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HOUSE OF COMMONS

ORAL EVIDENCE

TAKEN BEFORE THE

JOINT COMMITTEE ON THE DRAFT FINANCIAL SERVICES BILL

THURSDAY 13 OCTOBER 2011

SIR JOHN VICKERS

Evidence heard in Public Questions 288 - 350

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Oral Evidence

Taken before the Joint Committee on the Draft Financial Services Bill

on Thursday 13 October 2011

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witness

Witness: **Sir John Vickers,** Chair, Independent Commission on Banking, gave evidence.

Q288 Chairman: Sir John, welcome. Thank you very much for agreeing to appear before the Committee today, all the more so in that it is your second stint this week. We are conscious that Parliament is making very considerable demands on your time. Though your first appearance obviously has helped inform this Committee, we are focused more specifically on the legislative consequences of the Government's reforms and such of your proposals as they may decide to incorporate in this and other legislation. Perhaps I may ask you at the beginning whether you have thought at all about the likely legislative consequences of what you are suggesting, and how much could usefully be incorporated in this Bill by tabling additional amendments and how much is beyond the scope of the Bill, if any is.

Sir John Vickers: The particular area where we did consider the legislative implications was our recommendation concerning the Financial Conduct Authority and the competition duty. Quite clearly, that would fit within the scheme of this draft legislation. Beyond that, the short answer is we did not consider the legislative form that our recommendations, if adopted by government and Parliament, should take. That was for two reasons: first, we did not think it was our place to do that; and, secondly, I and other commissioners—I think I can speak for them—simply did not believe we had the expertise to say anything very sensible about that. We did express the hope that government policy would achieve clarity within the next few months by the end of the calendar year. Of course, we hope the recommendations are adopted. If that is the case we think it would be valuable, not least for the marketplace, for legislation to be enacted within this Parliament. Clearly, there are different ways in which that could happen, and I have no view on which route would be best.

Q289 Mr Ruffley: Sir John, various consumer groups have suggested formulations of the FCA's strategic objective. One is maintaining a fair and transparent market for financial services; another is promoting fair, efficient and sustainable markets that work well for consumers and users of financial services. What is your view on the formulation and those two options in particular?

Sir John Vickers: I should say first that, as a commission, we focused on the question of the competition duty rather than the overarching strategic objective, so what I say in response to your question is more a personal view. As I indicated in an earlier appearance before the Treasury Select Committee on which you sit, I am somewhat puzzled by the primacy of confidence within the strategic objective. Confidence is a matter of beliefs about a market and it can be misplaced, including confidence in financial markets. It would seem preferable to have some wording about how the markets are actually working rather than the beliefs of consumers and others about it. I do not have a formulation up my sleeve, though when I was at the OFT we used the general banner—this was not statutory language—about markets working well for consumers. The second of the formulations that you read out is very much along those lines. Without having any precise drafting to offer, it would seem preferable to cast it in terms of how the markets are working rather than confidence about them. That is a personal view.

Q290 Mr Ruffley: That is very helpful. In what situations is the competition objective in conflict with financial stability?

Sir John Vickers: On the whole, those two objectives are consistent with each other. It is possible, however, to envisage circumstances where that might not be the case.

Q291 Mr Ruffley: Could you flesh out some scenarios where there might be a conflict?

Sir John Vickers: In our issues paper a year ago, which was recapped in our final report, we referred to some of the academic debate on how there might or might not be tensions or, on the other hand, complementarities between the two objectives. There are risks in trumping competition with financial stability concerns, and what happened three years ago with Lloyds and HBOS is a lesson about those risks. In that case stability considerations were used to bypass the normal competition machinery and the result was arguably detrimental to both objectives.

In response to your supplementary question, there are some circumstances where there appears to be a conflict between the two but where on a proper diagnosis there is not. An example of that would be the view of some that in the run-up to the crisis there was excessive competition in lending, far too easy lending and loan-to-value ratios going through the roof. That was also feeding through into asset price inflation. Some would say that that was too much competition and bad for stability. I regard that as a misdiagnosis. The fault was the poor regulation, not the excessive competition. If I may use a parallel, in an imaginary industrial market where firms pollute and there is no pollution control someone might say, “Look, there’s too much competition and, with all this pollution, the solution is a cartel or something.” That would seem to me to be a great mistake, and the answer needs to be pollution control, not to deny consumers the benefit of competition. I would say the same in the context of financial stability.

Q292 Mr Ruffley: That is very helpful. What type of prudential safeguards do you think are necessary to ensure that competition is achieved?

Sir John Vickers: I could refer back to the example just given. What matters regarding competition is not simply a fight in the marketplace. One wants competition to serve customers well and does not have bad side effects, which clearly happens with things like pollution and can happen with financial risk. I would see prudential regulation as providing part of the framework in which competition channelled to those ends, and without those side effects, can operate. Rather than describe it as a safeguard, I would see it as setting the ground rules for the arena in which healthy and positive competition can then take place.

Q293 Mr Ruffley: What is your assessment of the design of those prudential safeguards?

Sir John Vickers: The design in terms of things like capital ratios, and so on.

Q294 Mr Ruffley: Yes. Do you think there is anything to which we should pay particular attention in the way they are going to be set out in legislation?

Sir John Vickers: There are some questions about levels in general, and we talk a lot about that in the report. There are also questions—perhaps this is where your question is aimed—in that prudential requirements could have effects for good or ill on competition between banks or other institutions of different sizes. If a "too big to fail" problem goes untreated, large, complex and interconnected institutions gain competitive advantages over others for reasons that are not to do with any underlying efficiency advantage. On the other hand, the way regulation applies to small institutions could have the unintended effect of thwarting their expansion or deterring the entry of newcomers into the marketplace. That is certainly a point on which we touch in our report.

Q295 Lord Skidelsky: I would like to take up a point about the complexity of financial products. A major criticism has been that many of the financial products are too complex to understand, not just by the consumer but by those who have been responsible for devising them. As you know, complexity is also a big growth area in academic economics. How can one guard against that? Would you support an amendment to the FCA's objectives to ensure that firms help consumers to make responsible and well-informed decisions? But is "help them to" enough? Is there a case for saying that some products are too complex to be allowed?

Sir John Vickers: These are very deep questions. A moment ago I was referring to the complexity of institutions and now we have moved on in your question to the issue of product complexity. One comment about the ring-fence design that we propose in our report is that some of the particularly complex financial products, of a kind that it appears a number of institutions themselves did not properly comprehend, would be very much outside the fence and would not be allowed to be provided within the ring-fenced entity. A degree of distance would be placed between high street banking operations and that kind of complexity, but that is more in wholesale markets, whereas your question at the end is clearly about consumer financial services.

This is a very difficult area. Ultimately, the consumer has to bear responsibility for his or her decisions in the marketplace, and it is a question about the provision of information to the consumer and whether there is clarity. We all know that more information does not necessarily mean better understanding. A balance has to be struck in that regard. The draft legislation in one of its clauses makes that point about consumer responsibility. There are points made about consumer education and the like. Whether it should be a duty on providers to help consumers, part of one's instinct is to say yes. On the other hand, thinking in practical terms that could be a very difficult thing to do, because for a number of financial services—think of pensions as a classic example—so much depends upon the circumstances of the individual. There will always be a limit on what even the best-intentioned provider can reasonably be expected to know. I do not know one way or the other whether I would favour an amendment of the kind you indicate, but those would be some of the considerations I would have in mind.

