HOUSE OF LORDS

European Union Committee

1st Report of Session 2008–09

EU Legislative Initiatives in Response to the Financial Turmoil

Report with Evidence

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The European Union Committee

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NOTE: References in the text of the report are as follows:
(Q) refers to a question in oral evidence

EU legislative initiatives in response to the financial turmoil

Background

1. On 25 November 2008, Lord Turner of Ecchinswell, Chairman of the Financial Services Authority (FSA), gave evidence to Sub-Committee A (Economic and Financial Affairs and International Trade) of this Committee about the European Commission's regulatory proposals and changes to supervisory structures in response to recent events in the finance industry. Lord Myners, Financial Services Secretary to the Treasury, provided information on the Government's view on these legislative proposals and their progress towards agreement at the Council of Ministers. This report aims to summarise these initial Commission proposals and makes available for the information of the House the current view of the Government and the FSA.

2. At the time of preparing this report, we had scrutinised proposed amendments to the Capital Requirements Directive[1] (CRD) and the Directive on deposit guarantee schemes[2] and cleared them from scrutiny. A general approach to these documents was agreed by the Council of Ministers on 2 December 2008 and the proposals are now subject to the agreement of the European Parliament. The Commission had recently published its proposed reforms of the rules regarding credit ratings agencies.[3]

3. We are now launching an in-depth inquiry on EU responses to these events. This will focus upon four key issues: Commission legislation to implement a prudential European financial regime; the future role of a European supervisory system; the effectiveness of European institutions in responding to the turmoil; and the role of the EU in the global response to events. A Call for Evidence is printed in Appendix 2. Sub-Committee A will take both written and oral evidence for this inquiry in the New Year.

Reform of Supervisory Frameworks

4. Reform of supervisory frameworks, at both a European and a global level, has been a key issue in the wake of the recent events. Greater cooperation of supervisors has been at the forefront of EU initiatives, particularly the suggestion of a group of supervisors, formalising the framework governing cross-border supervision of financial institutions.

5. No initiatives have yet been proposed with the sole purpose of reform of supervisory frameworks. However, both the CRD and Solvency II[4] (which reforms the regulatory and supervisory structures of EU insurance firms) tackle this issue. The Committee has previously examined the Solvency II

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1 COM (2008) 602/3 http://ec.europa.eu/internal_market/bank/docs/regcapital/crd_proposal_en.pdf

2 COM (2008) 661 http://ec.europa.eu/internal_market/bank/docs/guarantee/dgs_proposal_en.pdf

3 COM (2008) 704 http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf

4 COM (2008) 119 http://ec.europa.eu/internal_market/insurance/docs/solvency/proposal_en.pdf

proposals in its 6th Report of Session 2007–2008.[5] The attitude of the Government differs in their approach toward these two proposals. The original Solvency II proposals, which were strongly supported by the Government, would have installed a system of centralised group supervision for cross-border insurance companies.[6] In recent negotiations on the CRD however the Government have argued for the final decision on suitable capital adequacy levels of financial institutions to lie with local supervisors, maintaining the FSA as ultimately responsible for the capital adequacy of UK institutions.

6. We ask the Government, in their response to this report, to clarify their policy on the design and powers of colleges of supervisors for companies that operate subsidiaries or branches in other territories since they appear to take different approaches under Solvency II and the CRD. The Government should also clarify whether they adopt the same approach for colleges involving regulators from outside the EU as they do for those consisting solely of EU-based regulators.

The Capital Requirements Directive

7. The CRD (Directives 2006/48/EC[7] and 2006/49/EC[8]) regulates the capital held by financial institutions within the EU, reflecting international standards agreed at the Basel Committee in 2004. The proposed amendments modify the existing Directives in four key areas:

- Large Exposures Regime—The maximum exposure limit of a bank to any one client will be 25% of a bank's own funds, regardless of the length of the exposure;
- Hybrid Capital Instruments[9]—A quantitative limit is to be applied to the level of Hybrid Capital Instruments that can qualify as own funds. An EU wide criterion for higher quality own funds is also to be implemented;
- Supervisory Arrangements—Multilateral exchange of information between national supervisors is to be facilitated, including a mediation mechanism to be used when agreement between supervisors cannot be reached; and
- Securitisation—A quantitative minimum retention requirement of 5% of the total material share of the risk is to be retained by the originator. Disclosure and transparency requirements are also proposed.

Deposit Guarantee Schemes

8. The amendments to Directive 1994/19/EC[10] covering deposit guarantee schemes propose the following changes:

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[5] European Union Committee, 6th Report (2007–2008): *Solvency II* (HL 42)

[6] This issue was discussed at the ECOFIN Council of 2 December. The French Presidency suggested a compromise text removing the proposals for group supervision. Whilst this satisfied smaller Member States which were concerned that group support would remove control from local supervisors, the UK Government strongly objected to the amendment. A general approach in accordance with the French proposal was agreed at the Council and the European Parliament is expected to vote on the revised proposal on 15 December.

[7] http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf

[8] http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en02010255.pdf

[9] Capital structured as debt that has equity-like features.

[10] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML

- Raise the minimum guarantee level to €50,000 upon implementation, rising to €100,000 within a year;
- Reduce payout delay from three months to three days; and
- Eligible deposits will become 100% recoverable.

Rules on Credit Ratings Agencies

9. Credit ratings agencies rate the risk of debt issuances. The failure of the credit ratings systems, and the lack of supervision thereof, have been seen as major causes of the recent financial volatility. COM (2008) 704 sets out the following rules for these agencies:

- Agencies will not provide ratings for instruments for which insufficient information is available;
- Models, methodologies and assumptions on which ratings are based must be disclosed. Agencies are obliged to publish an annual transparency report; and
- The board of an agency must include three independent directors whose pay may not be based on the financial performance of the agency. At least one independent director should be an expert in securitisation and structured finance.

The Chairman of the FSA's Evidence

10. The following issues were explored at our oral evidence session (a full transcript is printed on pages 1–10) with Lord Turner of Ecchinswell:

- Regulatory institutions and structures (QQ 1–9, 14);
- Capital adequacy and the CRD (QQ 1, 3, 9, 11–12);
- Corporate governance and remuneration (Q 10); and
- Rules on ratings agencies (Q 13).

Ministerial Correspondence

11. Our correspondence with Lord Myners (printed in Appendix 3), Financial Services Secretary to the Treasury, discussed the following issues:

- Changes to Solvency II proposals in light of recent events (page 12);
- The progress of negotiations on the CRD and the Government's views on the proposals (page 14); and
- Current application of, and forthcoming changes to, deposit guarantee schemes in the UK (page 16).

APPENDIX 1: SUB-COMMITTEE A (ECONOMIC AND FINANCIAL AFFAIRS, AND INTERNATIONAL TRADE)

Sub-Committee A

The members of the Sub-Committee which conducted this inquiry were:

Baroness Cohen of Pimlico (Chairman)
Lord Haskins
Lord Kerr of Kinlochard
Lord Maclennan of Rogart
Lord Moser
Lord Renton of Mount Harry
Lord Steinberg
Lord Trimble
Lord Watson of Richmond
Lord Woolmer of Leeds

Declaration of Interests

A full list of Members' interests can be found in the Register of Lords Interests:

http://www.publications.parliament.uk/pa/ld/ldreg.htm

APPENDIX 2: CALL FOR EVIDENCE

Changes to the regulation and supervision of financial markets, nationally and on a cross-border basis, have been proposed in response to the financial crisis. The European Commission has published three key proposals, updating capital requirements and deposit guarantee schemes and introducing rules on rating agencies. Sub-Committee A, under the Chairmanship of Baroness Cohen of Pimlico, has decided to commence an inquiry examining the role of European Union regulation in the financial sector, the effectiveness of these proposals and further responses at a European level.

The inquiry will seek to answer the following questions:

(1) Current Commission Proposals: Will enforcing a prudential financial regime be an effective method of preventing a repeat of the financial turmoil? 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? Are changes needed to International Accounting Standards? How effective are current proposals to protect bank deposits?

(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? Do rules on state aid to the banking sector need to be clarified? What other rules are needed to ensure financial stability in Europe?

(3) 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? 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 supervision and crisis management in the EU?

(4) Working Practices: Do EU institutions need to amend their working practices on financial services? How effective are current working practises in providing a rapid response to a crisis?

