-outs from it, may have the secondary objective of weakening IASB in addition to correcting

shortcomings in the standards themselves. We believe it is essential to continue to seek greater global convergence, particularly the closer alignment of IFRS and US GAAP, and to examine ways of enhancing the IASB's governance structure so as to achieve its full acceptability in all quarters.

Further Legislative Opportunities

How can we achieve a coherent set of rules on last resort assistance, deposit protection and bank insolvency proceedings?

7. Legislation on coordination of minimum deposit protection has already been agreed in principle. Coordination of rules on last resort assistance and bank insolvency is more difficult: because of the fiscal, economic, market, and financial stability considerations which may vary from country to country and mean that different arrangements are appropriate; and because of varying legal frameworks. Consistency on treatment of Lender of Last Resort and insolvency is attractive as a goal but the discussion cannot be wholly removed from the political reality that these issues rest on the question of which taxpayer would pay in the case of LOLR facilities being needed: the technical issues cannot be resolved until the political agreement has been achieved. Rather than a coherent set of rules, which could be agreed only after lengthy debate, at this stage we should seek a structure of: exchange of information; mutual understanding of different countries' approaches; and coordination, liaison, and dialogue which ensures that national decisions are made within a framework of global cooperation.

Should a revised directive on the reorganization and winding up of credit institutions include a system of prompt corrective action, with intervention triggers tied to a leverage or liquidity ratio?

8. Ensuring maximum legal clarity in the event of the winding up of a credit institution or investment firm is important. Prompt corrective measures, if they could be agreed, and if there is evidence to demonstrate that the same measure would have the same effect in each EU Member State, would fit better in the CRD which addresses capital, liquidity and supervisory action and already covers the minimum requirements for authorisation as a credit institution and criteria that must be satisfied in the change of control of an institution. More work is required to identify the relevant triggers for corrective action, and the levels at which they might be set. We do not recommend the introduction of a leverage or liquidity ratio, which would run counter to the more discretionary approach in the Banking Bill.

9. Recent events have reminded us of the importance of gauging the levels of leverage and liquidity and assessing the implications. However, even aside from the technical challenges that setting industry-wide ratios could present (liquidity risk is highly subject to behavioural factors and is exceptionally hard to assess on a like for like basis between firms), it is essential to take a wider systemic view also. If leverage or liquidity constraints were to be set, whether on a regional or country by country basis, the effect would be to restrict the level and flow of business between different jurisdictions each of which might be compelled to retain funding and liquidity buffers. It is important to note that a global agreement to impose such constraints could itself have trade implications, but a unilateral regional decision would create particular difficulties for the funding of cross-border business and be likely to damage the position of the City of London, as well as undermining the breadth of services that firms provide to their clients.

Do rules on state aid to the banking sector need to be clarified?

10. State aid must avoid competitive distortions. To the extent that those temporary distortions are acceptable in the short term, plans must be developed to seek the unwind of the aid as soon as is reasonably practicable.

What other rules are needed to ensure financial stability in Europe?

11. See paragraph 7 above: we consider that better coordination networks are needed rather than additional rules: the focus should be on practical steps to assist effective supervision.

EU Supervisory Reform

Do we need a European System of Financial Supervisors or a central European authority to supervise pan-European financial institutions? What type of fiscal resources should such an authority have access to?

12. No, it is not clear there is a case for such a central European system or authority. While further improvements are needed to coordination and cooperation in EU supervision, significant issues would arise from structural changes. In particular, pan-EU financial institutions are typically also global financial institutions. EU arrangements must be consistent with, and not distract from, global cooperation

arrangements, which will necessarily involve more effective use of less formal cooperation structures, in particular supervisory colleges. They must also be taking account of the Lender of Last Resort responsibilities which attach specifically to national authorities.

How effective would group supervision be in creating a unified system of supervision across the single market?

13. Group supervision can mean a range of things, and it is important to understand that to a significant degree Group Supervision is already in place in the EU as there are already consolidated supervision requirements and a number of supervisory arrangements to deal with group structures that include multiple subsidiaries within the EU. How effective changes to the current arrangements would be would depend on the specific arrangements proposed. For example it is very different to identify a single supervisor for a group: (i) where all subsidiaries are owned by a single holding company within the EU; and (ii) where there are multiple subsidiaries owned by a parent outside the EU. Also the subsidiaries of EU companies that are incorporated outside the EU could not be brought within a single group supervisor model either. It is necessary in all cases to balance the legitimate interests of national supervisors with the need for streamlined supervision, and the public policy need for efficient, effective, and well-coordinated group supervision, taking account of the global as well as the EU dimension. The most appropriate arrangements may differ in different supervisory fields: it is therefore important to ensure that any "unified" system of supervision across the single market is not also a "rigid" system that diminishes effectiveness or impedes cooperation with third countries.

Would group supervision assert the primacy of large supervisors to the detriment of the supervising bodies of smaller Member States?

14. There is a risk that it would do so. It is vital to ensure that arrangements for group supervision are adaptable enough to reconcile the need for supervisory efficiency with the legitimate interests of supervisory bodies in smaller Member States.

Do we need a rethink of the home-host country divide with regard to supervision and crisis management in the EU?

15. Home country supervision is premised on the fact that a financial institution which has branches in other Member States will be subject to supervisory and administrative decisions made in the Home Member State: this reflects basic Treaty principles. When an authorised financial services firm branches into a different Member State, the Host State has few if any rights to object or prevent the branching. Does the question seek to establish whether this arrangement should be revisited? If so, it is important to understand that to amend this treatment would be to question the fundamental premise of the EU Single Market. Nevertheless, such a question could be seen as legitimate if there is to a be a full discussion of rights and responsibilities when assessing the more difficult and costly outcomes that can be faced in a crisis.

Working Practices

Do EU institutions need to amend their working practices on financial services?

16. Continuing improvements are needed in EU institutions' working practices. Over the past few years, in particular, the Commission and Level 3 Committees considerably improved their consultative approach. The Level 3 Committees have made great strides in building trust, improving standards, and enhancing the quality of supervision. The Council's 2006 "Francq Report" set out a series of improvements to the Level 3 Committees' working practices which are being implemented. In 2007 and 2008, ECOFIN agreed a further action plan on improvements to the Lamfalussy process, which is also in the course of being implemented. The focus needs to be on maintaining and continuing these improvements. Whilst the urgent need for improvement is not disputed, it is worrying that the last few months have seen an erosion in the Commission's consultation standards, prompted it seems by an over-hasty reaction to recent market events: dialogue with market participants and consultation has become more perfunctory, and in certain important respects the quality of legislative proposals has declined. High quality policy and legislative solutions need a climate in which open dialogue is encouraged.

How effective are current working practices in providing a rapid response to a crisis?