Q296 Baroness Drake: To stay with the point about protection of the consumer, whatever the aspirational effect of competition there will always be asymmetric knowledge and understanding. You will simply not be able to get rid of that. The FCA will have these product intrusion powers that almost take them into the area of saying to the providers that they have a duty of care. It is almost saying, “We have looked at your products, how you are selling them and to whom.” In a sense, giving the FCA those powers is beginning to walk them down the direction of duty of care. Do you think that is the case and that inevitably there will be a greater drift towards that once those powers are exercised?

Sir John Vickers: I would not claim expertise on this. That might be welcome to a certain point. I was trying to indicate that a balance needs to be struck. If one went too far in that direction one might end up with counterproductive effects for the consumers who one is trying to assist in the first place. It also needs to be borne in mind that consumers are a very heterogeneous group. When some years ago I was at the Office of Fair Trading and appeared before Lord McFall’s Committee I am sure he and I both remember that there were a number of issues under general consumer law, including the Consumer Credit Act, but not the regulatory powers that the FCA would have, about such things as misleading advertisements and unfair terms in consumer contracts. Policy and also case law on that has developed since the late 1990s when those regulations came into force in the UK. Those are also very germane to this set of issues, but this legislation takes a further step both in consumer protection and potentially on the competition side which expands the regulatory tool kit that can be used in these various markets. I think that is a good thing.

Q297 Baroness Drake: The Bill has a very broad definition of consumer from the individual mother to a hedge fund. Would it help if the Bill was amended to enable the FCA to discriminate more between different consumer groups? Do you consider that is a weakness of the Bill as it is currently drafted in terms of that very broad definition?

Sir John Vickers: It is certainly the case that the range of consumers and customers is extraordinarily wide and that is because the range of markets at issue is wide. I believe there is a clause in the Bill that is on the point and makes reference to different types of consumers and the FCA’s duties to have regard to that. It is also the case that the general case law in areas like unfair contract terms has been developed in a way that is sensitive to the circumstances of different kinds of consumer. As to whether more is needed in the draft legislation than is already there, the only honest answer I can give is that I do not know. It certainly needs to be addressed. Maybe the current draft addresses it enough; maybe not.

Q298 Baroness Drake: A broader question not directly addressed in the ICB report is whether the PRA should have regard to competition, in effect to examine the effects of regulation on competition. Certainly, the consumer groups have expressed concern about this because of the PRA’s power of veto in respect of the FCA. Do you think that the Bill should be amended so that the PRA has to have within its objectives a regard to competition?

Sir John Vickers: As indicated in response to an earlier question, what the PRA does can most certainly have effects on competition, for example in the area of entry barriers. We recommend that the PRA and OFT work together on that particular issue. It includes some quite technical questions about how banks of different sizes can as a practical matter calculate their risk weights for the purposes of meeting capital requirements, and so on. I would hope that the PRA would have regard to competition. The further question is whether that should be enshrined in legislation. I looked at that passage in the draft legislation. To my very amateur eye, I could not see any easy slot into which to place such a “have regard” duty. I do not know whether the scheme of that part of the draft Bill lends itself to doing that. I do not know whether that might be a problematic issue, and my expertise does not give me anything more helpful to say. I reiterate that it is very important that the PRA does have regard to competition. Whether it should be in the statutory scheme is much harder for me to say, and if there is a list of "have regards", then there would be a question of which others should go on that list.

Q299 Baroness Wheatcroft: Part of the crisis we are in was exacerbated by the sale of bonds and derivatives related to sub-prime housing. Without going into Adair Turner's concept of "socially useless" in relation to financial products, do you think that at the moment there is anything in the legislation that would go not just to consumer protection but the greater market risk and make some of those products potentially unsaleable? If there is not anything there at the moment, do you think there should be?

Sir John Vickers: That happened in a context where regulation around the world was poor, but, as we all know, it blew up most in that area in the United States. I believe that much higher capital requirements and changes to make sure that providers of debt to banks—bondholders—unlike in the crisis where many came out whole but are in line to take losses, would instil all sorts of incentives and disciplines around risk and lending which would go a long way to addressing that kind of issue. We had low capital requirements, so-called risk weights that were no such thing and what turned out to be a very brittle debt structure so the taxpayers were marched very near to the front of the queue of taking losses in a way that should never have happened. In a properly functioning market system things would not happen that way. I believe that would be one of the important disciplines in this whole area.

In its supervisory role the PRA would surely have regard to what was going on in the marketplace in the UK on all these fronts. The PRA's remit clearly does not extend to the United States. That takes us back to the question of how vulnerable or not the UK financial system is to imported shocks from elsewhere. Again, I point to our ring-fencing recommendations, one of the aims of which is to give a strong degree of insulation against such imported financial shocks.

Q300 Mr Brown: How far will economic activity be outside the scope of the regulatory regime that we have under consideration? In other words, those who do not want to be regulated will just try to move to a shadow market outside the reach of the regulator. How far should the regulator, particularly the FPC, at least be able to understand what is happening in these overseas markets and make recommendations accordingly? My point is that it is quite important they are able to act in time rather than describe what happened after the event.

Sir John Vickers: In the work of the commission we faced a variant of that question which was about activity potentially moving from UK banks either to non-banks and/or to non-UK institutions altogether. Your question is a wider one because it is in the context of the draft legislation. Surely, the FPC must have very close regard to global as well as domestic developments to do its job properly, especially because of the very open nature of financial markets in the UK. We have banks whose balance sheets collectively are four or five times a year's GDP. It is not Icelandic but it is otherwise at that end of the spectrum. That would be an essential thing for it to do.

As to the levers it has to pull to deal with those global issues, there are limitations because of the scope of the jurisdiction, but through European fora in the context of the EU and Brussels, especially through the international Basel processes where the UK does play a leading role, that is another route by which UK regulators can seek to address problems on those fronts.

Q301 Mr Brown: Therefore, it is essential to understand what is happening if a problem is emerging at a very early stage and be able to take action with trading partners. Obviously, the United States and our partners in the European Union are the most significant in this. Is there anything you can say to us about the way in which the legislation is currently framed as regards amending it or strengthening it to make sure that point is made more explicit

Sir John Vickers: I apologise that I am not familiar enough with the relevant passages of the draft Bill. I would hope it went without saying that the FPC's horizon would be global in terms of what it is looking at. Clearly, the scope of the legislation in terms of regulatory powers, the authorised persons covered by the legislation and so on can only be within the jurisdiction of the UK Parliament. Therefore, in terms of formal powers to address those issues there is inevitably that jurisdictional limitation. But a great deal happens, and the UK institutions are central to this in terms of the international debate. It may be that enough is done. I simply do not know whether legislatively there is more that would enhance and bolster those efforts.

Q302 Mr Brown: In defending the ring fence structure in the House of Commons the Chancellor of the Exchequer, in answer to Michael Meacher, said he thought there were strengths in the investment arm of a bank being able at a time of difficulty in its retail arm to transfer money to support that retail arm. Can you explain how that is compatible with a ring fence?

Sir John Vickers: Let me try. This leads to the question of why we did not recommend a full split. One of the arguments for a full split, some would say, is that it deals emphatically with the risk that problems in the non-retail bit would contaminate the retail arm of the bank despite the greater capital cushions and all the rest of it that go with the retail part of the ring-fence design. The argument in the other direction is the one you have alluded to which is that, depending on the economic and financial shock at issue, there may be some occasions when the retail side is in trouble and globally things are fine. In that circumstance with a ring fence as distinct from full split, there would be scope for rest of bank to bring in capital to support the troubled retail operations and see them through it. We took evidence on this. We believed that only would that possibility exist but there would be very strong reputational incentives for a wider banking group not to let its retail arm in the UK go in those circumstances. Therefore, there are arguments on both sides as far as that is concerned.