(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?

The aim of this inquiry is to provide an opinion on the effectiveness of the Commission responses, inform the debate surrounding these issues within EU institutions and examine possible opportunities for further reform. The inquiry does not intend to examine whether the United Kingdom should join the eurozone, nor the effectiveness of the national Government response to the crisis.

Guidance to those submitting written evidence

Written evidence is invited in response to the questions above, to arrive by no later than 9 February 2009.

The questions above cover a broad range of topics and there is no need for individual submissions to deal with all the issues. Evidence should be kept as short as possible: submissions of not more than four sides of A4 paper of free-standing text, excluding any supporting annexes, are preferred. Submissions longer than this should contain a summary. Paragraphs should be numbered.

Evidence should be sent in hard copy and electronically to the addresses below.

Evidence should be attributed and dated, with a note of the author's name and position. Please state whether evidence is submitted on an individual or corporate basis.

Evidence becomes the property of the Committee, and may be printed or circulated by the Committee at any stage. You may publicise or publish your evidence yourself, but in doing so you must indicate that it was prepared for the Committee.

Submissions will be acknowledged. Any inquiries should be addressed to Robert Whiteway, Clerk of Sub-Committee A, Committee Office, House of Lords, London SW1A 0PW; telephone 020 7219 3616; fax 020 7219 6715; e-mail whitewayr@parliament.uk.

This is a public call for evidence. You are encouraged to bring it to the attention of other groups and individuals who may not have received a copy directly.

APPENDIX 3: GOVERNMENT CORRESPONDENCE

Letter from Lord Grenfell, Chairman of the Select Committee on the European Union, House of Lords, to Ian Pearson MP, Economic Secretary, HM Treasury, dated 15 October 2008

EM 6996/08 and 11978/07: Directives of the European Parliament and the Council on the taking-up and pursuit of the business of insurance and reinsurance

Thank you for your predecessor's letter dated 7 July 2008, which was considered by Sub-Committee A at their meeting on 14 October. The Sub-Committee were grateful for the detailed answers provided to the issues that they had raised in their report on Solvency II.

In the light of the recent disruptions to the financial markets, the Sub-Committee decided to continue to hold the documents under scrutiny. Has there been any change in attitude towards risk and suitable levels of capital that insurance companies should hold? If so, did this occur in time to feed into the fourth Quantitative Impact Study, and what impact has this had on the Solvency II negotiations?

Letter from Lord Grenfell, Chairman of the Select Committee on the European Union, House of Lords, to Ian Pearson MP, Economic Secretary, HM Treasury, dated 6 November 2008

EM 13713/08: Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, arrangements, and crisis management

Thank you for your Explanatory Memorandum 13713/08 dated 21 October 2008 which Sub-Committee A considered at its meeting on 6 November 2008. The Sub-Committee decided to hold this document under scrutiny in conjunction with its forthcoming report regarding EU financial regulation. The Sub-Committee would like to request that you keep the Committee updated regarding developments to these proposals.

The Sub-Committee would also like to request clarification of the Government's position in relation to the amendments proposed. The Explanatory Memorandum explains the Government will continue to "seek adjustments to further improve outcomes": which proposals in particular does the Government wish to change and what outcomes are desired?

Letter from Lord Myners, Financial Services Secretary, HM Treasury, to Lord Grenfell, Chairman of the Select Committee on the European Union, House of Lords, dated 11 November 2008

Parliamentary scrutiny—EU dossiers ahead of December ECOFIN

I am writing to update you with regard to the upcoming ECOFIN Council. We have now received the draft agenda for the meeting on 2 December, when the French Presidency plan to seek agreement to several financial services dossiers which are still subject to scrutiny.

These dossiers are Solvency II, the Capital Requirements Directive, UCITS and the Deposit Guarantee Scheme Directive. The Presidency is seeking agreement from ministers to general approaches to allow negotiations with the European Parliament to proceed.

You have been, quite rightly, concerned that the impact of these dossiers should be considered both on their own merits and in the light of the current financial turmoil. The Government agrees that the current climate justifies ensuring that the detail of these dossiers is carefully scrutinised because of the significant potential impact on UK and European customers, businesses and public finances. We have continued to work hard with other Member States and the Commission to ensure that these dossiers meet our specific aims and also link in with our wider ambitions for improvements to regulatory and supervisory systems.

However, this consideration must be balanced with the need for the UK to play a full part in shaping these Directives at ECOFIN. We are now reaching the endgame on all four dossiers and we fully expect that the Presidency will pursue its aim of asking Member States to agree general approaches on all four on 2 December.

On that basis I have annexed to this letter detail on three dossiers on which you and Michael Connarty have requested further information: Solvency II, the CRD and UCITS [not printed]. I hope that this information will be sufficient to enable your Committee to clear the dossiers from scrutiny in time for December ECOFIN.

Solvency II (Explanatory Memorandum 11978/07)

This annex provides an update on the Government's views of the Solvency II project in the light of the current global financial turmoil. It gives information in particular in respect of attitudes towards risk and suitable levels of capital. This annex sets out that information.

The Solvency II Directive sets a calibration standard for the main Solvency Capital Requirement which insurers will have to meet on an on-going basis under Solvency II. This standard is that an insurer should have no more than a One in 200 probability of failure over a one-year period. Subject to meeting this standard, Solvency II allows insurers to adopt the risk appetite which their board and senior managers determine is appropriate as long as they have in place systems to manage those risks effectively and of course adequate capital given the chosen risk profile. This is in line with the current approach adopted by the FSA and remains appropriate.

It should be noted that any given capital requirement imposed by the authorities is a minimum standard which in general will be exceeded, often by a significant margin. The great majority of firms will hold an additional buffer of capital for several reasons. These include the desire to avoid regulatory intervention subsequent to any capital shortfall against the regulatory minimum and, for larger companies, to maintain a given credit rating.

Further, the Solvency II Directive has two capital requirements and when the lower of these, the Minimum Capital Requirement, is breached, the insurer's authorisation to write new business will be withdrawn. This should ensure that well before any insurer's capital comes close to being depleted, its existing policyholders are fully protected from the risks inherent in writing new business. We expect that the Minimum Capital Requirement will typically be in the range 20–50 per cent of the main Solvency Capital Requirement. It is reasonable to expect that companies will in general still have significant amounts of capital at the point when they are prevented from undertaking new business.

Our conclusion is that the calibration standard for the capital requirements under Solvency II remains appropriate.

However we have also considered the issue of the quality of capital which is eligible to meet those capital requirements. In the European Commission's proposals for the Solvency II Directive, the minimum amount of Tier One of highest quality capital that a firm is required to maintain is one third of the amount of the Solvency Capital Requirement. By way of comparison, in the banking sector the equivalent requirement is that one half of the minimum regulatory capital must be matched with eligible Tier One capital.

One key lesson emerging from the impacts of the global financial turmoil is that financial companies require high quality capital to maintain the confidence of counter parties and other financial market participants, as well as of their policyholders. At present in the UK insurance companies are required by the FSA to hold at least half of the regulatory minimum capital requirement in the form of Tier One capital. In practice in many firms the share of Tier One in total capital held is significantly higher.

Since the current FSA capital requirements are calibrated to achieve a similar prudential standard to that proposed for the Solvency Capital Requirement under Solvency II, it follows that, on the basis of the current proposal, Solvency II would *permit* a material dilution in the overall quality of capital held by UK insurers.

Of course it need not follow from the change in regulatory requirements that insurance companies would necessarily alter the share of Tier One capital in their total capital held. Nevertheless, given the events of the past year the Government's view is that it would not be appropriate to choose a lower minimum for the amount of highest quality Tier One capital. We therefore propose to advocate with the Presidency and other Member States that under Solvency II insurance companies are required to maintain Tier One capital equal to at least one half of the Solvency Capital Requirement.

The fourth Quantitative Impact Study

The purpose of the fourth Quantitative Impact Study (QIS 4) is to analyse the impact on insurance companies of the proposed quantitative elements of the Solvency II framework. At the time the specification of QIS 4 was developed by CEIOPS and then agreed by the Commission—late 2007 through to early 2008—global financial markets had not yet experienced the extraordinary disruptions we have recently witnessed. As a result the specification of QIS 4 is of course consistent with the Directive as proposed by the Commission but has not been altered in the light of the recent events in global financial markets.