17. Because every crisis is likely to be different and to an extent unforeseen, the response is necessarily ad hoc. In this crisis, in general the authorities have typically acted quickly to head off perceived threats. There has been criticism of shortcomings in the arrangements for coordinating responses internationally, and of the arrangements which enabled the authorities to work cooperatively in events leading up to the crisis, for example the evaluation of and response to early warnings. Careful analysis is needed to determine how these arrangements can be improved, while also ensuring that structures of cooperation facilitate and do not impede prompt and effective responses. We need to take care that arrangements are not too closely tailored to the current turmoil, but are able to identify and head off the next one.

Global Supervisory Reform

Does the turmoil signal the need for a global supervisory system?

18. The turmoil signals the need for a more globally coordinated supervisory system, both of prudential supervision and financial stability management. Such a system, entailing effective mechanisms for international coordination and information sharing, must be reconciled with national accountabilities, in particular the lender of last resort function.

If so, what role should the EU and existing financial institutions, such as the IMF, take in this system?

19. The EU institutions' role should be to ensure that regional cooperation and coordination arrangements within the EU contribute optimally to global coordination. Leadership in international standard-setting and coordination of financial stability and supervision should be taken by global bodies.

Is a new Bretton Woods agreement necessary?

20. There is no need for new global institutions. It is however important to ensure that the governance of the existing institutions commands global support.

9 February 2009

Memorandum by Professor Jean-Victor Louis, Université Libre de Bruxelles

1. We have opted for answering to some aspects of the questions raised under (3) concerning the topic mentioned in the title. We will dedicate some reflections to the legal basis of the creation of a European supervisory system. We will not look in depth at the question of the opportunity of such a system. We take for granted that the globalised financial system needs a global regulator and supervisor. It is especially true in the euro area thanks to the progress of the integration of financial markets and banking systems. But it is also true for the EU in general. In the words of Mr. Lucas Papademos, vice-president of the European Central bank (ECB) (*Wirtschafts Woche*, 3 January 2009), in the EU, 45 great banks with cross-frontiers activities possess almost 70 % of the assets of banks in Europe. What is special to the euro area is that it is building a true single payments area. National Central Banks are the providers, under a scheme adopted some years ago, of Emergency Liquidity Assistance (ELA), at their own costs but with the fiat of the ECB, and the ECB has demonstrated in the recent crisis how wide it can, if needed, open its liquidity window against collaterals.

2. In the first years of this century, a number of committees for Securities (first), Banking, Insurances and Pension funds (in a second stage), known as the Lamfalussy committees have been created as a follow up of the Financial Action Plan. On the other hand, the EC Treaty in its present form (ECT, article 105.6) and the Treaty on the Functioning of the EU (TFEU, article 127.6), after the entry into force of the Lisbon Treaty,[25] provide both for the possibility to confer to the ECB "specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions" with the odd exception of insurance companies. This step, among other procedural provisions, requires a unanimous vote in the Council.

3. In order to get a better regulation and supervision of financial institutions, one theoretically may engage in one of three ways: the first is a minimalist one and consists in strengthening the Lamfalussy structure through all the steps that are now been discussed; the second is based on the use of the enabling clause provided by the Treaty and the Statutes of the ESCB and ECB for endowing the ECB with "specific tasks" for the supervision of credit institutions; remarkably enough, such regulation would be applicable to all EU Member States within and

[25] We refer to both the treaties presently in force (Treaty on the EU –TEU- and European Community Treaty—ECT) and to the new Treaty on the European Union—new TEU—and the Treaty on the Functioning of the European Union—TFEU—in the coordinated version of the Lisbon Treaty.

outside the euro area. Referring to article 105.6 of the ECT, the president and the vice president of the ECB have recently revealed the disponiblity of the ECB to play a central role in banking supervision but they have not, publicly at least, detailed their views on the matter. This could be limited to the assistance provided to the Lamfalussy structure by the ECB, in a way similar to the role of the Bank for International Settlements (BIS) for the Basle committees and the Financial Stability Forum (FSA). But other actions more ambitious are possible and needed under this provision. Article 105.6 ECT raises problems of interpretation on the limits of "specific tasks" and on the reasonableness to exclude insurance companies, considering the development of groups active in both the banking and the insurance sector. The third way is the creation of a *European System of Financial Supervisors* (ESFS), on the model of the European System of Central Banks (ESCB), as proposed by Task Force led by Karel Lannoo of the Brussels Centre for European Policy Studies (CEPS), in a Report on *Concrete Steps towards More Integrated Financial Oversight*, December 2008. Belgian authorities have seen with favour such orientation. The creation of the ESFS would need a Treaty revision, as we will indicate later on.

4. The choice between the three options obviously raises important legal and political questions. Small but not negligible steps like the promotion of colleges of supervisors, the improvement of the functioning of committees and coordination among them and the further harmonization of the regulation are easier and susceptible to be more rapidly agreed than bigger and time consuming processes of drafting a coherent system. But long-term visions are not to be a priori excluded. The high level group created by the EU Commission under the chairmanship of M. de la Rosière in order to reflect on the financial crisis and to propose specific solutions, will surely express views on it in its report expected for the end of February. Institutional framework for financial supervision was not supposed to be the main concern of this group but the evolution of the crisis is such that new priorities emerge and positions are moving. Progresses in banking regulation and supervision have always resulted from specific crises and it is true that no post Second World War crisis had the importance of the one that started with the fall of the subprime market. It has in particular become obvious that coordination among national supervisors does not satisfactorily work, that Memorandums of understanding either bilateral or multilateral are not efficient means especially when close co-operation among supervisors would be needed in times of crisis and that important cross borders banking groups are subject to a burden of ineffective and partially overlapping reporting obligations. Nevertheless, oppositions to what is presented as a "centralisation" of prudential supervision remain. This element is making attractive the creation of a European but decentralised system of financial supervision.

5. We will try first to look at the legal feasibility of such a system at EU level. We believe that ideas need to be clarified. Second, we will look at the possibility of an action limited to the euro area through the implementation of an enhanced co-operation between all or most of the States having adopted the euro.

6. Let us mention first the questions raised by enhancing European responsibilities for prudential supervision under what we have called the second way.