It is not just fanciful to suppose that there might be a UK retail problem and not a global one. As we have seen in some other economies, there may be a domestic property market crash, commercial or residential, given the focus of retail lending, whether it is mortgage lending or business lending secured on commercial property, or two companies very much involved in commercial property. You can have domestic shocks. Even with fantastically good macro-prudential regulation, you cannot banish that risk. It seems important to retain the possibility of rest of bank supporting the retail operation.

The other set of reasons we went for ring fence rather than full split was that there are, at least arguably, various kinds of synergy between the different banking operations, some would say a diversification benefit, which a full split would lose. The cost-benefit analysis overall led us to the recommendation here.

Q303 Baroness Wheatcroft: Sir John, when the report came out the initial reaction from the banks was that the cost of lending would go up. As far as one could see that was unjustified. Did you think there was any justification for that reaction?

Sir John Vickers: We did some estimates and looked at those made by others of the costs to the banks and, as a separate question, the economy of recommendations of this kind.

In so far as these and other measures would get the taxpayer off the hook, to put it in those terms, inevitably bank funding costs would rise because the risk that the taxpayer ultimately bears would lie instead where it should, which is with investors. That would be reflected in funding costs. Our best estimate is that the cost to the banks expressed in terms of their collective balance sheet, which is more than £6 trillion, would be of the order of one tenth of 1%. We believe that most of that cost would be felt outside rather than within the fence so that any effect on lending costs would be very small in the wider scheme of things. To say there would be no effect at all is to go too far. There may be some effect but it is likely to be small. I would not regard it as a completely unjustified response that some have made, but I would want to put it in its quantitative context. I certainly would not agree with the estimates made by organisations such as the Institute of International Finance, which have huge effects on lending costs. I do not believe they are credible estimates.

Q304 Baroness Wheatcroft: The other objection from outside the banking industry is that the banks will find a way through the ring fence. They have become increasingly sanguine about the proposals because one suspects they have been looking at how porous the ring fence could be. There is a bit of flexibility in your report as to what goes inside and what does not.

Sir John Vickers: Yes.

Q305 Baroness Wheatcroft: To what extent do you think that they, clever people that they are, might find ways through?

Sir John Vickers: I would like to distinguish between the flexibility of the fence and the question of its strength. We recommended a ring fence that was flexible but, as we would see it, strong. It would be flexible because, while there are some activities like current accounts that we recommend must be in ring-fenced banks, there are other activities, such as trading derivatives markets and lending to financials—some of the very complicated lending within the financial system—outside it. But for corporate deposits and, on the other side of the balance sheet, lending to non-financial corporates, the logic of the design did not point strongly one way or the other, so why not leave that up to banks and their customers? That might also have a diversity benefit in that different banks might migrate to different points within that architecture if government and Parliament were to adopt it.

The question of the strength or porosity of the fence is quite a separate one. There we think a number of safeguards are needed cumulatively. We said quite a bit about the scope of permitted dealings between the ring-fenced part and rest of bank, essentially proposing a third-party basis. We have recommendations on separate and distinct capital and loss-absorbing debt requirements. An area that we said very little, if anything, about in our interim report, which in part was because of responses to consultation and in part because of our own work we realised was much more important, was the whole set of governance arrangements. Who is on the board of the ring-fenced bank; what are the directors' duties in the ring-fenced bank; what are their public reporting requirements, and so on? Clearly, there will be an important role, if a scheme like this goes forward, for the PRA in policing the boundary. That would also be necessary with a full split. It would be nice to think that with a full split all these problems are magicked away, if I am allowed to use that expression. That is not the case, because there would still be a need to monitor, even with a full split, whether the retail bank was creeping into activities it should not, and so on. Essentially, you have the same task whether it is full split or within banking groups.

There are lessons to learn from other jurisdictions. In the US there are regulations on what banks can and cannot do within wider financial conglomerates, and in the UK we have had under the building societies' legislation limits on the kind of hedging activity that can happen within those institutions. Hedging is an area which, if ill-policed and ill-monitored internally, could stray into activities that do not sit with the logic of ring-fencing, but that seems to work perfectly well in the building society arena. We think that could be a very good guide to what the treasury functions of a ring-fenced entity might do.

Q306 Baroness Wheatcroft: You have explained why you think full separation is not the answer and that the ring fence will bring some benefits, although they seem far from overwhelming. Nevertheless, do you think that shareholders might decide that if there is a ring fence they would prefer a full split and demand that from their banks?

Sir John Vickers: It is entirely possible, and it was a point we considered. In our view that would be fine and up to them. One of the questions on which we received and ourselves could generate frustratingly little evidence was how great were the benefits of synergy between retail and wholesale investment banking. Distinguishing between the true synergy benefits and the scope of the implicit taxpayer guarantee is a very hard thing to do. If the true synergy benefits are minimal it could well be that some institutions would follow the path that you have described, but that would be up to the institutions in the marketplace. If a series of policy measures can get the taxpayer very remote from all these institutions there would be much cleaner market incentives than the distorted arrangements which have existed recently.

Q307 Baroness Wheatcroft: You were not overwhelmed by corporate customers saying they really had to have everything under one roof?

Sir John Vickers: Not overwhelmed. That benefit, as far as it exists, is to a considerable extent maintainable under a ring-fenced system, because if a medium-sized corporate wanted maybe some foreign exchange hedging or whatever that could be arranged in a one-stop shop way consistent with a ring-fenced architecture. Therefore, it is permissive of those synergy benefits, but if they are worthless in fact then full separation is a possibility for some banks. It is not that I have some in mind, but that would be the logic and it seems perfectly reasonable.

Q308 Lord Maples: What one finds in practice—my experience of this is limited but not non-existent—is that if you are a corporate and you want different services from a major banking institution you deal with one branch if you want a forward foreign exchange contract, other people if you want M&A advice and others if you want to float a bond issue. To bring that together they give you a relationship manager, who is usually an advertising executive type in a smart suit who takes you out to lunch and points you in the right direction. If that is the synergy benefit, I wonder how valuable it is. The report talks about agency benefits. Is it that difficult for a medium-to-big corporate that uses these services not to buy them on an ad hoc basis from this or that institution without a loss to the economy?

Sir John Vickers: I doubt that it is huge, but we felt that in crafting in these recommendations that they would allow certain kinds of relationships as you describe without undercutting the logic of the financial stability benefits that we are seeking to achieve.

Q309 Lord Maples: Was the decision as between total split and ring-fencing a difficult one for the commission to make? Was it a finely balanced decision when you thought of this and that, or in the end were you unanimously and overwhelmingly in favour of the ring fence?

Sir John Vickers: As chair of the past commission, we were wonderfully united in our thought process throughout. A year ago I was not counting any chickens at all on that front. I would not describe it as finely balanced as between full split and ring-fence design; we firmly came down in favour of the latter. Rather than it being a binary decision, in our interim report in April we had spoken in general terms about ring-fencing without fleshing it out, so through the summer a lot of our work was on that. At one extreme, ring-fencing by a matter of degree could end up almost as full split. We thought the right way to go was to have a strong fence, ideally with zero porosity, and yet allow co-ownership of different kinds of activity under the same ultimate corporate umbrella. There is some merit in having the benefit of flexibility about where the line is drawn, and it is not so clear how that would fit with a full split. A final point was that there are some EU law issues that would make a full split more difficult to implement, but that was not the decisive consideration. We had come to the collective view before addressing that legal difficulty that a ring-fence design like this was preferable.