Nevertheless, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has produced analysis of the financial stability of the insurance sector at EU level, including an assessment of its exposure to US sub-prime mortgage risk either via holdings of Asset Backed Securities, or through investment in hedge funds. The conclusion reached is that across the exposure to this risk category is modest for the EU insurance sector as a whole.[11]

Further, the fact that it was not possible for QIS 4 to reflect the implications for policy of the global financial turmoil does not imply that it cannot be taken into account in the Solvency II legislation.

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11 As outlined in CEIOPS Spring 2008 report on financial conditions and financial stability in the European Insurance and Occupational pension find sectors 2007–2008 http://www.ceiops.eu/media/docman/public_files/publications/reports/CEIOPS-FS-10-08.pdf

The Solvency II framework has the flexibility to be adjusted to the lessons of the financial crisis once the policy implications are fully analysed. As you are aware Solvency II adopts the Lamfalussy arrangements for developing financial services legislation. This means that the Directive currently under negotiation provides a framework and core principles but leaves considerable areas of the detailed technical legislation for so-called 'level two' implementing measures.

The Lamfalussy arrangements were deliberately designed to achieve flexibility in EU financial services legislation so that it could respond to significant changes in the financial sector. This will allow lessons that are relevant to the insurance sector to be applied in the detailed legislation of Solvency II. However, we must avoid knee-jerk reactions to the current financial problems and in particular we need to be careful to ensure that the economics of the insurance sector, which is fundamentally different from the economics of banking, is taken into account fully where any read across between the sectors is envisaged.

Along with other Member States' authorities, HM Treasury and the FSA have a central interest in ensuring that the level two implementing measures in Solvency II provide the technical requirements to deliver a robust prudential framework whilst also being proportionate in the regulatory burden imposed on industry.

Capital Requirements Directive (Explanatory Memorandum 13713/08)

This annex sets out how negotiations on the Capital Requirements Directive are developing and gives a clarification of which outcomes the Government desires and which aspects it wished to change.

Its sets out updates on negotiations and the proposed timetable for completion. Firstly, on the timetable. There is a high probability that the French Presidency will seek to achieve a general approach among Member States at the December meeting of Finance Ministers. While this timetable poses significant challenges, especially in regard to the ongoing scrutiny process, negotiations have progressed well in a number of areas.

On the negotiations themselves, the proposal covered four main areas:

- The large exposures regime: limits to ensure financial institutions are not exposed too heavily to any single or connected counterparty;
- The supervisory framework and supervisory colleges: reinforcing the efficiency and effectiveness of supervision of cross-border banking groups by formalising supervisory colleges in legislation and requiring closer cooperation on the determining of group capital levels;
- The definition and limits on hybrid capital: providing a common interpretation of the three main eligibility criteria that correspond with 'higher quality' capital, permanence, loss absorption and flexibility in payments, and establishing harmonised quantitative limits for the extent to which hybrids may be accepted as firms' original own funds; and
- Securitisation and risk transfer activities: revisions aimed at improving risk management by better aligning potentially misaligned incentives, disclosure and diligence requirements on the investor before they can invest and monitoring requirements on an ongoing basis, alongside transparency requirements on originators before they can sell.

In terms of the large exposures regime, the current approach sets out a maximum limit for all exposures from banks to non-banks and all interbank (bank to bank) exposures over one year, but contains a national discretion on interbank exposures for less than a year.

So far in negotiations the main thrust of the Commission's original proposal, to extend the current limit for inter-bank exposures to all exposures regardless of maturity, has been maintained. Further to this, our key negotiating objective, that of ensuring a proportionate regime for the UK's smallest banks and building societies, has also been maintained.

The Government believes this will represent a significant improvement to the stability of the financial sector in the UK, decreasing the risk of large systematic linkages between institutions. The original Commission proposal aimed to reinforce the efficiency and effectiveness of supervision of cross-border banking groups by formalising supervisory colleges in legislation. It also required agreement between supervisors of entities in the same group on issues for the whole banking group such as total capital for the group, the distribution of capital across subsidiaries, liquidity in subsidiaries and branches and reporting requirements, and where agreement is not reached, a mediation mechanism was proposed using CEBS[12] as an advisory body. Ultimately it was proposed that the consolidating supervisor (that is the supervisor responsible for the parent institution or holding company) would take the final decision.

This approach would produce significant benefits for cross-border banking groups, and potentially deliver more efficient supervision and reduce burdens. The current draft of the compromise text maintains this general approach, which the UK has broadly supported. Furthermore, on the issue of determining the total required capital for the group, the text now proposes that the final decision on key supervisory issues shifts back to the local supervisor. The Government believes this approach strikes the right balance between efficiency of supervision and the distribution of supervisory powers and responsibilities, and will be seeking to ensure this option remains in the text, which will allow the Financial Services Authority to remain ultimately responsible for the capital levels of UK institutions.

The Commission's original proposal on hybrid capital [which] was to introduce a common interpretation of the three main eligibility criteria that correspond with 'higher quality' capital (permanence, loss absorption and flexibility of payments), and establish harmonised quantitative limits for the extent to which hybrids may be accepted as firms' original own funds, has largely been maintained. Subject to some modifications to ensure that instruments issued by mutuals (who cannot issue pure equity) can, in some circumstances, be deemed as comparable to equity, this is an approach the Government continues to support and one that will bring significant benefits to cross border financial institutions.

Finally, the Commission had proposed revisions aimed at improving risk management by better aligning potentially misaligned incentives, specifically by requiring investor institutions in the EU to only invest in credit risk transfer products if the originator has committed to holding a net economic interest of at least five per cent. It has also proposed disclosure and diligence requirements on the investor before they can invest and monitoring requirements on an ongoing basis, alongside transparency requirements on originators before they can sell.

The Government initially had concerns over the scope of the quantitative retention requirement, which would effectively cover a wide range of instruments beyond simply securitised assets. Negotiations are progressing well, and the scope is being

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narrowed. This will help ensure that the requirements reflect a proportionate response to the financial market disruption. We hope to see continued progress on further refining the scope as negotiations proceed. In terms of disclosure and diligence requirements, the Government was supportive of these improvements, but has agreed amendments to ensure they are workable in practice and are less burdensome on the industry.

Letter from Lord Grenfell, Chairman of the Select Committee on the European Union, House of Lords, to Lord Myners, Financial Services Secretary, HM Treasury, dated 18 November 2008

EM 14317/08: Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on deposit guarantee schemes as regards the coverage and payout time for depositors

Thank you for your Explanatory Memorandum 14317/08 about deposit guarantee schemes. This was considered by Sub-Committee A at its meeting of 18 November 2008. The Sub-Committee cleared the item from scrutiny. The Sub-Committee would like to ask about certain issues raised by the proposed amendment. How does Directive 94/19/EC define "credit institutions" and does this prevent customers recovering deposits in separate banks which are part of the same banking group? Does the UK FSCS guarantee deposits (a) per person, per "brand", (b) per person, per institution or (c) per person, per group? Do the proposals modify this status and will any modification require a subsequent change to United Kingdom primary legislation?

The Sub-Committee would also like to ask when the FSA expects to publish the results of its consultation paper on compensation limits referred to in paragraph 14 of the Explanatory Memorandum.

Letter from Lord Myners, Financial Services Secretary, HM Treasury, to Lord Grenfell, Chairman of the Select Committee on the European Union, House of Lords, dated 24 November 2008

EM 14317/08: Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on deposit guarantee schemes as regard the coverage and payout time for depositors

Thank you for your letter of 18 November 2008. I would like to respond to the questions raised by Sub-Committee A and update you on the progress of the negotiation.

I am grateful to the Sub-Committee for clearing the proposal. As you will know, the Presidency intend to seek agreement to it among several financial services dossiers at the ECOFIN Council on 2 December in order to allow negotiations with the European Parliament to proceed.

Sub-Committee A has asked how Directive 94/19/EC defines 'credit institutions' and what effect this may have on depositors in separate banks which are part of the same group. The Directive defines a credit institution as 'an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account'. This embraces banks and building societies.

The Directive applies the guarantee to deposits with separate companies within the same group. Depositor protection in the UK is framed in terms of all accounts held in firm operating under a single authorisation by the FSA.