7. 1° A EU action under article 105.6 ECT (or under the broadly similar article 127.6 TFEU) or any possible other legal basis, requires a judgment based on subsidiarity, because this test applies to any EU action in fields that are not of its exclusive competence, which is clearly the case for prudential supervision. Pertinent provisions on the subsidiarity principle are included in article 5.2 of the ECT Treaty (article 5.3 of the new Treaty on European Union, under the Lisbon Treaty). In general terms, it would be necessary to demonstrate that the action at the level of Member States is not sufficient in order to achieve the objectives of the envisaged action and that these objectives would be better realized at EU level. There seems to be no particular difficulty as far as the first part of the test is concerned. There is a broad agreement on the fact that an improvement is necessary. The situation is more complex if we look at the second part of the test: is an action under article 105.6 ECT of such a nature that it could significantly contribute to the realization of the objective of financial stability? There are pros and cons, of a more or less convincing value, on the concentration of (some) prudential supervision responsibilities at the level of the ECB. Two are most frequently mentioned: one concerns the possible conflicts of interest between the responsibility of the ECB in monetary policy and in managing liquidity crises, the other stresses the high degree of independence of the ECB, judged incompatible with crisis management, because it involves tax payer money. These arguments are not universally shared. Many would indeed see independence as an asset. And there is a lack of material evidence of the so-called conflict of interests. In favour of allocating to the ECB responsibilities in the matter, one could invoke its global view of the financial system that it acquires in overseeing this system and the huge amounts of central bank money spent in systemic crises such as the one we are into. It could be sensible to closely associate the ECB also to the preventive side of prudential supervision.

8. The recourse to article 105.6 ECT raises other questions: the first one concerns the limitation included in the text to "specific tasks". We do not consider as a great obstacle. Nobody could be in favour of providing the ECB with all the responsibilities in the field of prudential supervision. Its role would be primarily for, or limited to, systemic institutions and some degree of decentralization would be in the essence of the system. One of the most delicate questions would be, whatever the way selected, which kind of allocation of powers between the centre

and the periphery could be provided. The absurd exclusion of insurance companies in a regime built on article 105.6 ECT is more problematic. Let us repeat that action under article 105.6 ECT or article 127.6 TFEU would concern all the EU Member States, also those with a derogation or a special status in respect to the euro. These articles are indeed not included in the list of those provisions only applying to Member States having adopted the euro. That would lead the ECB to exercise functions in an area larger than the euro area. If one decides that the legal basis of article 105.6 ECT or 127.6 TFEU does not allow for the required action one has either to turn at the clause allowing for some flexibility (article 308 ECT; article 352 TFEU) or to envisage a revision of the treaty.

9. 2° In order to use the so-called "flexibility clause" of the Treaty, it is required to demonstrate that there is no other legal basis available in the Treaty or that existing legal bases are insufficient in order to achieve the required objective. Article 308 ECT does not provide for a procedure for reforming the Treaty. One could possibly demonstrate that the legal basis offered by the Treaty (article 105.6 ECT previously mentioned) is insufficient and that appropriate measures are to be taken on the basis of article 308 ECT. If this test is met, this article could serve for attributing some competences to the ECB, in particular for insurances activities of cross border banking groups, if it is demonstrated that without this competence, the ECB's action would be ineffective against systemic institutions, but it could not be used to create a new structure like the one envisaged in the CEPS report mentioned in point 3 of this statement. There is indeed a well-established case law of the Court of justice of the European Communities (expressed in the *Meroni* case, 9 and 10–56 of 13 June 1958, ECJ Reports, 1958, p. 9) that prohibits the attribution of discretionary powers to an entity not provided by the Treaty, because it would endanger the balance of powers created by the Treaty. The Court has ulteriorly stated that an action under article 308 ECT has to respect constitutional limitations deriving from the acquis communautaire. It is the reason why we are of the opinion that the structure involved in the creation of an ESFS, as sketched in the CEPS report, would require a Treaty revision under the ordinary (cumbersome) procedure.

10. The main obstacles for an action under either article 105.6 ECT or article 308 ECT (and corresponding provisions of the TFEU) is the need to reach unanimity within the Council for adopting the required decisions. As a last resort (see article 43a of the present TEU), the Treaty opens the possibility to make recourse to the general *procedure of enhanced cooperation* as provided by the treaties (see articles 43 to 45 of the present TEU and article 11 and 11a of the ECT; articles 326 to 334 of the TFEU). Enhanced co-operation is a remedy against paralysis. The general clause included in the treaties has never been used up to now but the threat to use it has been instrumental in achieving agreements when some tricky questions were at stake. This procedure permits to avoid the development of co-operations outside the treaties' framework, based on international law, that in the past have opened the way to Community actions. Under the present treaties in the version resulting from the reform of Nice, the decision to proceed to an enhanced cooperation between at least eight Member States (nine under the Lisbon Treaty) would require a decision adopted by a qualified majority in the Council (article 11.2 ECT). This decision would be submitted to a number of conditions. Under article 43 of the present TEU, the apparently more problematic conditions in the field of prudential supervision are linked with the necessity for the enhanced co-operation to avoid undermining the single market (article 43 (e)), constituting a barrier to or discrimination in the trade between Member States and distorting competition between them (article 43 (f)). These limitations are reproduced in article 326 TFEU. These limits are not, in our view, to be hold for a severe obstacle to enhanced co-operation. There are good arguments as suggested above to consider that the euro area has made possible developments towards integrated financial markets in a measure that the single market alone was unable to realize. These developments are requiring an action at European level in the field of financial supervision. A further element is to be taken into account. If openness to the other EU Member States remains a cardinal principle of enhanced co-operation that has the objective of strengthening the integration process (article 43.1 and article 43a ECT; article 20.1, subparagraph 2 new TEU), some conditionality could be included in the decision authorising the start of an enhanced co-operation under article 43a ECT. The Lisbon Treaty expressly refers, in article 328.1 TFEU, to possible conditions of the participation to a co-operation. This kind of conditionality was introduced in order to avoid free riders, which would agree to participate to closer co-operation with a view of influencing or even paralyzing it. It is suggested that one of these conditions could be the adoption of the euro or the participation to the Exchange Rate Mechanism (ERM 2), one of the convergence criteria's for the participation to monetary union. An enhanced co-operation can be used in order to activate the enabling clause of article 105.6 ECT (or of article 127.6 TFEU) but nothing rules out the use of the enabling clause of article 308 ECT or 352 TFEU in order to realize an enhanced co-operation. Specific limits to the recourse to this clause should be met. If political will is not available, the possibility remains of enhanced cooperation outside the treaties by a coalition of the willings showing the example to the others.

11. Question 3 on EU Supervisory Reform raises also different points that we will briefly touch upon. As far as fiscal resources needed for the rescue of financial institutions, the already mentioned CEPS report suggests involving the European Investment Bank (EIB) in the management of a fund of intervention. It would be worthwhile to examine if this responsibility could fall within the present EIB mandate. The two questions on group supervision and on home-host country divide would be put in a completely differing context if one adopts

a ESFS, where all supervisors, invested with both a national and a European mandates should report to the central unit. One could imagine that the kind of multilateralisation/decentralisation that the ECB probably has in mind would led to the same result. It is evident that as suggested by the CEPS report, further studies should be dedicated to all the aspects of the proposal of creating a European System. That would require time. This could lead in the present situation to the determination of ways for improving the situation at short term without compromising a more ambitious regime for the future.