Q310 Lord Maples: You said that whether you had a total split or a ring fence the policing of either the total split balance sheet or the ring fence itself would be complex issues. What clearly emerged from the last crisis was that the people doing the policing did not really understand what the offenders were up to. When the Chancellor gave evidence to us earlier in the week the phrase he used, which also appears in his book, was that we needed much more intrusive regulation. It seems to me that policing this ring fence will require very proactive or intrusive regulation—I would like to know what word you would use—to make sure that these clever investment bankers are not finding ways of shifting risks to the retail banks' balance sheets.

Sir John Vickers: I agree. It would need a number of things: close supervision, as you describe, and internal governance arrangements. None of these things is perfect, but I think the internal governance arrangements and the duties on the directors, with an appropriate degree of independence in respect of those directors, are another brick in the wall, if I may put it in those terms. There will be the indirect effect of higher capital requirements and greater loss-absorbing debt if recommendations like this are followed, because in the crisis it is not just that the policemen were unaware; sometimes the institutions themselves and their investors were unaware. A lot of their investors did not have much incentive to be aware because they reckoned, correctly, on coming out whole in the case of a number of the debt holders in any event. Senior medium to long-term unsecured debt providers in particular, or maybe contingent capital providers, will have much stronger incentives to monitor a number of these risks. It is a separate point from the ring fence and monitoring that line, but I think it is germane to it. They will have stronger incentives. You will have directors with much sharper incentives in the ring-fenced entity and also much closer regulatory attention.

Q311 Lord Maples: If we may switch for a moment to the question of how the independent board of directors will behave, you talk in your report about culture. If we go back to the long distant past of the early 1980s, retail bankers were dull people who were not all that smart, did not expect to be paid a lot of money, did not take a lot of risks and their shares were owned by widows and orphans; and investment bankers were clever people making money off their wits, and this trouble happened when they got together. We now have our ring-fenced retail bank over here with its independent directors. Their performance did not shine in the last crisis. Nevertheless, I agree that the structure here would be different. But presumably the chief executive of the bank will be appointed by the banking group, dominated certainly in the current balance sheet context by investment bankers. Are you not creating a situation where there is almost an adversarial relationship between the executives appointed by the investment bank, or the group which will be dominated by investment bankers, and some independent directors whose performance in the past in all sorts of corporate scandals, not just banking, does not fill one with confidence that they would be able either to understand the issues or stop a powerful chief executive doing what he wanted to do?

Sir John Vickers: He would have a different job to do in this scenario from that in the unstructured scenario that led up to the crisis. As to adversarial relationship or friction, that might indeed arise from time to time, and that I would not see as unhealthy. That would just be the way of things. There might well be times when the wider group was very frustrated at the inability to transfer capital out of UK retail to other ends. They might well be frustrated at the inability to put UK retail deposits into global wholesale investment banking, but that is just how it would be under ring-fenced architecture. I believe that the directors' duties and independence, the higher capital requirements and the supervisory attention to all these things would create a very different set of incentives and information conditions from those that existed pre-crisis. The activities of the ring-fenced bank would be much simpler than the spaghetti which operated in a number of institutions pre-crisis.

Q312 Lord Maples: To make those non-executive or independent directors effective seems to me to be a rather different job from the typical non-exec of a public company who perhaps devotes a couple of days a month to it. This seems to me to be a job that probably ought to be very well paid, more importantly better resourced in terms of the staff and the information gathering that is available to you and the amount of time that one is expected to devote to it. Do you see it like that, or do you see it as a more typical non-exec function?

Sir John Vickers: No. I would be sympathetic to what you have said. In the work of the commission an issue that arose in many contexts was how detailed and prescriptive we should seek to be. That was always going to be a question of balance, whether it is on how independent directors would operate or the nature of loss-absorbing debt. We tried here to strike a balance. It was also dictated by how much time we had at our disposal, but those would surely be very important issues to develop and for the regulatory institutions, the PRA in particular, in the future world.

Q313 Lord Skidelsky: Perhaps I may repeat some of the questions asked by Baroness Wheatcroft and Lord Maples by citing a financial correspondent, whose name I can certainly provide. This is a very sceptical view, so please do not feel you have to repeat answers that you have already given: "Chinese walls break under pressure. There will always be huge shareholder pressure for universal banks to boost profits at the expense of a sound commercial banking core. Senior executives will still have a legal obligation not only to maximise profits but to know what's going on across the entire group. The Vickers proposals also depend too much on sophisticated regulation which assumes regulators will always be one step ahead of bankers." I think the argument of that particular correspondent is for complete separation.

Sir John Vickers: I would refer back to some of the things I have said already and add one or two further points. I certainly used to think of Chinese walls mostly in the context of information flows between parts of a bank or financial institution. Do the dealers know what the investment bankers are up to? In the context of information flows there are well-known issues about forms of separation. I suggest that what we are talking about here is rather different in kind. While not wishing to play down the policing of the boundary and risks around that, I would say that the package of measures—the ring-fence design, the legal context, the independence of the directors, the duties on the directors, the regulatory context and the disclosure requirements—together create a strong boundary and there would be a distinct ethos and culture on either side of that fence. Some of the points made by that commentator would arise just as much under full separation. Full separation does not do away with these difficulties.

Q314 Lord Skidelsky: I have one other question that is a little different and it is about the time scale of implementation. In evidence to the Treasury Select Committee you suggested that an earlier implementation date such as 2014 would result in short-term negative impacts on the industry. In the ICB report you say that implementation should be completed at the latest by 2019 and that early resolution of policy uncertainty would be best. In your view should the Government commit themselves to a more ambitious time scale? I can see a potential issue about recovery versus reform. In terms of reform, you want to get these larger capital requirements in as soon as possible, but as to recovery you want the banks to lend as much as possible. How do you view that sequencing problem? I would call it recovery and reform.

Sir John Vickers: I agree that that is the heart of the dilemma. We saw our task as being to make recommendations for the medium and longer term. There were two main reasons we went for the end date of 1 January 2019. One is that the Basel III agreement has that as the date. Our recommendations go significantly beyond what Basel III requires. Our recommendations would require banks to do more than baseline Basel III would require. We certainly did not think that that factor argued for an even later date than 2019, but it did create some difficulty in going for an earlier date. The second reason was exactly the one you state, which is that the current fragile state of the macro-economic recovery in the UK and globally would make hazardous a rapid acceleration of the timetable, trying to get it all in place within, say, three years. We were comfortable with stating the beginning of 2019 as the end date for the financial stability measures in here. The competition measures are on a different timetable according to our recommendations. Personally, I would be happier if the Basel date were a little earlier, but it would have seemed arbitrary for us to say 1 July 2017 or some such, given that the international agreement has already put up that end date.

Q315 Lord Skidelsky: Are you not worried about the emasculation of the proposals the longer the wait in the improbable event that we recover fully in the next four or five years and people say, “Well, what’s the problem? Here we are; there’s no longer any pressure”?