The FSCS (Financial Services Compensation Scheme) protection limit therefore applies on a per-person, per-authorised institution basis. The European proposals would not modify this, except insofar as the Commission is tasked, among other things, with reporting by December 2009 on the scope of products and depositors covered.

Any future modification is likely to be implemented through changes to FSA rules, not through primary or secondary legislation to amend the Financial Services and Markets Act 2000. The FSA has invited comments on the per-authorised institution criterion in its consultation on compensation schemes, published in October (CP08/15). It has said that it will consider simplifying the eligibility criteria and may bring forward proposals in a further consultation in the New Year. The Sub-Committee has asked when the FSA expects to publish the results of its consultation paper on compensation limits. That is a matter for the FSA. However, I understand that the consultation closes on 5 January 2009 and rule changes and a policy statement will be published later in 2009.

I would also like to update you on progress of the negotiations on amendments to the Directive. The Government has continued to support an increase in the minimum level of compensation, a shorter payout deadline and the move to compensate 100 per cent of eligible deposits.

Member States have reached an agreement, subject to the views of the European Parliament, on an increase to €50,000 when the Directive enters into force and to €100,000 by 31 December 2011. The limits will be inflation-linked. The payout delay should be reduced from three months to 20 days, with a further 10 days in exceptional circumstances, by December 2010. Compensation will extend to 100 per cent of eligible deposits. Further measures include a requirement for guarantee schemes to cooperate and schemes must be stress tested regularly.

A provision authorising the Commission to propose temporary increases in a crisis has been withdrawn. Instead there is a commitment to further work in a number of areas. The Commission is tasked with reporting by December 2009 on:

- the effectiveness of payout procedures
- the determination of contribution schemes
- the effectiveness of cooperation arrangements
- the potential impact of increasing the limit to €100,000
- whether €100,000 should become an upper limit, it will do so unless the report finds against.

I believe that, taken together, these changes represent a significant improvement in the protection afforded to depositors and the effectiveness of the Directive. Further improvements are likely to follow the Commission's report in December 2009.

APPENDIX 4: REPORTS

Recent Reports from the Select Committee

Developments in EU Trade Policy (35th Report Session 2007–2008, HL Paper 200)

Government and Commission Responses Session 2006–07 (34th Report Session 2007–2008, HL Paper 199)

Adapting the EU's approach to today's security challenges—the Review of the 2003 European Security Strategy (31st Report Session 2007–2008, HL Paper 190)

Correspondence with Ministers (30th Report Session 2007–2008, HL Paper 184)

EUROPOL: Coordinating the fight against serious and organised crime (29th Report Session 2007–2008, HL Paper 183)

Session 2007–2008 Reports prepared by Sub-Committee A

Developments in EU Trade Policy (35th Report, HL Paper 200)

The Future of EU Regional Policy (19th Report, HL Paper 141)

The 2009 EC Budget (18th Report, HL Paper 140)

The euro (13th Report, HL Paper 90)

Solvency II (6th Report, HL Paper 42)

Other Relevant Reports prepared by Sub-Committee A

A European Strategy for Jobs and Growth (28th Report of Session 2005–2006, HL Paper 137)

The Stability and Growth Pact (7th Report of Session 2004–2005, HL Paper 74)

The European Central Bank (42nd Report of Session 2002–2003, HL Paper 17)

Minutes of Evidence

TUESDAY 25 NOVEMBER 2008

Present	Cohen of Pimlico B (Chairman)	Trimble L
	Haskins L	Woolmer of Leeds L
	Moser L	

Examination of Witness

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

Q1 ***Chairman:*** Good morning, Lord Turner. Thank you very much for coming. I need to remind everybody that we are being televised, so it will all appear on the Parliamentary channel. Of course, you do get a draft of your evidence to see before we publish. I have already made a deal with Lord Turner that I will ask him a question as opposed to an opening statement. If I may, I will therefore start straightaway with an enormous opening question. We are very grateful to you for coming because we really need to index this whole subject for ourselves and you are part of us getting a grip on the enormous subjects before us. We would really like to ask you about supervision and regulation, firstly in the European context and, secondly, where you think the proposed global supervision scheme is going to impinge on the European scheme. If I may, I will take it in bits. What do you think the most effective means are to ensure consistent oversight of financial stability in the EU? Roughly then under the headings: are there adequate structures in place to ensure that Member States' regulatory institutions work? What are your views on calls for a single European Regulator? How do you feel about a college of supervisors? All of this is in a European context.

Lord Turner of Ecchinswell: After this extraordinary financial crisis which the world has been through, I think it is very important to focus on what are the most important things to get right for the future and to be clear which of those need to be got right at a national level, a European level and a global level. I would say that one of the most important things to get right is an appropriate regime for the capital adequacy of banks and, in particular, for the capital adequacy of the trading activities of banks. I think there is a very reasonable case that in the past we did not require adequate capital for the trading activities of banks and where with banks in particular, we did not adequately make capital counter-cyclical, we did not require that capital buffers were built up during the good times to be available for the bad times. There are lots of other things we need to do which we can talk about, accounting, liquidity, rating agencies, et cetera, but if I take that one central point, the issue then becomes who has to design counter-cyclical capital requirements. I think the first thing to say is ideally this is agreed at a global level. Banking is a global business, many of our institutions operate across the globe, therefore a capital adequacy regime should ideally be agreed at a global level. The key mechanisms for agreeing a capital adequacy regime are in particular the Basle Committee on banking supervision, which played a key role in the existing capital adequacy regime in Basle 2 and also the Financial Stability Forum, which has been charged initially by the G7 but now the G20 to develop ideas on this. There one is trying to get a global agreement on a set of rules. Where does Europe come into that? Europe comes into that because these rules receive a legal expression in Europe through the Capital Requirements Directive, so our law, as it relates to the capital adequacy, comes from Europe in that respect. The fundamental concepts of capital adequacy would ideally be agreed at global level. There is a legal expression through the Capital Requirements Directive, but the fundamental concept has to be global. How it is put into place, actually enforced, gets to the issue of supervision, because it is the nature of capital adequacy that you cannot simply express it as a rule and just get people to obey the rule. It is a very complex thing which needs to be subject to very careful and in some cases discretionary supervision. At the moment that is done at a national level and I believe for the foreseeable future that is only going to be done at the national level. I do not think there really is a realistic possibility or a desirability of a single European Regulator; I do not think it would necessarily help us. The way we fundamentally work at the moment is that the capital adequacy of a bank group is determined by the supervisor of the home state of its major legal entity, so the FSA is responsible for HSBC and Barclays, and BaFin and the Bundesbank (the German authorities) are responsible for Deutsche Bank. The reason why I do not think we are going to move away from that system at least for many decades is that ultimately if you get it wrong, banks are bailed out by governments. Unless you are suggesting that when we get it wrong banks are going to be bailed out by combinations of governments which agree in a combined fashion to bail them out, ultimately the supervision has to be organised around a national level as well. However, that does not mean there is not a major role for colleges of supervisors. Again, I think one has to be a little bit clear here about colleges of supervisors at European level and at global level. There are already colleges of supervisors organised at global level. For instance, we have had one for quite some time for banks like HSBC or Standard Chartered, which are somewhat informal mechanisms and have no legal status. They have not been established by any category of treaty-based law, but they are fairly effective mechanisms for the relevant senior supervisors of global groups to share perspectives and share information. Those are going to be given a greater formal definition and extended to a wider set of global financial institutions by proposals which are being put forward by the Financial Stability Forum; that is part of the agenda of the Financial Stability Forum. There is then a separate set of colleges that already exist within the Capital Requirements Directive because if you are to agree with a European bank to allow it to use the internal ratings approach under Basle 2, that is a decision which requires the joint decision of many different supervisors across Europe. That is the core of what that sort of college presently does, it makes that specific decision. At the moment we have a global set of colleges which are informal, non-treaty based and focusing on a very wide set of supervisory issues bringing together the three or four major supervisors of a group like HSBC or Deutsche Bank or UBS. We also have a specific set of colleges, what you might call colleges or combinations of supervisors, set up under the Capital Requirements Directive to make the specific decisions which are required as to whether banks can use the internal ratings approach under Basle 2. How do we see this is likely to develop? We believe the most important thing to develop in the immediate future is to extend the global approach to colleges, which has been driven by the Financial Stability Forum, to a further stage of formalising them and making sure they are put in place for all the major global financial institutions. At the moment we would see that global aspect as the primary bit where we should develop the role of colleges. Having said that, again I think one has to be realistic about what colleges can achieve. They can achieve sensible sharing of information and perspectives on capital, liquidity, accounting and risk management. But I do not think they can cut across the fact that we have to have a clear sense of who the home country supervisor is, who is ultimately responsible for the overall capital adequacy of a group. There are also very important issues, which I think we should come back to, in relation to the supervision of subsidiaries and branches, what we call "host company supervision", where you are looking at the supervision of an individual part of a global entity.