6 February 2009

Memorandum by Moody's Investors Service

Question 1: *We have heard concerns from many witnesses that the regulation of ratings is impossible due to the complexity of the ratings system. Can you comment on this suggestion?*

Answer: Moody's Investors Service (MIS) draws a distinction between, on the one hand, the regulation of the conduct of credit rating agencies (CRAs), ie the processes and procedures that they employ to produce ratings with integrity, and on the other hand, the regulation of the content of the opinions of credit rating agencies.

We do not oppose the regulation of the conduct of rating agencies. It should be possible to craft appropriate and tailored regulation regarding the practices, policies and procedures of CRAs in a manner that protects the independence of the credit rating agency, does not raise regulatory barriers to entry and is globally consistent. If, however, such regulation becomes too granular and prescriptive, it will risk crystallizing or heavily encumbering the conduct of CRAs. Consequently, CRAs may be less able to provide timely credit views in response to changes in the credit markets. This risk exists with the EU regulation.

However, we believe it would be wholly inappropriate to regulate the content of the rating opinions of credit rating agencies. Such an approach would substitute the opinion of the CRA regarding the credit of the issuer or bond with the opinion of the regulatory authority and would erode in a fundamental way the independent nature of the rating.

Question 2: *The British Banking Association, in its evidence to this Committee, argued that the requirement for EU financial institutions to only trade instruments rated within the EU, would "substantially limit the ability of EU regulated financial institutions to make use of non-EU related credit ratings for regulatory purposes". Do you agree with this assessment? Have changes made in European Council resolved this issue?*

Answer: In the original Commission text, article 4(2) stated:

> "Investment firms and credit institutions referred to in Article 1 of Directive 2004/39/EC should not execute orders on behalf of their clients with respect to financial instruments which have been rated, unless the credit rating has been issued by a CRA registered in accordance with this Regulation".

The British Bankers' Association's read of this article is correct, in that unless modified or deleted, entities based in Europe would not be able to use ratings produced outside of the EU. The Council and the European Parliament, in their respective drafts will likely delete the trading restriction in article 4(2). However, it is still the case that EU banks will face restrictions in terms of their use of non-EU ratings for regulatory purposes.

Both the Council and the Parliament are in favour of introducing a system whereby non-EU ratings will have to be "endorsed" by an EU registered credit rating agency. Through endorsement, the EU rating agency will have to determine whether the rating was issued under regulatory requirements that are in the Council text "at least as stringent" as those in the regulation, or in the Parliament text "in accordance with this regulation". In addition, the Parliament is seeking to introduce an equivalence regime whereby the EU Commission will deem a jurisdiction's legal and regulatory framework for rating agencies to be equivalent to the EU regulation. Under this configuration, a CRA will be able to endorse the ratings of its non-EU subsidiaries only if the jurisdiction in which they are based has been deemed to have an equivalent regulatory environment to that of the EU. Once a non-EU rating has been endorsed, it can then be used for regulatory purposes in the EU.

Consequently, neither the Council nor the Parliamentary amendments have resolved the issue unless the rest of the world adopts regulations that are the same in their details to the EU Regulation. It is, therefore, highly likely that many jurisdictions will not be deemed equivalent and/or CRAs will not be able to endorse the ratings of their non-EU subsidiaries. Consequently, regulated financial institutions in the EU will be precluded from using many non-EU ratings at least for regulatory purposes or for other purposes depending on which version of the text is adopted.

Question 3: *A previous witness has criticised the excessive reliance on rating agencies as 'laziness' on the part of regulators and financial institutions. Do you agree?*

Answer: Moody's has and will continue to encourage regulators and investors to form their independent views on credit quality and not make inappropriate use of credit ratings.

Question 4: *Many witnesses to the Committee have criticised the speed at which EU legislation in response to the financial crisis has been constructed, raising concerns that this will lower its quality. Do you agree with this criticism?*

Answer: We are not opposed to regulation of our industry in the EU. However, we believe that an optimal solution is more likely when all parties, whether national member states, regulatory authorities, policy makers or market participants are provided with adequate time to fully consider the implications of the proposed regulation. Appropriate consideration arguably is even more important in times of market stress. On balance we believe that the EU proposal for CRAs could have benefited from further time to evaluate the various perspectives of market participants.

The speed of action by the EU has however put in jeopardy the work being done to achieve a globally consistent regulatory framework for rating agencies through the G20 and the International Organisation of Securities Commissions (IOSCO).

Question 5: *Some witnesses have expressed concern that the regulation of rating agencies will write ratings into regulations and subsequently reduce the requirement on purchasers of financial instruments to conduct their own due diligence. How do you view this suggestion?*

Answer: It is possible that by creating a relatively prescriptive and detailed regulatory framework, legislators could create the mistaken impression that because ratings are a closely regulated product they are fully endorsed by a national or EU authority. We further believe that it is likely that because of the more detailed oversight framework, both regulators and investors may have the false sense of security that these ratings are "guarantees of performance" and therefore can be relied upon fully.

We believe that the markets would be well-served if authorities were to discourage this impression. In particular, we believe that authorities should seek to enhance the issuer disclosure regime in the securities markets so that investors are better equipped to perform their own analysis and assess if a particular security, whether structured, corporate or governmental, fits their particular investment strategy.

31 March 2009

Memorandum by Professor René Smits, University of Amsterdam

In response to the call for evidence by the House of Lords' European Union Committee, I respectfully submit the following thoughts on EU responses to recent financial instability. I hope my thoughts may still be useful for the Committee and stand fully ready to assist the Committee further if it were interested in an elaboration of my thinking.

1. Current Commission Proposals

A rethink of EU banking supervisory standards is necessary but should take place in the context of a global new approach to the finance industry. Going it alone will not help Europe's finance industry or the EU as such. Only if global or, at least, transatlantic approaches fail, would I advise the EU to adopt unilateral measures or to adapt its own legislation out of an international context.

The recent amendments to the Deposits Guarantee Directive are to be welcomed but do not go far enough. The "Icelandic problem" and the tendency of Member States to "pass the buck" when it comes to deposit guarantees require a more fundamental rethink of deposit insurance in Europe. This rethink must go beyond the current patchwork of national deposit guarantee systems which have been harmonized only partially and which do not provide for a level playing field. The possibility to "top up" the coverage of deposits in a branch in a host State by applying for that State's higher level of guarantee than that which is carried by the bank from its home State leaves depositors guaranteed at varying levels even at the same bank. This is incompatible with the core idea of the internal market. Europe needs to address funding issues at the Union level. This requires going for an EU-wide system of either pre-funding or post-allocation of losses incurred under payouts by guarantee schemes. Failure to tackle these problems will permit a recurrence of nationalist tendencies in a next crisis (only guaranteeing deposits at Irish banks, for instance, at least initially) and will maintain the divergent approach to deposit protection, leading to moral hazard (with depositors fully protected up to very high amounts in some Member States whereas their peers in other States are supposed to bear an initial own risk). Even though these problems may seem intractable and difficult to solve at the political level, it is imperative that they are addressed to prevent a recurrence of the current messy situation and, more importantly, so that the internal market remain intact, even for banking services.