Sir John Vickers: At one of our early meetings we spent no more than one minute on whether we should state a slightly more hawkish view than our true view so that after emasculation things would end up where we truly wanted them. We thought that was dishonest for one thing, so we have stated our view exactly as we saw it. It is for government and Parliament to resist emasculation or watering down if they see fit in the policy making and legislative process. It will then be for the regulatory authorities, if Parliament does enact measures of this kind, for the further future. It is a risk. One sees evidence of lobbying activity in a variety of jurisdictions on these fronts, and it is very important both within the UK and in the wider international community that there is strong resistance to watering down such things internationally as the Basel III requirements. Indeed, we think there is a strong case for strengthening, not weakening, those international requirements on matters such as capital requirements.

Q316 Lord McFall of Alcluith: I recognise your phrase “wonderfully united” in the context of your commission’s unanimous report. I used to hear that quite regularly, but there is a lot underneath on that issue. On the psychology of the market and companies and the herd mentality, did you consider reputational risk here? Is there a case for saying that with full separation there is less likelihood of reputational damage because if there is an entity then the strong part will step in to rescue the weak part?

Sir John Vickers: We did, and in a sense that is the problem of contagion. If international part of bank x is in trouble, would that jeopardise the UK retail entity? It would be foolish to say that that risk is zero. It exists. The other side of it is the point you covered earlier about circumstances where retail is in trouble and rest of bank can bring resources to see it through those problems. There are ways to seek to mitigate that risk, and we would argue that a number of the proposed measures do that. It is not just the bigger self-standing equity capital cushion, at least 10% in the case of the large ring-fenced banks on our recommendations; it is the further loss-absorbing debt, which might take the form of contingent capital, beyond that getting us to at least 17% of risk-weighted assets; and, beyond that, if a bank is judged by a regulator not to be resolvable, a further 3% capital or loss-absorbing requirement, or possibly pure equity. There is also the point about the insured depositor preference. One of the contagion risks is that queues form, as with Northern Rock; people wanting to pull out their money. If you have much greater loss absorbency and ordinary depositors and the insurance scheme backing them are nowhere near the front of the queue—indeed, they are at the back of the queue of taking losses—that is a lot of mitigation of the risk you describe, but I agree it does not disappear altogether. I agree.

Q317 Lord McFall of Alcluith: Looking at the crisis in the past few years, two issues came to the fore: the lack of corporate governance on boards and the attitude to risk. For example, in HBOS it was excessive risk; in the case of RBS it was lack of corporate governance. Quite a bit of the evidence taken by the Treasury Committee indicated that it was very hard to measure risk. Professor Charles Goodhart, who was here on Tuesday, said it was almost impossible to measure risk. Professor John Kay, who was also here, said he had been teaching it for 25 years at Oxford but threw his lecture notes into the bin just before he came before the Committee. How do we ensure that we make risk more transparent to companies and the regulator themselves so they know they are measuring it?

Sir John Vickers: I am very sympathetic to the thrust of that question and would say a few things in response. To repeat an earlier point, the supposed risk weights did no such thing. As leverage was rising from the ’20s through the ’30s and ’40s the average risk weight, in almost a perfect mirror image, was declining. We see it again in a very different context with eurozone sovereign debt. It is perfectly plain for everyone to see that the risk weights do not properly reflect the risk. Part of the Basel III process is to improve the risk weights. Any improvement is to be welcomed, though it is certainly not an improvement to a state of perfection.

One of our recommendations I have not mentioned this morning is about aggregate leverage; that is, the ratio of balance sheet to equity capital unweighted for risk. In the Basel III proposals a leverage ratio of 3%—in other words, a factor of 33—is part of the agreement. We think it is very important to have a leverage backstop of that kind precisely because of the difficulties of risk-weighting, and that for the large ring-fenced banks, which on our recommendations have a higher than Basel III capital requirement, the leverage backstop ratio should be moved pro rata. I find it a bit curious that in the Basel proposals I have seen the globally systemically important banks do not have a tightening of that leverage ratio in line with the proposed higher capital requirements on them. Normally, if risk weights are doing their job I doubt that leverage backstop would be a binding constraint on institutions. If I was a regulator and it started to be a binding constraint, I would worry whether the risk weights were doing their job. I think it can be informative about the very point you make.

A final response would be that the problems you cite are even worse when the providers of finance to banks are not themselves bearing the downside risks. When you get them into a place where they are bearing the downside risks they have much greater incentives to monitor these things themselves.

Q318 Lord McFall of Alcluith: At the last general election a report came out from the Future of Banking Commission on which I, David Davis, Vince Cable and Clare Spottiswoode served. We focused on the issue of culture, being behaviour, ethics and the resolution of conflicts of interest. Is that an issue that should be on the agenda, because there was not much reference to it in your report? Should it be a permanent feature of the agenda going forward?

Sir John Vickers: It is certainly a very important set of issues. It seems to me quite difficult to regulate directly. However, a number of indirect influences can be brought to bear. We would say that the ring-fenced architecture, the governance arrangements that go with it, the directors' duties and the point just mentioned about providers of finance and risk should all be helpful in this regard. Another point which has not yet been mentioned explicitly—but why not?—is the whole question of remuneration and the very understandable public anger around it. I believe it has been particularly acute in a context where the taxpayer and public finances have been bearing that risk. While getting the risk away from the public finances would not solve all remuneration problems, it would be a pretty important step towards addressing them, along with other measures and regulations which `1directly bear on that.

Q319 David Mowat: Your report sets out quite a lot of onerous requirements for these ring fences to work. What is in it for a composite bank to have a ring-fenced subsidiary if that ring fence is working properly?

Sir John Vickers: I hope that the recommendations are proportionate, and they are certainly intended to be. If a scheme of this kind were adopted then UK banks and non-EEA banks doing retail banking in the UK would have to operate in a ring-fenced setting. If they are not doing activities of the kind disallowed from being in a ring-fenced bank that would not touch on their corporate structure. I think one of the advantages of the flexible fence is that, compared with drawing a sharp, immovable line, there will be a number of institutions which will not have a line through them because they can situate themselves on one side or another. In line with Baroness Wheatcroft's earlier question, they might say to themselves, "Given all this, we'll separate ourselves and float off the retail or wholesale investment banking bit." That would be a matter for them, and that would be fine. I do not think it should be a public policy concern if they made that choice.

Q320 David Mowat: I think that is true. My concern is that perhaps one of the reasons the banks are more sanguine about the ring fence than we expected is that they think they can get round it in a way that takes away the efficacy of the reform. It is almost a Catch-22 situation. If the ring fence works the banks will not want to do it, i.e. they will split because there is no purpose in a composite bank having a properly ring-fenced retail organisation in terms of cost of capital and all sorts of things.

Sir John Vickers: Of course, they would disagree with the statement that there is no purpose in composite banking. We have talked about the one-stop shopping point, which may or may not be material in the scheme of things. Some have argued publicly, and very much to us in hearings, that there are capital and liquidity synergy benefits in universal banking. As I indicated, we were a bit frustrated at not having more quantitative evidence on how great those benefits would be. If they are small it is more likely that banks would make the choice to separate themselves if the fence operates as intended. There is perhaps a note of scepticism in your question about how well the fence would operate. We believe that what is proposed here would be a strong fence and that would deal with half of your question.

Q321 David Mowat: But if there is a liquidity benefit in a composite bank having a ring-fenced retail outlet, it almost implies that it is not ring-fenced in the way your report talks about it as being almost like a third-party entity with arm's length transactions and all that go with it?