Q2 ***Chairman:*** Thank you very much, Lord Turner. We shall come back to that question. I have got a supplementary on that. What happens if there is a disagreement between members of a college? We do not have much experience of that, do we?

Lord Turner of Ecchinswell: The answer at the moment is, I think, one again has to understand these different approaches. Colleges as understood at a global level, which until now have been entirely informally developed entities but are being given a bit more formalisation through the initiative of the Financial Stability Forum, are not ultimately decision-making processes, they are information-sharing processes. That is still incredibly valuable. It is very valuable for our supervisors at the FSA to be sitting down every six months with the supervisors of, for example, HSBC. For the US, it is actually the Chicago Fed in that case, because HSBC happens to be registered as a holding company within the Chicago Fed rather than the New York Fed. The college also includes the Hong Kong Monetary Authority, and other major supervisors. We compare notes on our understanding of all the aspects of HSBC's management. We do that for that bank in particular on a six-monthly basis with a fairly formal agenda et cetera. There are also similar mechanisms which have been in place for some years for Deutsche Bank. What is happening within the Financial Stability Forum is the definition of about 33, I think it is, global financial institutions for which such colleges should be in place. There is a process of making sure that each of the major home countries' supervisory bodies reports back by the end of this year whether those colleges are in place and, if not already in place, what the plans are for doing so. Those are not ultimately decision-making bodies. Decision-making, in the sense of what is the precise capital requirement, is fundamentally done by the individual supervisors of legal entities. It is done by home country supervisors in relation to group capital adequacy and host countries in relation to the local subsidiary. What one will typically have is a capital adequacy requirement or a liquidity requirement, both in relation to the group and in relation to the specific legal entities within the group. Again, I cannot see that we are going to divert from that. Indeed, I have to say that some of the experiences of this year will probably make host company supervisors more determined than before to focus on the capital and liquidity of the local entity for this reason. It goes back to my point about where the fiscal resources ultimately come from to save an entity. Let us take the case of Lehmans, for Lehmans to have been rescued depended on the action of the American Government. It is not going to be the case, particularly post Lehmans, that any supervisor around the rest of the world says, "We are willing to cede the supervision of that to the home country supervisor and rely on them at a global level to get it right". I have to say, post Lehmans there is going to be a greater focus than before in making sure that your particular legal entity within the total group has adequate capital and liquidity separate from the group. Until and unless you imagine that in conditions of crisis the US Treasury Secretary is going to ring the Chancellor of the Exchequer and say, let us jointly organise a recapitalisation of Citicorp's, as over this weekend, or RBS for us. At the end of the day people are going to focus on legal entities because they are not part of the decision-making process about what we do *in extremis* and what we do in rescue. We have to be careful with the assumption that we can proceed to the "global" supervision of banks, absent the creation of a global government. Until and unless we have a global government with global fiscal resources which makes joint decisions on behalf of all global taxpayers as to whether you bail out a bank, the supervision of banks will have a very significant national element. You cannot cede the ability to make those decisions about supervision away from the legal entities in your particular part of the world unless you are also participants in the decision as to whether to bail it out. I do think this debate about national or European or global decision-making needs to be rooted in a realistic understanding of what happens *in extremis* and the fact that *in extremis*, emergency liquidity is provided by central banks and emergency fiscal support is provided by governments.

Chairman: Thank you, Lord Turner. That is very clear indeed and I can see it has sparked a row of questions on my right. Lord Trimble?

Q3 ***Lord Trimble:*** First just to comment before I come to my main point. I entirely take the point you have just been making at length in the last sentence there. Can I say that you are going to find it easier to make that argument if you drop this word "college" because college carries with it the connotation of an institution and what you are actually describing is not an institution at all but simply an informal way of sharing information to enable other people who have got an institutional role to take whatever are the important decisions. If you use an institutional term such as college, particularly a global college, then some people are going to run away with the idea that you are creating a new global authority which is going to rule the world or rule bits of it and, as you say, that is quite unrealistic. Coming back to more fundamental matters, you were saying that the key issues from your point of view were capital adequacy, accounting requirements, liquidity requirements and so on and, as you pointed out, these are rule-making matters, these are matters of law, they are quite different from supervision. What I find rather puzzling in this is you are approaching this as if it was a matter of regulation and rule-making, whereas the real problem is supervision which is a different function entirely. To give you the basis of this, this is a point which Lord Lawson has made a couple of times in debates on this issue. They are saying that banking supervision is a fundamentally different thing from market regulation, and the points you are making about accounting liquidity or capital adequacy requirements, that is market regulation. Banking supervision is looking over someone's shoulder to see whether they are being sensible or not in how they operate their business.

Lord Turner of Ecchinswell: Let me pick up both points. First of all on the point of colleges and languages, I have come into a job where I have inherited a certain language which is fairly dominant throughout the world and I will probably live with it and try and make sure it is understood. I am not sure what people take from the word "colleges". I entirely understand the point, but it is a word which is out there on a fairly large scale at the moment. On your substantive point about rules and supervision, I think there is a greater overlap to this than you might be implying by that. If we look at capital adequacy under the Basle 2 arrangements, the way that it works is to try and have a quite fine-tuned definition of the capital that it requires a bank to have related to the risks that it runs. The way this works is a bank which is allowed to use what is called the "internal ratings approach", which is pretty much all the big sophisticated banks, is developing what is called an "individual capital assessment" where they are, within the guidelines of the rules, coming to their supervisors, so in the case of UK banks this is the FSA, and saying, "Here is our proposed bank capital adequacy plan" and these are 200-page documents with layers and layers of detail beyond them that are saying, "We are doing mid-corporate lending in India. Our models of the past loss rates that have emerged on mid-corporate lending in India suggests that over time it might produce this loss rate on average, but in extreme circumstances it could produce this loss rate. When it produces these defaults, this is the loss given default et cetera, et cetera, therefore we believe that we need this amount of capital in order to support that slice of lending". For a large global bank there will be hundreds of these individual statements as to the risk characteristics of this bit of lending, this bit of deposit taking, it will specify their operational risk, it will specify their trading risk, out of which becomes a capital adequacy plan. Therefore, and this is an absolute core role of what an FSA supervisor of a bank is doing, we are assessing that capital adequacy plan, challenging those models, saying are those models good models, comparing the model which Bank A is using with the model which Bank B is using and saying, "No, we think you are making optimistic assumptions compared with your peer group", looking in the trading area at whether their operational risk control is adequate.

Q4 ***Lord Trimble:*** I understand the point you are making.
Lord Turner of Ecchinswell: Therefore, the end point is the application of the rule of capital adequacy and, indeed, the determination of how much capital they have is supervision. I really disagree with either yourself or Lord Lawson that there is a clear distinction between rule setting and supervision.

Q5 ***Lord Trimble:*** Can I make the comment that what you are describing, where people are making an assessment of risk and putting in its place whatever they think is necessary for that risk and then you are assessing their judgment on risk compared with what other people are doing in the same sort of market at the same sort of time, is fine when everything is good, but will not work when things turn bad because then the risk suddenly changes. You are talking about a system which is not designed to deal with circumstances when things go bad.
Lord Turner of Ecchinswell: Yes, but I am not sure there is any simple rule that can.

Q6 ***Lord Trimble:*** That is what I was quarrelling.
Lord Turner of Ecchinswell: Where we started was the distinction between regulation and supervision and I am suggesting there is no distinction between regulation and supervision. In both regulation and supervision we need to make sure that we have systems which are robust for systemic events, events where the whole system goes in one direction.

Q7 ***Lord Trimble:*** Clearly we have not had that.
Lord Turner of Ecchinswell: We have not had that and we have got to get that right.