2. Further Legislative Opportunities

On deposit protection, I refer to my previous remarks. On bank insolvency proceedings, the current arrangements only provide for a limited measure of harmonisation, focusing mainly on the attribution of competences among courts and other authorities of Member States in which banks in trouble operate. Europe should go beyond the Reorganization and Winding-up Directive which led to the announcement in the Official Journal of bankruptcy proceedings of Icelandic banks (already widely reported in the media) three months after they had been initiated. This Directive does not provide for a coherent set of rules on reorganizing or winding up banks in difficulties. I perceive a need for some sort of European winding up regulation for the banking (or, perhaps, even wider: finance) industry.

In line with consistent calls for this by the ECB, and in line with the recommendations of the *Larosière* Report, the European Union needs a single rulebook for its finance industry (and also for its payments systems).[26] This implies the adoption of financial sector rules in the form of regulations rather than directives. Only directly applicable regulations can ensure that banks and other financial institutions know which rules to follow across the continent. Nowadays, directives are implemented divergently and with quite some "goldplating", into 27 different laws. Apart from the issue of the national application of EU law through Member State authorities (on which more below), the adoption of a consistent set of rules is paramount to preventing an immediate carve up of the internal market when difficulties arise. An extreme example concerns the divergent policy measures adopted in various Member States concerning "short-selling" and the lack of clarity as to their application. Yet, even in normal times, the absence of a coherent framework of rules undermines competition among financial institutions and their effective supervision. The *Larosière* Report's suggestion to revoke all national exemptions, opt-outs and derogations in current legislation is a bold step. It should be followed by a recasting of Europe's financial regulatory framework into regulations.

3. EU Supervisory Reform

Apart from the absence of a consistent EU-wide rulebook, the application of harmonized rules through a large number of separate agencies explains the lack of coherence in financial supervision in Europe and the divergent responses in times of crisis. There is a lot to be said for supervision as close as possible to the supervised. Thus, it is wise to maintain the national supervisory authorities as the first point of contact and the main conduit for supervisory action. However, they should be directed by a European authority, both in respect of their general policy and supervisory practices and in respect of their supervision of individual institutions. The *Larosière* Report suggests the first but fails to knowledge the need for the second. To my mind, a central European authority should, indeed, supervise pan-European financial institutions. A continued reliance on colleges of supervisors to supervise pan-European financial institutions risks maintaining a patchwork of divergent practices and undermining competitive conditions on the market. As set out in the attached memorandum on the *Larosière* Report which I wrote together with two colleagues from the Benelux,[27] such colleges consist of different authorities, reflecting the national markets in which the institutions supervised are active. They will have different ideas on how to act in the face of prudential concerns or when the bank is in distress. As we wrote, the *Larosière* Report "introduces innovative elements to ensure a level playing field between larger institutions supervised by such colleges and other players on the market. But [it] does not address the danger that each such college will develop differently from its peers overseeing other cross-border firms, which would undermine effective supervision and a level playing field among the larger institutions themselves." A thorough look into the competitive issues raised by colleges of supervisors is necessary.

I argue for a strong involvement of the European Central Bank in prudential supervision. I also favour far-reaching solutions to the problem of a lack of clear authority for the financial market. The idea of splitting responsibility for "macro-prudential" supervision (ie, supervision with a view to systemic stability) and responsibility for "micro-prudential" supervision (ie, supervision with a view to the protection of deposit

[26] Reference is made to my article *The changing payments landscape of Europe: issues of regulation and competition*, based on a presentation before a seminar on "EU Financial Services Regulation: completing the internal market" at Queen Mary, University of London, on 26–27 October 2006 in: Piet Eeckhout and Takis Tridimas (eds), Yearbook of European Law 2008, Volume 27, pp 405–444. The article gives the state of the law as at 25 July 2008 and contains my criticism of the Payments Services Directive.

[27] *De Larosière: fine recommendations fail to tackle main issues*, 26 March 2009, by Laurens Jan Brinkhorst, Professor, University of Leiden, Jean-Victor Louis, Professor emeritus, Université Libre, Brussels and René Smits, Professor, University of Amsterdam, to be published on http://www.euractiv.com/

holders and other creditors of a financial firm) does not appeal to me. Also, relying, as the *Larosière* Report does, on a new group consisting of some 30 members to establish the existence of systemic risk and requiring them to report to a group of 27 members (the Ecofin Committee) does nothing to solve the lack of coherent authority in the internal market. Europe needs to go further if it is to remedy the current opaque division of responsibilities and lack of leadership. Reference is made, again, to the attached memorandum.

In general, the home/host State division of responsibilities should not be given up as it is a core element of the functioning of the internal market, also in other areas. After all, the idea of mutual recognition, elaborated in the EU supervisory arrangements in respect of financial firms, derives from the similar approach to marketing of products and services in other areas (initially brought about by the *Cassis de Dijon* ruling of the European Court of Justice). Nevertheless, for larger institutions, a Union-wide authority seems the only practical solution, as indicated above. Also, even for smaller institutions, there should be an EU authority that can give binding instructions to the competent national supervisors in order to ensure consistent and coherent supervision. Such binding instructions are also necessary in case a smaller institution appears to be systemically relevant. Certain financial institutions are not "too big to fail" but they are "too interconnected to fail".

4. Working Practices

Some of the suggestions by the *Larosière* Group on the functioning of supervisors (peer review and strong emphasis on their effectiveness and independence) merit to be followed up. Reference is made again to the attached memo (not printed). Generally, the crisis has shown the European Union to be maladapted to the need for forceful and unified action. The Commission and the European Central Bank are doing a commendable task of trying to steer the national measures to a level of convergence called for by the European Council and the Ecofin Council. Nevertheless, merely relying on state aid rules (in the case of the Commission) or consultative competences in respect of national measures (in the case of the ECB) has proven insufficient to prevent protectionism creeping in, if not in law than at least in practice. Let me confine myself to one example: the requirement for recapitalization of ING to inject €25 billion into the market, which is largely considered to mean: the Dutch market. Europe needs stronger crisis management and, hence, stronger institutions. At the very least, the European System of Central Banks should rethink the self-imposed restricted reading of its competences and acknowledge that lender of last resort competences belong to it, rather than to the National Central Banks functioning outside of the Eurosystem's responsibilities.[28]

The lack of effective economic policy coordination among Member States shows the ineffectiveness of the Economic Union element of EMU. This calls for remedying the defects in economic policymaking. I cannot elaborate these elements further here but stand ready to explain my thinking.