Sir John Vickers: Not quite, because there would be freedoms. In a way, I find it easier to think about the capital side. Subject to the various parts of the banking group maintaining required capital ratios, there would be freedom for capital to move around the group and at least in principle there could be a risk diversification benefit in that. It is not the case that risks hit in a perfectly correlated way. It is an entirely coherent argument that there are capital synergies of that kind and corresponding liquidity synergies. The hard question on which we did not reach a satisfactory conclusion is quite how large those benefits are, which was the point I mentioned earlier.

Q322 David Mowat: The implication of ring-fencing as a structure is that we would accept that the non-ring-fenced parts should go bust. Can you really imagine a scenario in which several investment banks were able to go bust without it causing retail issues, even in a ring-fenced environment?

Sir John Vickers: It would depend on the nature of the crisis. There may be some situations where the investment bank going down would pose no threat to the retail side. There are other crises one can imagine where because of the surrounding circumstances there would be some jeopardy to the retail side. Ring-fencing would gain a huge amount relative to where we were previously in terms of much higher capital and other loss-absorbing capacity on both sides of the fence. With a modular structure banks would be much easier to resolve than the rather hopeless situation beforehand where, on the same banking book, you had high street activities and some quite exotic global things. There would be many greater options available to the authorities to cope with a crisis of that kind. Indeed, the retail banking entities would be able to go under in a way that nevertheless preserved the continuity of the vital everyday service provision that those banks provided. In the US, albeit with much smaller banks than we are talking about here typically, the FDIC routinely winds up banks yet ensures that the service provision, which is what the customer cares about, is able to carry on.

Q323 Chairman: I would like to clarify a slight element of ambiguity, or maybe even misunderstanding on my part, about your report. One of the primary aims is to protect the British taxpayer from having to bail out more than necessary and to limit that implicit obligation to UK retail banking.

Sir John Vickers: Yes.

Q324 Chairman: That is achieved both by ring-fencing to reduce the risk of contamination of the retail bank by more risky activities and, within the ring fence, requiring a higher equity capital ratio. Is the equity capital ratio requirement of 10% just limited to UK banks, is it UK banks and their European Economic Area activities or is it the retail activities of any group worldwide?

Sir John Vickers: Before I answer that question, perhaps I may seek to clarify a remark you made earlier. Our aim is not to limit the government guarantee to the retail part but to go further than that and put the taxpayer as remote as possible from losses also in the retail entities, so it is to limit the scope in various ways. We hope that the circumstances in which the taxpayer would be called upon to rescue activities within the fence would be much rarer and smaller in scope than we have seen in the past. As to the scope of the 10%-plus equity capital requirement, that would be for the ring-fenced entity.

Q325 Chairman: Is that the ring-fenced UK activities?

Sir John Vickers: Yes. A simple setting would be that a UK subsidiary but the scope of those activities would be partly a choice of the bank and the customers. You would have to have current accounts and overdrafts for individuals and SMEs; they would have to be within the ring-fenced entity, and there would be various kinds of other deposit and lending to non-financial corporates which could go beyond the UK, partly for reasons of EU law. The scope of that is cast in terms of EEA, not UK, so it would be whatever the ring-fenced entity is doing. The scope of its activities would have applied to it the 10%-plus capital requirement.

Q326 Chairman: But there would be no obligation on an international bank headquartered in the UK to have the 10%-plus equity capital requirement for a retail subsidiary in New York, China or Africa?

Sir John Vickers: No. Maybe all its activities are not of a kind within the UK retail ring fence, and then it would be either the regulatory requirements in the other jurisdictions or the international requirements. We see an advantage in the ring-fence design as well as the insulation and resolvability advantages. It enables one to have higher capital requirements domestically than apply internationally, and in our view for reasons of competitiveness in the international banking business that architecture has merit.

Q327 Chairman: The second element of my clarification is that the wider capital requirements apply to the whole group, so the 17% to 20% of loss-absorbing capacity?

Sir John Vickers: The primary loss-absorbing capacity.

Q328 Chairman: That applies to the activities of the whole group, if the group is headquartered in the UK?

Sir John Vickers: Yes. When I said just now and in our interim and final reports that international capital standards could apply to the international activities of the banks, i.e. those outside the ring fence, that was always subject to the explicit proviso that the bank should be sufficiently resolvable that the UK taxpayer is not on the hook for the external activities. We regard the primary loss-absorbing capacity, which could take the form of equity, contingent capital and debt with at least a year to run that is subject to a statutory bail-in power, as an essential part of credible resolvability. Therefore, those requirements would indeed apply. One can readily think of UK high street banks doing international activities that would not have the 10%-plus equity capital requirement for their activities outside the fence but would need credible resolvability, including primary loss-absorbing capacity of that kind, for the major banks.

Q329 Chairman: Have you considered whether that creates an incentive for large banks to move their headquarters outside the UK while retaining all their current activities in the UK so that they have only the 10% requirement for UK retail, plus presumably 17% to 20% for UK activities generally? They would not be required to have capital adequacy higher than international standards for all their other international activities, but they would just have to have what was required wherever those activities were, or their headquarters were located?

Sir John Vickers: Perhaps there are two aspects to that question. A question we spent a lot of time considering is whether in theory a bank could evade measures of this kind by moving elsewhere in the European Economic Area and run UK retail operations from headquarters elsewhere in the EEA. I say "the EEA" because of the passporting rules. Moving headquarters to New York would not be a way of avoiding these recommendations, if they were adopted.

Q330 Chairman: But, surely, it would be a way of escaping the 17% to 20% on their global activities outside the UK?

Sir John Vickers: Yes. I was coming to that. I was starting with the very closely related question about avoiding the retail requirements. On that our conclusion was that the incentive to make such a move was pretty limited, especially in the context of retail banking where a few basis points here or there are not going to cause activities to whoosh one way or the other. The UK high street is where it is. In addition, a bank would have to confront formidable legal and major reputational and operational costs in making the kind of move I have just described. We do not think that our proposals give rise to the risk of that kind of geographical arbitrage.

As to your question about a bank trying to minimise the extent to which its activities are subject to the requirements that go with ring-fencing—the 10% and so on—in our scheme they would have a degree of flexibility. They would have to conduct the mandated services—current accounts for individuals and small businesses—within the fence, but they would have a choice about operating other activities outside the ring-fenced entity. As to going up to 17% to 20%, we do not believe that the costs of that to the banks are very great. We doubt that the incentive for that kind of arbitrage would be a very strong one. We were very conscious of the international market and regulatory surroundings of any UK proposals, so we factored that very much into our analysis.

Q331 Lord Maples: I want to follow up the previous question asked by Mr Lilley. Your answer was about the resolvability of investment banks. One of the issues here with investment banks is not so much the depositors and their confidence in the whole system, which obviously is relevant to retail banks, but the incredible web of counterparty risks that most investment banks have built up. If you let one go under you risk dragging the rest with it. Do you think the lesson of Lehman Brothers was that that is an overwhelming reason why we should have saved them, or that allowing them to fail has demonstrated that those counterparty risks are not an overwhelming reason for saving a bank?