Q8 ***Lord Trimble:*** Can you do that as a matter of rules which apply in all circumstances? I doubt it.
Lord Turner of Ecchinswell: No, but I think that makes my point, that to do this you need rules which are closely supervised, which is why the distinction you were drawing between regulation and supervision is not one which I recognise. I think that is a different issue from how we get the regulation and the supervision correct to deal with systemic risk, but the distinction between regulation and supervision is not one which works in this area.

Q9 ***Lord Woolmer of Leeds:*** On that very point, Lord Turner, you came into the job not after the event but well into the event. In practice, the public out there across the world see an almost complete failure in the system of supervision. You set out very clearly and coherently all the theory but in practice, all these colleges of supervisors, host countries and home countries and so on, did not supervise the system well enough to prevent a meltdown. It would be interesting to me to hear from you in this still relatively early stage what is it that is going to change to restore the credibility of supervisors across the globe which will give people the confidence that things really have changed. Nobody in the supervision world has said, "Sorry, we really absolutely got it wrong". It would be helpful to hear in practice what you think is going to change. Secondly, on that theme, again you talked convincingly about the fact that host countries are not going to ignore what is going on simply because of home country regulation, and you gave the example of Lehman Brothers. The UK is host to a lot of financial institutions, many of whose home country is the United States. What is it precisely that the FSA is going to be able to do which regulates and supervises American institutions operating out of London in a way that it did not before?
Lord Turner of Ecchinswell: First of all, let me say that I accept entirely your first point that the system failed and people are right to look at the totality of the system of the world regulation and supervision combined of the global financial system and say pretty clearly something went wrong. It would be pretty bizarre if after having spent $500 billion of public money in the US and £37 billion of public money here we did not say something had gone wrong. Secondly, I do not entirely accept that nobody has said sorry. The FSA in its internal audit report on Northern Rock—this was before my time—was exemplary in putting its hand up and saying, "We got a set of things wrong". We got it wrong in terms of not paying enough attention to when a whole business model was risky, we got it wrong in some of the details of supervision having too rapid a turnover of the individual supervisors of Northern Rock so that they were not close enough to the company et cetera, et cetera and we are focusing on putting right the failures which were identified in the Northern Rock internal audit report. I think they were identified in far more detail and far more effectively by a document which we produced and published than by anybody else's commentary on it. We are putting that right through what we call the "Supervisory Enhancement Programme", which are improvements in the number, quality, training and processes of our key supervisory staff of key systemically important institutions. We are doing that. Having said all that though, within the debate

about how we prevent this occurring in the future, I think it is very, very important to identify the things which are really, really important and will make a big difference. I think the improvement in our supervision is important, but even if the FSA had been exemplary in its supervision of Northern Rock as an individual institution and similarly around the world, we might still have had a world financial failure if we had not had a couple of big things right. The first, as I have stressed already, is a different approach to capital. We have learned that there was simply not enough capital held against risks in trading books. This gets to a debate which I know you have later on your list of questions to do with gross leverage ratios et cetera, but I think in retrospect—and this was not the FSA alone, here we were part of a global rule-setting process, we were part of the rules defined by the Capital Requirements Directive, rules worked out by people who thought they were very sophisticated and the best experts in the world—we did not put enough capital against risky trading activities in the capital markets and trading activities of banks. We did not have a system of capital adequacy of banks which was counter-cyclical, indeed it may in some ways have been pro-cyclical. Across the world there was inadequate focus on liquidity and the supervision of liquidity. In a sense regulators across the world moved to a belief that as long as people were operating in a traded market, there would always be liquidity because you could always sell things. They moved away from some of the classic old beliefs of banking that you actually had to have short-term absolute liquid assets, things which were short-term to maturity rather than things that you could sell. Even more important, what we are doing in our Supervisory Enhancement Programme is important, but if people want reassurance that we will significantly reduce the likelihood of this occurring again in five or 10 or 15 years' time, I would look to the new rules which are going to be brought forward by the Basle Committee and the Financial Stability Forum and others on the capital adequacy of banks, both in terms of total amount, the amount specifically related to the trading books and the extent to which it is counter-cyclical, that is what will really make a big difference. I would look to regulators throughout the world paying much more attention to liquidity. We have a consultation paper about to come out on that. There is new Basle Committee guidance on that, but that is where we need to make sure we get it absolutely right. Finally, at national, European and global level I would look to a much more structured focus on what is sometimes called "Macro Financial Stability Analysis" and "Macro Prudential Analysis". In retrospect, I think in the UK the biggest failure which occurred was not a failure of a specific supervisor of an individual bank but a failure to look at the whole system and to realise that there should have been warning signals that the whole system was risky. It should have gone as follows. We were running a very large current account deficit. We had very, very rapid growth of mortgage lending, including to people who had not been in categories of people who had borrowed for mortgages before. We had a set of business models, by which I mean the new go-getting mortgage banks, Bradford and Bingley, Alliance & Leicester, Northern Rock, which were rapidly expanding beyond their deposit base and relying on the ability to sell retail mortgage backed securities. That was the flip side of the current account deficit, that was part of how the current account deficit was being financed. Those were being sold to, for instance, SIVs and conduits. These were new forms of shadow bank which were taking very significant forms of maturity mismatch risk. They had short-term liabilities and much longer-term assets, as indeed had US money market funds. I think the big failure was not made at the level of the individual supervision of an individual institution because I do not think you can see the pattern at that level, it was the failure to put this whole story together and say there is something fundamentally risky about what is going on here. Therefore, we either ought to be pulling monetary policy levers which lean against the wind, as the phrase goes, macro-prudential levers, such as capital adequacy requirements which lean against the wind. One of the most important debates to be had at global level—and I have to say, I think it is more important than the debate about college of supervisors, though I think that is a useful thing for us to be doing—is how we, Europe, the world and the IMF get a better ability to see the overall pattern of the risks which are coming at the total level and to be taking appropriate measures to lean against the wind. That then takes us back to the capital adequacy requirements because one of the ways you lean against the wind, and it may be a much more effective way than classic monetary policy, ie interests rates, is through increasing capital requirements, either on a rule-driven basis or a discretionary basis, when it is obvious that we are in the middle of an unsustainable boom.

Lord Trimble: My Lord the whole function of the central banker is taking away the punchbowl when the party gets too frivolous.

Q10 ***Lord Haskins:*** Alan Greenspan worked, of course, on the assumption that good corporate governance would avoid all these problems and the boards would see the issue coming and act accordingly and it would not be left to the regulator. Have you anything to say about corporate governance and the way it has failed during this crisis?

Lord Turner of Ecchinswell: The idea that good corporate governance at an individual institution level could avoid the risks which eventually occurred is wrong because I think we have a fundamental collective action problem here, the fact that we are dealing with an issue which is systemic. I think it is very difficult for an individual institution or an individual set of managers to see the overall pattern of what is unsustainable. It is also the case that an individual institution is caught in a problem whereby if they are the first to abandon this risky activity, they perceive that they lose market share without necessarily themselves being protected against the systemic problems when they occur. They might to a degree, and clearly there is a differentiation around the world of those banks which were most cautious and those which were least cautious, but the share prices of good banks have fallen dramatically as well as bad banks. Although there is a role for good governance and good management, and I think there are lessons, there is a collective action problem here which has to be dealt with through Central Bank action and through regulatory action. Let me give you one example, the issue of remuneration, which, again, is on your list of questions. There are issues about the way remuneration is structured which can either encourage excessive risk-taking or not encourage excessive risk-taking. If you are paying people off the immediate one-year profit and loss of a trading book and saying, "It looks as if we made a profit, therefore I'm going to give these traders a whacking great cash bonus", you will probably tend to produce more risky activity. If you say, "Well, there may or may not be real profit here. I'm going to give you a bonus, but it's going to be in shares deferred for five years with the ability if things go wrong to take it away from you", you are probably likely to produce activity which at the limit is slightly less risky and pays more attention to some of the long-term challenges of the firm. However, it is very difficult for an individual remuneration committee or board to be disciplined about this because what you get are proposals of "We need to get Manager X", you say, "Okay, we'd like a sensible remuneration structure for Executive X from this other bank. We'd like it to be deferred. We'd like it to be paid in shares" and they say, "That's all very well, but our competitor has offered this sum in cash and immediate". This is where one of the things that regulators can do, by setting a set of principles and making it plain that remuneration practices are one of the things we are going to look at and supervise and put in our risk mitigation programme, is create some space where the individual remuneration committee feels more empowered to do what it wanted to do in any case because, again, it is one of these collective action problems. You need things which make it easier for that remuneration committee to know what it knew in its heart of hearts was the sensible thing to do in the first place. There are lots of things that good governance can do, but we have systemic problems which require good macro policy and good overall supervision policy in order for us effectively to guard against the risks.