5. Global Supervisory Reform

Let me confine myself to two remarks. The first concerns the necessity of Europe answering the need for regulatory change within a global context, as indicated before. The second concerns the need for a single EU seat at the IMF and a rearrangement of voting power within that institution, to reflect the relative size of populations and economies. This should make the IMF more representative. Giving a stronger voice to emerging economies is also needed in respect of the Basle Committee on Banking Supervision. It has taken the first steps in that direction. My views on the representation of the EU in the IMF and in other global fora such as G-7/G-8 and G-20, are set out in a recent paper.[29]

3 April 2009

[28] Reference is made to my thesis *The European Central Bank—Institutional Aspects*, Kluwer Law International, The Hague/London/Boston, 1997, 2000 reprint, notably pages 269–271, and to my presentation *Lender of last resort: issues of competence and competition* before a seminar on 25 November 2008 on State Aid and Financial Services: Impact of the Credit Crisis?, organised by the British Institute for International and Comparative Law, available at: http://www.renesmits.eu/Lender_of_last_resort_-_issues_of_competence_and_competition.ppt

[29] René Smits, *International representation of Europe in the area of Economic and Monetary Union: legal issues and practice in the first 10 years of the Euro*, paper prepared for, and also reflecting discussions during, the Conference 10 years of European Monetary Union: a legal perspective, organised by the Legal Committee of the ESCB, and held in Frankfurt am Main (D) on Thursday 29 January and Friday 30 January 2009, available at: http://www.ecb.int/events/pdf/conferences/emu/RSmitsInternationalRepresentationOfEMUpaper.pdf?51d106e17152ad3de9a3332d1093934c. This paper will be published in *Euredia*, European Banking and Financial Law Journal, see: http://www.bruylant.be/euredia/ and http://euredia.univ-lyon3.fr/. See, also, my presentation before the aforementioned conference, at: http://www.ecb.int/events/pdf/conferences/emu/RSmitsInternationalRepresentationOfEMU.pdf?1a7c37dbb5916ac7fe2a850f8371b547

Memorandum by Standard & Poor's Ratings Services (S&P)

1. *We have heard concerns from many witnesses that the regulation of ratings is impossible due to the complexity of the ratings system. Can you comment on this suggestion?*

1.1 In responding to this question, S&P believes that it is most important to distinguish between ratings and credit rating agencies (CRAs). The content of ratings, as well as the methodologies that are used to produce those ratings, should not be the subject of regulation. Any attempt at this type of regulation would amount to a serious and unacceptable interference with analytical independence. We are confident that this point is well understood by policy-makers and regulators.

1.2 On the other hand, S&P recognises that there are potential benefits in establishing a framework for the regulation of CRAs, to ensure the appropriate implementation and observance of policies and procedures in areas such as the management of potential conflicts of interest. We believe that a system of regulation and supervision of CRAs could, if appropriately calibrated, also support efforts to rebuild confidence in credit ratings.

1.3 In a paper entitled "Toward A Global Regulatory Framework for Credit Ratings" we have set out in further detail our recommendations as to what regulations should seek to accomplish in general terms, as well as specific recommendations that we believe could be instituted globally for CRAs.

2. *The British Bankers' Association, in its evidence to this Committee, argued that the requirement for EU financial institutions to only trade instruments rated within the EU, would "substantially limit the ability of EU regulated financial institutions to make use of non-EU related credit ratings for regulatory purposes". Do you agree with this assessment? Have changes made in European Council resolved this issue?*

2.1 We agree with the British Bankers' Association that this requirement should be removed from the draft Regulation. If it remains, it would create an unworkable and unenforceable compliance burden for EU regulated financial institutions and place European investors at a disadvantage by limiting their opportunity for investing outside Europe. It could also have anti-competitive implications, in that it would in effect require every CRA that wished to rate instruments that may be purchased to be used by European investors to register under the EU Regulation. As the Regulation currently stands, this would require a non-European CRA to relocate its activities to Europe.

2.2 The provision is also extremely difficult to defend from the point of view of investor protection—investors would be prohibited from trading in instruments that have been rated by non-EU CRAs, but they would not be prohibited from trading in instruments that have not been rated at all.

2.3 The Committee is correct to note that the European Council has called for the deletion of the second paragraph of Article 4 of the draft Regulation. This change would address this issue, although we note that this amendment has not yet been adopted under the EU's legislative process.

3. *A previous witness has criticised the excessive reliance on rating agencies as "laziness" on the part of regulators and financial institutions. Do you agree?*

3.1 It is not for S&P to comment on whether various users of ratings have been guilty of "laziness".

3.2 We do, however, agree that investors and financial institutions should not use credit ratings as their sole input in taking investment decisions. We support the view that investors should know clearly what they are investing in, and that they should use appropriate risk management systems.

3.3 As regards the use of ratings by regulators, S&P has never sought to promote the use of ratings in legislation and regulation. In addition, where credit ratings are currently used in regulation, care should be taken to ensure that credit ratings are only used in relation to credit risk and are not used as measures of other risk factors such as market risk or liquidity risk.

4. *Many witnesses to the Committee have criticised the speed at which EU legislation in response to the financial crisis has been constructed, raising concerns that this will lower its quality. Do you agree with this criticism?*

4.1 There has been some concern over the speed with which the Commission and other parties have sought to introduce legislation in relation to CRA oversight. We query whether the Commission had enough time to conduct a proper consultation exercise before publishing its proposal (which included the draft of the Regulation) on 12 November 2008. We note that the Commission only published its consultation document on the new legislation on 21 July 2008 and provided for a consultation period of just 5 weeks (i.e. until 5 September 2008) for stakeholders and interested parties to express their views on those proposals. That five week period fell squarely in the month of August, when many organisations would have been operating with reduced staffing levels.

4.2 We are not clear that this consultation process was conducted in a manner which fully respected the Commission's own Better Regulation Action Plan.[30] Although not legally binding on the Commission, this Action Plan sets out what the Commission considers good practice in the legislative process, and should not be departed from without good reason. The Action Plan acknowledges that "wide consultation is one of the Commission's duties according to the Treaties and helps to ensure that proposals put to the legislature are sound" and notes that "this is fully in line with the European Union's legal framework, which states that 'the Commission should [. . .] consult widely before proposing legislation and, wherever appropriate, publish consultation documents'".[31] Concretely, the Guidelines issued in the context of this Better Regulation Action Plan provide for a minimum consultation period of eight weeks, and recommend that this should be extended during main holiday periods and to take account of, among other things, existing binding instruments (which, in this case, would include the SEC rules in the US which impact on a number of CRAs, including S&P).[32]

4.3 These issues are particularly important since the EU (after the United States) is one of the first jurisdictions to introduce statutory regulation of CRAs. Other countries will also be introducing legislation and it is likely that their systems of regulation will be influenced by the provisions that the EU adopts. Indeed, Commissioner McCreevy has said in terms that, in drafting this legislation, the EU is "adopting a leading role" and that it wants the standards in the draft legislation "to become global standards".[33] This ambition makes it all the more important for the EU legislation to be carefully thought out. In particular, we believe that it is most important that, before finalising its position, the EU allows time to conduct a dialogue with its international partners in order to ensure that the legislation is compatible with a global framework of regulation. We also believe that there needs to be a sensible implementation period once any legislation is passed into law.