Sir John Vickers: There are many lessons from Lehman Brothers. I should mention other regulatory initiatives going on internationally which go some way to addressing those issues. In our report we said very little about the moves towards central counterparties and central clearing of some of these derivative contracts. Instead of this great multifaceted web, if things are channelled through central points that can locate risks in a particularly dangerous place, it simplifies the monitoring of a number of these things. Another point is that in our ring-fence design we seek to provide a degree of insulation from that kind of complexity and the risk that goes with it through to the more simple, ordinary, traditional retail banking activities. Another point is to do with the wholesale markets and the term of funding there. When doubts start to arise about counterparties and all the rest we saw how rapidly that could seize up. Another topic on which we did not say a lot is liquidity regulation, partly because so much is being done on other regulatory fronts. That also goes to the point about dealing with those risks.

Q332 Lord Maples: Are you reasonably sanguine about the possibility in future of letting an investment bank go into resolution, whether that means administration or liquidation?

Sir John Vickers: At this point I would not be sanguine, no, because despite the measures just mentioned the question of international resolution has not reached an adequate resting point. In the Basel process with the Financial Stability Board and so on the question of international resolvability of these geographically complex institutions is an extremely important one on the agenda. It is not the only very important item of work in progress internationally, but one could not be at all sanguine at least until that point is satisfactorily dealt with.

Q333 Mr Brown: The European Union's regulatory architecture, rather obviously, provides minimum requirements. From what we have been told at previous hearings, I have started to form the impression that those in charge of these things intend them to be a maximum as well, yet you are describing a United Kingdom regulatory regime that in some respects, for example capital requirements, goes further than the European Union's minimum requirements. I would just like to get your understanding of how far it is possible for the United Kingdom regime to do that, how far we can require the consent or acquiescence of our partners in the European Union, and whether you think that might be an obstacle to doing what you are recommending to us?

Sir John Vickers: We did look at that, particularly after the publication in July of the European Commission's draft directive CRD IV, which is the latest in the series of capital requirements directives. That is in a form which in principle applies maximum as well as minimum harmonisation, so it is a kind of uniformity across the Community. In the report our unanimous view is that that is not a wise approach. The problems are of a race to the bottom, not a race to the top and that, in line with what the Basel process and IMF have said in their comments on the financial regime in the UK, a much more sensible international approach is to have minimum standards above which jurisdictions can go. If they do go above they are doing a favour to other countries, not the opposite. That is our position of principle.

There is, however, the practical question: if the Commission's proposal were enacted in exactly its current form—there is a long way to go because of parliamentary and ministerial deliberations within the European processes—to what extent would that constrain capital or liquidity requirements? That is another one where this question arises. On that, the indications are mixed. There is some scope in the proposal as drafted for different member states to do different things if their circumstances are judged to warrant that. It is true that in the UK we have banks whose balance sheets collectively are a very significant multiple of GDP. Some of those balance sheets individually are an order of magnitude similar to GDP. Therefore, entirely consistent with European Commission logic, there may well be scope for flexibility in that regard, but it is mixed. Just looking at the face of the draft proposal, it is not immediately clear what the answer is.

There was a letter from the director-general of that part of the Commission which deals with these issues published in the *Financial Times*. That indicated there would be very significant scope for variation of the kind I have just mentioned, but these things remain to be seen. We certainly do not draw back from our point of principle that we regard maximum harmonisation as just wrong from an economic and policy point of view.

The other point I might mention which is of some relevant is the Basel proposals on the so-called globally systemically important banks. For the largest in that category, which includes some of the largest UK banks, there would be an equity requirement of 9.5%, which is obviously very close to 10%. Therefore, the degree of difference in relation to those banks is not so great. There are, however, some banks which are nationally systemically important but are not globally at the high end of systemic importance. My view on that is that the whole logic of the Basel approach to globally systemically important banks needs to be applied nationally as well. It is entirely consistent with that logic, almost driven by it, to have higher than baseline requirements at national level, too.

Q334 Mr Brown: Where do you believe authority ultimately lies when this question has to be resolved?

Sir John Vickers: That would take me well beyond things I know about in the area of European law and policy. I assume it is an EU treaty obligation to comply with European law, so if a regulation goes through the European processes, which applies to the UK, then the UK like any other Member State must operate within it. There may well be scope—who knows?—for at least some of these measures.

Q335 Mr Brown: But do you think that includes not going beyond it? There is no question of not complying with it.

Sir John Vickers: Just as an abstract point which is well away from our context, if European law says that a Member State may not do a certain thing I imagine that it may not do that thing. As to the economic logic of this, I go back to my example of pollution. If a European regulation said that Members States must keep their pollution down to this level and also up to that level people would rightly laugh.

Q336 Baroness Drake: I think the reference in the *Financial Times* was to M Barnier's comment that there is flexibility. We have had the advantage of talking to Mr Enria, chairman of the European Banking Authority. His evidence was that if you want to move from the minimum capital requirements, as in the rule book, there will be a process and an evidential burden that will have to be met to vary from those. One of the concerns he expressed was that national banks would try to improve their financial stability and liquidity at the cost of other countries within the single market. If that is the view he articulates, how do you feel it sits with being able to argue the case for the UK implementing the standards that you put in your report?

Sir John Vickers: I would not share the phrase "at the cost of". It seems to me that it would be to the benefit of others to have stronger and more resilient UK banks. Then they are less likely to be a source of shocks that might ripple elsewhere in Europe, and a transmitter and amplifier of shocks internationally.

Q337 Baroness Drake: I was not trying to invite you to comment on the merits of your standards but merely ask how, if the UK Government faced that kind of argument in the European context, one manages that view and achieves the standards that you are recommending? There seems to be a tension there with the EU authorities wanting quite a firm evidential burden placed on governments before they move away from those standards.

Chairman: Before they moved above, or even towards the maximum?

Baroness Drake: Yes.

Sir John Vickers: I do not know how great that burden would be. In the reference I made I did not have in mind M Barnier's remarks as quoted in the *FT* but rather a letter subsequently by Jonathan Faull of the directorate-general of which M Barnier is the commissioner. I simply do not know, even under the draft proposal which may of course be amended, how easy or difficult it would be to vary in those ways. If I were the UK in these international fora the point I would make is that it is to the benefit of European partners to have safer UK banks. Far from being in any way antithetical to the interests of other Member States, it is a thoroughly good thing for them, all the more so given the important role that the UK plays in the international financial system. I can see that if someone has a philosophical desire for uniformity for the sake of it that argument might not cut much ice, but that would seem a very odd position to adopt in the first place, and commonsense and economics are in unison on this issue against maximum harmonisation.

Q338 Lord Skidelsky: I ask a slightly more theoretical question. I want to probe your economic philosophy a little bit. Am I right in thinking that your proposal is designed to make less frequent those bursts of excessive credit creation, which in a Hayekian view lie at the origins of crises or collapses, and make banks less likely to over-expand credit? In that context one goes back to a more repressed financial system as it worked in the 1950s and 1960s in the era before big bang and post Glass-Steagall. Is the design of the whole set of these proposals to retain the advantages of stability that once existed within a framework of free capital movements? Is that the way you look at it? Many people do regard the trigger of the crisis as excessive bank lending, and this is perhaps designed to make it more difficult for that to happen.