Chairman: Thank you, Lord Turner. I am trying to exhaust our questions on regulation and supervision because I need to go on to the more provincial considerations of what we are going to do about the EU directives. Lord Moser?

Q11 *Lord Moser:* I was going to ask a supplementary very similar to Lord Trimble's because you started your opening answer on capital adequacy, in relation to trading activities of banks and this is incredibly important. I was simply going to ask at that point whether you would be satisfied just to deal with a sort of ratio or whether you would go into details of the trading activities, but then when you answered Lord Trimble, you talked about the detailed supervision or monitoring that you would go in for at the FSA and that all focused on risk management. In other words, you get these big documents from a bank and the risks they are going to take and you ask is the capital adequate for those risks. I understand the structure, the worry expressed in my case against a background of total loss of confidence in banks—I come from a banking family—is that risk assessment is not a science, risk assessment is a very risky business. When these banks give their risk assessments, I do not believe in them basically because they want to do business. The centre of this whole structure still worries me. I understand totally that capital adequacy is the beginning of your monitoring but it ends up with the banks saying, "This is okay because we've assessed the risks, it's fine". I do not believe it.

Lord Turner of Ecchinswell: I think the difficulty is if you do not believe it, you would probably end up believing that banks are rather risky things whatever we do, which may have an element of truth. What you suggested there touches on a crucial debate as to whether we try and regulate banks' capital adequacy through simple ratios, such as a gross leverage ratio, or by what are called "risk sensitive" or "risk precise" type measures, such as Basle 2 attempts to do. I think there is a pretty strong emerging argument for doing both in a belt and braces approach. Each of them has problems. The problem, you are right, if we take the Basle 2 approach, which is the individual capital assessment that I described earlier, where what one is saying is the principle is we want to hold the amount of economic capital which is really required for the risk, so we want a granular analysis by the bank of what the risks are in Indian mid-corporate lending or prime mortgages in the UK or trading activities and it is built up in a very sophisticated form. Getting that right depends crucially on both the quality of what the bank does in its analysis and also depends crucially on the quality of the challenge from the supervisor. That is the point at which the supervisor can say and does say, "No, we disagree with that, we disagree with your assumption about what the default risk on this category of bonds will be" and we can do that and we do do that. It is a very detailed process and it could be that in that detailed process people still get it wrong and they simply underestimate the amount of risk in an activity. Therefore, people hanker after a simple rule which will control this, such as leverage again, your capital as a per cent of your total assets should be five per cent, 10 per cent, whatever. The difficulty is that, of course, the simple rules are what we used to have and what we realised was that any simple rule will produce activity which maximises the risk underneath it. If you had a simple rule which says capital to total assets will be five per cent, a bank has a clear incentive to put on risky assets, poor quality mortgages, not high quality mortgages, because in your simple rule you are basically saying, £10,000 of mortgage is £10,000 of mortgage, you are not differentiating. Whereas, the first approach, which is the principal approach, allows us as the supervisor to say, "Hang on, I can see that your mortgages appear to be riskier than the average mortgages, therefore I want you to be having seven per cent, even though I am demanding four per cent off the other guy". So the simple rule also has its problems, and indeed America had a simple rule on leverage; it had that before this crisis. A simple rule has to work on equity to assets. What is an asset? People said, "An asset is a thing which is on the balance sheet, and these things which were off the balance sheet in our SIVs and conduits were then not on the balance sheet, so they are not an asset, so I do not have to hold equity against it." So for any simple rule that you have which you write down with a legal definition, some clever lawyer will find a way of doing some other economic activity which does not count as an asset within that rule, whereas the first approach, which is the principles and discretion approach, enables us to say, "I know this is not an asset but it is still a risk, so I want some capital against it." I think what we have learnt is that there is quite a strong argument emerging, and this may well be where the world ends up, for a belt and braces approach. If we look at the way, for instance, the Swiss have now decided to have a gross leverage ratio. It is quite interesting why they ended up with that. It was heavily to do with the large trading books of Credit Suisse, to a degree, but UBS in particular. UBS, which has recently been subject to a re-capitalisation and bad asset scheme by the Swiss National Bank and Government, was reporting right up to the time when problems emerged very, very strong ratios on the sophisticated risk assessment process. It was arguing that was how the previous rules had said, "Everything we do in this whacking great trading book is secured, based upon collateral calls, based on marginal calls, therefore it is very low risk, therefore in our sophisticated weighted risk asset approach we do not need much capital against it, therefore we have a high capital ratio." But things still went wrong, and they went wrong because, despite the fact they had a high capital ratio against risk weighted assets, they had a huge balance sheet. So the Swiss National Bank and the Swiss regulatory authorities have essentially said, "We do not trust either yourselves or ourselves to be sophisticated enough to work out precise risk in a whacking great trading book, we just have a generic feel that if it is huge in some way it is risky, and therefore in addition to the Basle 2 type looking-at-your-individual-risks approach, we are going to have an aggregate leverage ratio as well." As I say, I think we will probably end up as a world regulatory community believing we need both. If we just rely on gross leverage ratios, people will be finding all sorts of ways round the rules, and if we just rely on the detailed analysis of the banks and our ability to challenge that, we will sometimes get it wrong in a way that a single rule would have managed to capture. So that is why I think we will end up with a belt and braces approach.

Chairman: Thank you very much. I am now going to move this discussion, enormously useful as it has been, from the high level to the things which are actually going to have to go through ECOFIN next week, and ask you for a quick opinion on all of them. What is going through ECOFIN is the CRD, and an opinion would be enormously useful. Lord Woolmer?

Q12 ***Lord Woolmer of Leeds:*** In the Capital Requirements Directive there is a proposal, as you know, for a 5 per cent quantitative retention requirement of the total material share of the risk for the originator in securitisation deals. It has been said that this may encourage banks to move offshore in European terms. What do you think of that fear? Given that G20 is going to look further at things, does this imply that the Capital Requirements Directive may be re-visited again later next year?

Lord Turner of Ecchinswell: This issue relates to what is sometimes called "skin in the game", as people call it, that when you originate a loan and then you distribute it, should you be required to at least keep some exposure to it. I think in the FSA we have been less convinced than the European Commission that this reform is a crucial reform, in the following two respects. First of all, many people who have got into trouble on securitised lending in the big trading books and have made large losses were actually maintaining skin in the game; the fact they were maintaining skin in the game did not necessarily stop them getting into trouble. Indeed, if you look at the total system, you could argue that the problem with the way we run securitisation is actually that the banks in total kept far too much of the risk, not too little. When securitisation was originally described and grew up in the 1980s, people said, "Here's the plan, we don't want a West Texas Savings and Loans institution to carry a non-diversified book of exposure to West Texas mortgages, because that means that if the local economy goes down we will have householders going down and a bank going down; much better to turn it into a security and sell it on a diversified basis to a diversified set of investors throughout the world." So the concept was, deposit-taking institutions, banks or savings and loans institutions, will end up holding less of this long-term risk which will be held more by pension funds, insurance companies, et cetera, who are natural hold-to-maturity investors of diversified holdings of assets. If you then look at the figures in the latest IMF Global Financial Stability Review of where the losses on securitised lending have been, about 70 per cent of them have been in the trading books of the banks, not in the pension funds and life companies. Having developed this idea which was meant to originate and distribute risk, at the level of the overall banking system the system was not distributing at all, it was originating. You were often distributing your own originated security but then your traders were, as an exercise in position-taking buying somebody else's securities. So at the total system you could say the problem has been not too much originate and distribute but the fact there has been far too much originate, distribute and then buy it all back in order to indulge in trading activities. If you look at the specific issue of the thing which I myself originate, should you continue to hold a slice of that, in many cases as I have said that already occurs, in many cases you could say it is an unnecessary restriction because you want people to be able, once they have originated a risk, to get it fully off their books if necessary to get the risk away from the banking system. You also have to think about how you are going to implement this because of course you can lay off an economic risk by taking a position in the credit default swap market even if you have maintained that risk on your books, so you have to think about the operation of it. So there is a set of reasons why we have been less convinced that this is the core of the issue but it is a proposal which in its current form we can live with, we think it is reasonable in its current form. The likelihood of a significant movement offshore set at the level it is at the moment? No, I do not think that is very large.