5. *Some witnesses have expressed concern that the regulation of rating agencies will write ratings into regulations and subsequently reduce the requirement on purchasers of financial instruments to conduct their own due diligence. How do you view this suggestion?*

5.1 S&P believes that purchasers of financial instruments should always conduct their own due diligence irrespective of any regulations. As stated above, if ratings are used as benchmarks of credit worthiness in those regulations—which, incidentally, we have never encouraged—it is important that other benchmarks should be considered as well.

5.2 As the European Commission has recognised in its draft legislation, regulation should not mean second-guessing the opinions of CRAs. It should explicitly preserve the independence of ratings and ratings methodologies.

27 March 2009

Memorandum by Which?

1. Which? welcomes the opportunity to submit evidence to the European Union Committee's inquiry into "EU responses to current market instability".

2. Which? is supportive of the aim of the European Commission to provide better and more competitive financial services to European consumers. However, we strongly believe this must not be achieved by lowering regulatory hurdles to such an extent or in such a way that consumers are exposed to unacceptable levels of risk. UK consumers have to take responsibility for a wider range of financial needs than their counterparts in other member states and therefore have access to a range of financial products with differing levels of complexity. This is reflected In the UK regulatory regime and compensation arrangements which are often more encompassing than in other EU member states to provide adequate consumer protection.

[30] COM(2002)278; see also the Commission's Guidelines on general principles and minimum standards for consultation ofinterested parties (COM(2002)7040) and Impact Assessment Guidelines (SEC(2005)791).
[31] COM(2002)704, page 4, referring to Protocol No 7 on the application of the principles of subsidiarity and proportionality; annexed to the Amsterdam Treaty.
[32] COM(2002)704, page 21.
[33] Press conference on credit rating agencies, Brussels, 12 November 2008.

3. Our current concerns about the impact of European Union directives on consumers are focused on:

- — The passporting arrangements under the Second Banking Directive.
- — The potential harmonisation of depositor protection under the Deposit Guarantee Schemes Directive.
- — The impact of European State Aid rules.

Passporting

4. Currently banks from within the European Economic Area (EEA) can operate in the UK by obtaining EEA authorisation status with the FSA. This is also known as "passporting". Thus a bank such as ING or Anglo Irish, for example, can operate in the UK without being subject to the requirements of the UK regulatory regime.

5. Which? is concerned that the current passporting arrangements under the Second Banking Directive allow firms to sidestep at least some of the consumer protection arrangements in the UK. Our concerns relate both to the lack of oversight abilities of host state regulators and to the complexities it introduces into depositor protection arrangements.

6. With respect to regulatory oversight, host state regulators have little to no influence over the regulation of passporting firms, if home state regulators are not doing their job properly then UK consumers are put at risk. The collapse of Icesave is a clear illustration of the dangers that consumers face.

7. Despite our concerns we do not believe that the creation of a pan-European regulator would be in the best interests of UK consumers. The financial services model in the UK does not bear many similarities to that of many other European countries, and our financial products and system of regulation is frequently more complex. We would therefore be concerned that any pan-European model would result in a stripping away of protection for UK consumers.

8. Ideally we would like to see a change in EU legislation which shifts the responsibility for regulation of passporting firms from home to host state regulator. However, even with this change, the host state regulator would not be in a position to exercise control over the activities of the passporting firm's parent company and therefore might be unaware of financial difficulties or risky business models endangering the financial future of the passporting firms. As a result we believe that collaboration between national regulators needs to be strengthened. Cooperation on the supervision of larger banking groups is supposedly already taking place but smaller firms like Landsbanki and Kaupthing seem to have slipped past the radar.

9. Passporting also raises issues in relation to depositor protection. In the event of the bank failing, consumers will be covered by the bank's home state compensation scheme. If that compensation is lower than UK compensation, EEA firms can volunteer to top up their compensation limits by joining the FSCS. Thus, if the Icelandic scheme had honoured its commitments, Icesave customers should have received their first €20,000 in compensation from the Icelandic scheme with the rest of the balance to £50,000 provided by the FSCS.

10. The differing compensation limits and arrangements between countries cause confusion for consumers. Which? does not believe it is sufficient simply to require passporting firms to make "appropriate standardised disclosures to their customers" as proposed by the FSA in their latest consultation.[34]

11. Changes are needed to ensure that there is a single point of contact for consumers to access the full amount of their compensation in their home country. In addition there is now the added risk which must be addressed that foreign governments will not honour their commitment to pay compensation to non-citizens. The UK government must act urgently to lobby for a change in EU regulation making topping up to be compulsory for passporting EEA banks, and requiring member states to act as lenders of last resort for their compensation scheme. Only then can UK citizens feel confident in placing deposits with foreign banks.

Harmonisation of Deposit Guarantee Schemes

12. Which? considers depositor protection to be one of the cornerstones of the current UK banking model. Without a well-functioning scheme consumers will lose confidence in the banking system. The "run on the Rock" last year underlined the importance of depositor protection and also threw up the question if the current system is adequate and achieves what it sets out to do.

[34] Financial Services Compensation Scheme Reform, FSA, January 2009, pg44

13. We support the current measures adopted by the EU but are concerned that any additional harmonisation of deposit guarantee schemes would damage the protection UK consumers can receive. We will therefore be looking with interest to the consultation proposal due shortly from the European Commission, who are due to report on harmonisation by the end of 2009.

14. It is vital that the UK depositor protection scheme can be adapted to reflect the needs of the UK banking model and that consumer protection is not weakened by harmonisation. Which? welcomed the proposals by the FSA to move from a system of net payouts to one of gross payouts and are waiting to see the FSA's proposals for the protection of temporary high balances. We are keen to ensure these vital changes can be adopted.

15. Which? supports the Commission's proposals to set minimum levels of depositor protection but we do not believe that restrictions should be made on upper limits. Levels of savings vary widely across the EU and a limit that is sufficient to protect savers in a country such as Bulgaria would not be appropriate for the UK. An upper limit would also prevent the UK Government from taking the action it has done to date in protecting all savings when banks have collapsed.

16. The impact that the potential harmonisation could have on reducing UK consumer protection can already by felt in the FSA's approach to the issue of whether compensation limit should apply to brands rather than institutions.