Sir John Vickers: I certainly agree that ICR proposals, along with other measures—we have not talked about macro-prudential regulation, which would be another part of it—are designed, among other things, to curb excessive lending. I and, I believe, my colleagues have not thought about it in the philosophical or Hayekian terms that you described earlier in the question. If I may put in simple terms how I have thought about some of these questions, clearly we had grossly excessive leverage before the crisis. Moreover, it turned out that a lot of the debt which should have borne loss did not. It would bear loss only in insolvency which was too horrible a place for governments to let these institutions get to. We had a thin layer of equity capital and a very brittle debt structure. Ordinary market forces—I do not intend to sound Austrian at all—do not operate properly in that environment, particularly when everyone has worked out that that is the environment in which we now live. It would be a very hazardous way to run a market economic system to continue to tolerate such thin layers of equity capital and brittle debt structure. To move over a period of years to a system where there is a much greater equity cushion, where some debt can do its loss-absorbing job and where the providers of funding, who are best able to monitor the risks that banks are taking, have financial incentives aligned with that, that is the place to try to get to. The other side of that coin is the taxpayer getting very remote from all these activities. That is not exactly philosophical, but in very broad terms that is how I would describe it.

Lord Skidelsky: Actually, I am a philosopher of the market system.

Sir John Vickers: From you, Lord Skidelsky, I take that as a compliment.

Q339 Lord Maples: Just to reassure you, "Austrian" is not a term of abuse to some of us.

Sir John Vickers: I meant it neutrally.

Q340 Baroness Wheatcroft: You have been very eloquent in explaining the merits of the system that you propose. I understand that the Basel timetable has influenced your thinking, even though you feel it is a little long winded. Without racing ahead of Basel on capital requirements, do you think there would be any merit in making the structural changes sooner?

Sir John Vickers: Quite possibly. We did speak about the Basel date at the latest. I should add that part of the ring-fence design is precisely to do with capital and loss-absorbing debt requirements, so it is not an altogether separable issue. But it would be entirely consistent with our recommendations for government and/or Parliament and/or the regulator to say that the subsidiarisation part has to be in place by, say, 2017 and the full population of the capital bucket could take a little longer. That would be perfectly coherent and consistent with what you have said.

Q341 Baroness Wheatcroft: Did you consider how quickly it might be possible to do it?

Sir John Vickers: We did not spend a great deal of time thinking about that, in part because we were hesitant to say more about the legislative timetable than to express the hope that it happened within the current Parliament, which takes us up to the spring of 2015. We did not think it was our place to do that. I should not go further than to say that a 2017 date for the structural component would be consistent with what we said, but we did not draw wall charts with such timing on it.

Q342 Baroness Wheatcroft: Related to the timing, your commission has now been disbanded?

Sir John Vickers: Decommissioned.

Q343 Baroness Wheatcroft: You have been good enough to come and give the House some of your time. You were before the Treasury Committee earlier this week. Do you see yourself having any continuing role to ensure that something is done as a result of your work?

Sir John Vickers: Not to ensure something is done; that would not be our role. I am sure that all of the commissioners will remain very interested in this topic. One has frequent opportunities to write in a well-read organ about these matters. Of course, he was muzzled on these questions for 15 months. I refer to Martin Wolf. I will certainly continue to take an interest but would not intend to hover frowning if less than all of this was done. I am very glad that we as a group have concluded our business on this.

Q344 Baroness Wheatcroft: Can you say something about the role of auditors and bank accounts in taking us into the situation we found ourselves in? Nobody, regulators or auditors, comes out of the situation looking particularly good, but do you think something should be done to change the role that auditors play to some extent in supervising banks?

Sir John Vickers: It is not a topic that I have thought about in any detail. The role of auditors in the context of ring-fencing would be another imperfect but additional safeguard to the other points discussed in response to Lord Maples's question. Linked to that are the public disclosure requirements with which we believe ring-fenced banks should have to comply.

Q345 Baroness Wheatcroft: You talked about risk earlier. There is quite a widespread view that the auditors were lax in flagging up the risks that banks were taking. Would that be your view?

Sir John Vickers: That strikes me as a very plausible view. I have not seen direct evidence that would allow me to be definitive on that.

Q346 Lord Maples: On the point about auditors, is the issue not so much that they did not flag up the risks but that they did not insist on write-downs in values of impaired debt and impaired assets?

Sir John Vickers: There are other initiatives in parallel with, but beyond the scope of, what we were doing about accounting standards in this area, too.

Q347 Lord McFall of Alcluith: Should auditors go back to the old principle that they should attest that the accounts represent a true, fair and comprehensive statement of the affairs of the company?

Sir John Vickers: Is that not the standard?

Lord McFall of Alcluith: No.

Sir John Vickers: Again, I have no expertise or standing on that question, but yes.

Q348 Lord McFall of Alcluith: If the FSA had followed this regulation, then auditors would be at the centre of a company's business model. The FSA did not look at the company's business model before but now look at it. Given that element of independence, the Treasury Committee previously said there should be a link between auditors and the FSA so there is a true and fair assessment of the company, because they know the company inside and out.

Sir John Vickers: My instinctive response would be very sympathetic to that, but I do not know enough. I apologise.

Q349 Lord McFall of Alcluith: If I may follow up the 2019 time scale, there are two issues here: first, political impetus and the 24-hour news cycle. Today's news is stale in a few months' time. Secondly, there is a war of attrition by the banks and lobbyists on politicians. Do you have one piece of advice for us as parliamentarians on how we lock in your reports? Do you have one real message for us as you leave hoping that these recommendations will be implemented?

Sir John Vickers: We certainly hope that they will be implemented. I repeat that we have not pitched our recommendations more hawkishly than we think right, and we very much hope that the legislative process and the ensuing regulatory process would absolutely hold its nerve against whatever pressures may arise.

Your point about impetus is an important one. It would be highly desirable if in the first instance government could give early clarity about its position in a way that was absolutely clear to the marketplace. The market can then start doing its job ahead of the regulatory timetable. With Moody's downgrades last week and the reasons given for them, we see that there can be benign developments in the marketplace once the market is convinced that things are going to happen. That can accelerate the market timetable relative to the official timetable in a healthy way.

Q350 Chairman: On the timetable, you envisage quite a substantial increase in the capital of the banks over the next seven years. Do you expect that to come from rights issues, retained earnings, suspending dividends for a significant period, increasing the margin on lending, or shrinking their balance sheets?

Sir John Vickers: We believe that can be done given the time scales without a form of deleveraging that would be detrimental to the real economy, to use that phrase. It is very instructive that over the last 25 years by far the greatest growth in bank lending has been within the financial sector rather than to households and non-finance businesses. Even though those two other segments have grown, the rapid growth and enormous rise in leverage pre-crisis was in lending within the financial system.

As to where the capital and debt is to come from, given where the banks are now with their equity ratios the move to 10% over a period of seven and a bit years is not a very steep path. Through some fresh raising of capital but also the scope within retained earnings—possibly beyond equity capital—there may be things about deferred remuneration, that transition path would seem very much achievable. As to non-equity, other possible components of primary loss-absorbing capacity could be debt subject to bail-in powers, contingent capital and other forms of capital. There are different ways in which banks could achieve those requirements. Most of the main banks already have unsecured debt of the appropriate maturity. What is less clear at the moment is how truly loss-absorbing that debt would be if push came to shove, and with a statutory bail-in power that would be a major enhancement of the credibility of that debt-bearing loss. This could happen in various ways. It might depend on market appetite for contingent capital, bail-in debt and all the rest, and it is hard to foresee exactly which path would be taken. Maybe different institutions would take different paths.

Chairman: Sir John, thank you very much indeed. We are extremely grateful to you for your very lucid, coherent and clear evidence. I also congratulate you on your report. Whether one agrees with its recommendations, I think everybody would agree it is a beautifully written and coherent report, and I hope that ours will be at least somewhere on that scale when we finally report at the end of our deliberations. You deserve your decommissioning in a most positive way.