Chairman: If we could ask Lord Moser to ask a question on credit rating.

Q13 ***Lord Moser:*** Some people in the blame-game point at the ratings agencies. This is a straightforward question, what is your feeling about future regulation of the agencies, what is necessary, what can be done, and what should be done in the European context? They have made their proposals, are they adequate?

Lord Turner of Ecchinswell: I think the over-use, or in some case the misuse, of credit ratings is a significant part of the story of what has occurred. I think it is reasonable for us to register and oversee rating agencies, but I think I would be very cautious in believing that the regulation of rating agencies will be a crucial bit of what gets it right in the future. I think actually more important is the fact that there is going to be natural market reaction which is more sensible about the use of ratings in the future than has been in the past. Let me explain what I mean by that. If you look back through the history of rating agencies, for many years they rated the individual securities of major corporates and they ranked them as AAA, AA, et cetera, et cetera, and my understanding is that if you look over the decades this was done reasonably well in the sense that the test of this is an empirical test, was it the case that the rankings AAA or AA or BBB in 1980 were a reasonably good predictor of whether they did or did not default? If we want to do the analysis of whether they did their jobs well, that is what we are essentially saying. What happened I think in the last 10 years is that ratings were extended to a wider and wider set of securities, including to some very complicated, structured securities, where it was actually much more difficult to work out what the true default risk to maturity would be, because these things had not existed before, so you did not have a track record; they were inherently more complex and they did not have a track record. The rating agents were too willing to say, "I put my rating on this CDO" without really working out whether that rating could be considered of the same quality as the rating which had previously applied to a General Electric straight bond. Secondly, I think probably too many investors relied entirely on ratings. It is very difficult for many investors not to rely on ratings. Corporate treasurers throughout the world depend on ratings to say, "I am only going to put my cash with a AA rated bank". It is difficult to imagine a system which does not have some reliance on ratings, but the system relies on a balance between a reliance on ratings and other people doing fundamental research, and probably too many people ended up saying, "Because this has a rating, therefore by definition it is good." Thirdly and I think crucially, people implicitly fell into the belief that the rating might be telling them something about the mark to market value of this instrument, ie what I would be able to sell it for in six months' time, and of course it is not going to tell you that at all, it is meant to tell you what is the probability of default if held to maturity. When you get changes in the liquidity of a market, you can have a major collapse in a price of an instrument even though the probability of default if held to maturity has not changed. So there was an over-extension I think of the science of ratings to things on which it was not good science on which to rate them, there was an over-reliance on ratings in general and in particular there was an over-reliance on the idea, implicit in some people's behaviour, that they told you something about liquidity and market value rather than just telling you what they meant to tell you, which is what is the percentage probability of this thing defaulting if held to maturity. There are then a set of ways in which ratings also played a key role in what occurred because of the way ratings end up as triggers within the system; the loan covenants will have a ratings trigger in it and if one thing changes other people automatically change their behaviour. So all of that is a problem. There were also clearly within the ratings areas issues of conflicts of interest which may have encouraged that tendency to rate things for which there was not a good basis to rate. There is a problem which needs to be carefully managed in governance terms, that rating agencies are paid for by the people who are issuing the stock, that is who pays for a ratings agency, and there is an implicit danger of conflict of interest there which needs to be carefully managed. All of which says in a whole variety of ways that it was a significant part of the problems which have occurred. Therefore it is perfectly legitimate to say, "We want to be able to register them, we want a regulatory oversight of them, and we want to at the very least make sure we have governance procedures that make sure they have appropriate skills, they have appropriate procedures for making sure there are not conflicts of interest." What I do not think one can envisage however is that the nature of regulation is ever going to involve us as the FSA saying, "No, we disagree with the rating that you have given to Company X." It is quite difficult for us to be second-guessing the science of ratings without us becoming the rating agency, and I think all regulators are going to be very, very wary of that. That is why I say, although there is something you can achieve with the oversight of rating agencies, probably the most important thing that is going to occur is a market reaction. I think investors are going to be much more wary in future of relying entirely on what the rating says. I think they are going to be particularly wary of it where this is a rating of a complex and recently innovated structured security with some alphabet soup name. Indeed what I think is actually going to happen is a lot of those things are simply going to disappear from the financial markets and the securitisation model is going to get back to the basics, back to what it was originally meant to be about, which was the much more straightforward and transparent definition of securities to a much greater extent sold through to the end holders of those securities, rather than sliced, diced, structured and traded en route. So, yes, I think it is a legitimate part of it, but I think the most important thing that is going to happen in the role of ratings and in the whole structure of securitisation is a market response which is going to stop people using ratings in an inappropriate fashion.

Chairman: Thank you very much. I think we just about have time to ask Lord Haskins to talk about deposit guarantee schemes, since this is critical for ECOFIN.

Q14 ***Lord Haskins:*** You said earlier with regard to Lehman Brothers that the host country in the future may take firmer action than in the past; that there was a tension between home and host country. That is okay if there is an American bank involved but if it is a European bank, a German bank, do you think that sort of firmer action by the host country is compatible with the single market?

Lord Turner of Ecchinswell: I think the issue of the interface between the single market and European supervision and European deposit protection is a fundamental issue. At the moment we, as a regulator, are required under single market rules to accept the passporting rights of a branch; a subsidiary requires its own authorisation. As long as something sets itself up as a branch in the UK we are not the prudential supervisor of it. That is true not only from elsewhere in the European Union but from elsewhere in the European Economic Area. So Landsbanki was a branch of an Icelandic bank, not a subsidiary of an Icelandic bank, and we were therefore not the supervisor of the capital adequacy of Landsbanki. We were required by the European single market legislation to rely on the Icelandic authorities as the home regulators of the overall entity, Landsbanki. This was something which caused us considerable concern over the last year, a concern as to whether we were happy with the supervision and the support which was there and also, in retrospect, we have learnt questions about whether ordinary people understood that distinction. It was there on the websites, the websites did say, "This is regulated by the Icelandic Regulatory Authority" but I think we realise that ordinary people tend to think a bank is a bank is a bank and do not make those distinctions and we have to get that communication clear for the future. It does raise this very clear point, if we have a branch from another European country, EU or EEA, which has a banking system which is so big relative to the fiscal resources of that country *in extremis*—which was clearly the case in Iceland, you had a country which simply did not have the ability, as we do, to prevent the bankruptcy of banks because it simply has not got enough money as a country to do it—should we have to recognise the branch under a single passport? I think you have to go one of two ways. You either have to say, "We cannot have that very straightforward single market rule in terms of the recognition of that branch" or you have to go the other way and either have pre-funded deposit insurance, which makes sure they have put enough money aside outside their small country in order to be able to pay depositors in the event of a default rather than relying on the fiscal resources, or you do have to have some sort of not European supervision but European supervision of supervision; some process of saying, "Is the quality of this small country supervisor up to the quality which we want in order to require everybody else to recognise those branches?" It is not an easy issue I think to know what is the sensible approach. The UK political approach to this, and I think the FSA approach to this and the Treasury and all the political parties in the past have tended to say this in the UK, is, "We want open competition and single market rules, and therefore we support this passporting of branches because it is good competition and services, but we are against European supervision of supervision or European supervisory rules", and I think we have realised that there is a fault line in trying to say those two things simultaneously. It is not obvious which way you go, and one way to go would be to give us the power to say, "We do not have to recognise the branch of a bank in a small European country which does not have the fiscal resources to support it"; that in those circumstances we would have the right to say, "If you want to operate in this country, you are going to have to operate as a subsidiary", at which point we can make sure there is adequate capital and liquidity here. But it is a crucial issue which needs some thinking about.

Q15 ***Chairman:*** Thank you very much. I would love to ask you one more question but I expect you are running out of time.
Lord Turner of Ecchinswell: I am, yes.

Q16 ***Chairman:*** I feared as much. Thank you very much for coming. It is much appreciated. We might, please, ask you to come back again towards the end of the inquiry when we all know a bit more and we have seen what is happening in Europe.
Lord Turner of Ecchinswell: Yes, that is fine.
Chairman: Thank you very much indeed for coming.

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