17. Under the current system, compensation is paid on a per institution basis. As a result, for example, a consumer who has £50,000 invested in a fixed-term bond with Halifax and £35,000 in an ISA with Birmingham Midshire will only be covered to the limit of £50,000.

18. Given the plethora of different brands it is extremely difficult for consumers to understand the corporate structure of a bank and determine whether they are covered. In order to ensure that consumers who have been diligent in spreading their deposits are not caught out, the FSCS must be adapted so that limits apply to brands, not institutions.

19. The FSA accepts the problems with the current approach, seemingly supports a change to per brand cover and has identified a way in which this issue could be addressed. However the regulator is refusing to make this change because they believe a fully harmonised approach to the level of coverage is likely to be imposed across the European Union, which would rule out such a change.

EU State Aid

20. Which? considers that the European Commission State Aid regime is the appropriate instrument to ensure that recipients of state aid do not distort competition. However we also believe that it is difficult to judge the long-term competitive impact of state aid given the current levels of uncertainty and change in the market environment, and that these conditions make it essential for the Commission to employ a degree of flexibility in its approach.

21. With this in mind we are concerned by reports that Commission is threatening to veto the UK government's revised remit for Northern Rock.[35] The original requirement for Northern Rock to repay its debts by 2011 was resulting in considerable levels of consumer detriment as the bank was forced to run down its mortgage book dramatically. Northern Rock has become known for repossessing more homes than any other lender and stated in its half year results report that the increase in repossessions is "in line with the company's policy of rapid movement towards recovery where it is clear the borrower will not maintain payments".[36] In the first half of 2008 the industry average for repossessions was 0.18% compared to 0.56% for Northern Rock.[37]

22. We welcomed the Government's decision to review Northern Rock's original business plan as we felt this may enable the bank to relax its heavy-handed approach to repossession. We feel that the world has moved on since the time of its nationalisation and the risk of "unfair competition" from Northern Rock seems weak, given the many significant changes to market conditions. Any prospect of aggressively growing its market share appears unlikely given liquidity problems and its remaining weakness.

[35] "Brussels threatens to block proposal for Northern Rock to step up lending", *The Guardian*, 23 February 2009
[36] Northern Rock plc Half Year Results six months ended 30 June 2008
[37] ibid

23. We understand that new state-aid guidelines are being drawn up by the EU Competition Commissioner and her team. We would hope that these new guidelines will reflect the current turbulent market conditions and adopt a degree of flexibilty to ensure that the impact on consumers of any conditions imposed can be considered.

23 January 2009

Memorandum by the Wholesale Markets Brokers' Association and the London Energy Brokers' Association

Commission legislation to implement a prudential European financial regime—Will this be effective in preventing a repeat of the current financial turmoil? Will new rules on credit ratings agencies and changes to the Capital Requirements Directive help or simply encourage financial institutions to relocate outside of the EU?

Although probably a good thing I cannot see the mere fact of harmonisation of rules will prevent future crises as the current crisis arose in an already well regulated prudential environment (Basle II and CRD etc). Banks need to be encouraged to assess, monitor and control their liquidity risks much better than they have done—thus homogenised approach to more sophisticated liquidity risk modelling is needed and I don't see why the EU could not take a pivotal role in this process.

Blaming the ratings agencies gets us nowhere—The EU supported by many National Regulators have precipitated the "death of caveat emptor" in financial markets and introduced the moral hazard of relying on credit rating agencies. The agencies are of course conflicted in the way they do business. Reform of the agencies will not help. Education of the financial participants (both retail and wholesale) to ensure that they recognise that they are responsible for their own investment decisions is a better way to do it. Outsourcing 100% of your counterparty risk assessment to a third party has been proven to be a bad idea. Look at the CDS spreads instead.

Institutions will not relocate outside the EU if the changes in regulation are sensible and achievable. As always we need better regulation not simply just more of it.

The crisis was caused by a systemic failure to understand the risks involved in (mainly) securitised products, and the failure of the risks to be spread through out the system as was expected. Banks retained much more exposure than was realised by regulators and policy makers.

Rating agencies also failed to understand the risks, reacted too late and have conflicts of interest. That said, the responsibility for credit risk assessment lies with the buyer/investor/lender.

Basel II, Pillar 1 metrics for credit risk gave far too much credence to rating agencies. Basel II should be revised to either exclude rating agencies ratings, or calibrate them more severely.

Basel II failed to address the issue of either cash or product liquidity in Pillar 1. Liquidity shortcomings should be met by higher capital charges.

The future role of the European Supervisory System—Do we need a central European authority to supervise the activities of pan European financial institutions?

No- the system should work perfectly well using the existing national regulatory authorities. MiFID is a good example. However there will undoubtedly be calls to promote CESR (or one of its creations) as the Great God of European regulation. This overlay will become inflexible and will jeopardise the position of London as the premier EU financial centre.

This would be counterproductive and might led to financial markets leaving London (as part of the EU). The problem is a global one and must be addressed on that basis. The BIS committee on Banking Supervision and the IMF (for macro economic reasons) are the right fora. National supervisors may then, under strict criteria, amend a revised Basel accord subject to the nature of each banking environment.

Banking systems in the EU are too diverse (a mixture of domestic shareholder owned banks, savings banks, co-operatives, state banks, global banks, etc.) to have a single EU regulator. London would be particularly disadvantaged because of the predominance of the wholesale global markets businesses, in contrast to the mainly retail nature of EU banks business (unless through their London branches and subsidiaries.)

The effectiveness of European institutions in responding to the current financial crisis—Did they act rapidly enough? Do these events signal the need for reform of European institutions?

Not sure what they did? I suspect that they did not act rapidly enough because they did not understand what was happening and did not know what to do—a bit like the rest of us really so not a criticism. Reform? possibly. A build up of technical knowledge (lessons learned) probably.

Central Banks (effectively the Bank of England and the ECB) did respond to inject liquidity when it was realised that a systemic failure in liquidity had occurred, but were unprepared for the intensity of the crisis. There was not enough global co-operation. EU institutions cannot be seen in isolation.

Regulators have reacted slowly in terms of changing the rules, but on the ground supervisors were quick to focus on liquidity. There does not appear to be enough interaction between regulators and central banks.

The role of the EU in the global response to events—Is their a need for a global supervisory system? What role should the EU and existing financial institutions such as the IMF play in any new system?

No too inflexible (no competition between regulators is bad) and opens system up to regulatory capture on a global scale. Bad idea.

It would be dangerous to invent a global supervisor which would inevitable overlap or conflict with the BIS in Basel. The Basel accord should be widely agreed on (as it has been since 1987) and then supported by national supervisors who should use the accord in the light of their own economic and financial infrastructure.

22 January 2009

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