

HOUSE OF LORDS
HOUSE OF COMMONS
ORAL EVIDENCE
TAKEN BEFORE THE
JOINT COMMITTEE ON THE DRAFT FINANCIAL SERVICES BILL

THURSDAY 3 NOVEMBER 2011

SIR MERVYN KING, PAUL TUCKER and ANDREW BAILEY

Evidence heard in Public

Questions 762 - 847

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Oral Evidence

Taken before the Joint Committee on the Draft Financial Services Bill

on Thursday 3 November 2011

Members present:

Mr Peter Lilley (Chairman)

Mr Nicholas Brown

Baroness Drake

Mr David Laws

Lord McFall of Alcluith

David Mowat

Mr George Mudie

Lord Newby

Mr David Ruffley

Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Sir Mervyn King**, Governor of the Bank of England, **Paul Tucker**, Deputy Governor (Financial Stability) of the Bank of England, and **Andrew Bailey**, Deputy Chief Executive-designate of the Prudential Regulation Authority, examined.

Chairman: Good morning, gentlemen. We are extremely grateful to you for coming and agreeing to appear before the Committee and to help us in our consideration of the Financial Services Bill. Thank you for getting us off to a prompt and early start. We would like to begin questioning with Mr Mowat.

Q762 David Mowat: My first question is about the ICB recommendations on the ring fence. Earlier this week we had a session with leaders of the main banks. They seemed to accept the recommendations, or at least were prepared to implement them, or intended to implement them. Is your judgment that the ICB got it about right?

Sir Mervyn King: It is a difficult and complex business. Each person will be tempted to move more or less in that direction. I am broadly comfortable with where they are. It is a very good report. The Government created a commission of outstanding individuals, and it would be unwise to go against their recommendations. They thought it through very carefully. I would recommend that you implement this as soon as possible.

Q763 David Mowat: Have you given any thought to how you would regulate the ring fence?

Sir Mervyn King: The one point that occurs to all those who might be in the regulatory community, depending upon whether the Bill is passed, is: to what extent should the definition of the ring fence be a role for the regulator, as opposed to a role for Parliament in setting out the legislation? Our strong view is that as far as possible this should be done in legislation and not left to the regulator. I say that because the difficulty that will arise with this

approach is that the banks and their lawyers will have enormous amounts of money, time and resources to come up with all kinds of clever ways to try to get round the rules set out in legislation. Unless those rules are pretty clear the regulator will be chasing the banks round in a circle and will come under enormous pressure.

One of the major problems in regulation in the last 10 to 20 years has been that of regulatory capture. By that I do not mean people were bought off but that the sheer weight of resources, time and legal effort put in by banks to try to persuade regulators that what they were doing was compliant with the rules made life extraordinarily difficult for the regulators. I would suggest that, as far as possible, you take the ring-fencing aspect of the Vickers Commission proposals in a separate Bill and make sure those are got right in the process of legislation.

Q764 David Mowat: Your view is to be as prescriptive as possible in setting out how the ring fence would work, which gives less wriggle room, if you like, in how it might be implemented?

Sir Mervyn King: Yes, absolutely. One has to be clear about the principles behind it. There would be things that might have to be left to the judgment of the regulator, but there cannot be any confusion about the principles upon which the regulator has to act down the road. As little as possible should be left to the regulator. They will already have an enormous job in making judgments about the riskiness of the balance sheets of banks. I would rather the efforts and resources of the PRA be devoted to judging the risks which banks are taking on their balance sheets than a perpetual legal game of trying to define the ring fence.

Q765 David Mowat: If a ring fence works properly in the way you are suggesting, in terms of it being that prescriptive, what is in it for the composite banks to have a retail subsidiary that is so separate? Is it additive to shareholder value to do that?

Sir Mervyn King: You make money out of having happy customers, not unhappy customers. That is normally the way one does it.

Q766 David Mowat: Is there anything else that you would have liked to see in the ICB report?

Sir Mervyn King: They have examined this in great detail. We talked to them about it. This is now the only game in town. The banks have said they are prepared to accept and implement this. I don't think there is any merit in reopening this, so we should go ahead and implement it.

Q767 David Mowat: If I may move on to Europe, we have had evidence from a number of people who have said that the principal issue in terms of regulation is not necessarily structure but people and how they exercise judgment, and all that goes with that. Therefore, within reason most structures could be made to work effectively, and yet the twin-peak structure that we are putting in place is quite different from the European structure that overrides it in terms of the sectoral versus matrix approach to it. Do you see that being a problem, or is it something we can work with?

Sir Mervyn King: No. The reason we want to move towards a twin-peak approach is precisely to deal with the point made in your first sentence, which is that it is a question of judgment and culture, not structure. I was in favour of the 1997 reforms, but I came to see that it proved extraordinarily difficult to enable the regulators to make judgments in the field of prudential regulation when the same people were being asked to carry out conduct of business, enforcement and consumer protection regulation, which by its nature has to be rule-

based, is highly legalistic and will appear to be rather bureaucratic. It is very important to get away from that when it comes to prudential regulation.

As to prudential regulation, the reason it has become so legalistic and bureaucratic—it matters that we avoid this—is not because of the FSA but the firms themselves. Their lawyers will tell them that, provided they cannot find a specific rule that prohibits an activity, they can go ahead and do it. That stops the firms themselves thinking, “Is this taking too much risk on the balance sheet? Is it an activity in which we ought to be involved at all?” The judgments which ought to be made about the ethics, ethos and the culture of the bank itself tend to get undermined when you end up with a game in which the regulators are continuously rewriting the rules because at the same moment the firms are devising new products to get round the detailed legal rules which were in place before in order to avoid the spirit of regulation.

I give two examples of where we think it will be important for regulators to exercise judgment and why we need to make a break from the style of regulation we have seen in the past. One is that I would like Andrew and his colleagues to be able to say to a bank—this is a hypothetical example but is clearly relevant to what happened before the crisis—“Your leverage has gone up from 20 to one to 40 to one in the past four or five years. You have not broken any rules. Nevertheless, this is a highly risky set of activities to undertake, and we want you to reduce your leverage.” The only way that regulation can have an effect is if the regulators have the freedom to impose their judgment and not base it purely on a myriad of detailed rules.

Another example would be to say to a bank, “The structure of your bank is so complex and opaque, with so many offshore and onshore legal entities, that we don’t understand the risks you are taking. We are not entirely confident that you do either, but certainly outside investments cannot assess it. We think that degree of opacity is inconsistent with a sensible and stable contribution to financial stability.” These institutions are operating not only for themselves; they are big enough to affect the economy of the whole country. Therefore, the regulator has to be free to make a judgment about that degree of opacity, even though nothing is done that could be said to violate a specific detailed rule. That degree of judgment is vital. The choice is yours. If you want to stay with a highly legalistic and bureaucratic regime for regulation, which many of the institutions would prefer, please do not give it to us. We would not want to take on that responsibility. If you want judgment to be exercised, we are prepared to take it on.

Q768 David Mowat: For the avoidance of doubt, you don’t see a conflict between the ESA structure that the Europeans are developing and the twin-peak structure that we have?

Sir Mervyn King: I don’t think so. We are the only country in Europe to have a Financial Policy Committee which has a direct parallel at the European level in terms of the European Systemic Risk Board, so in that area we are much closer to Europe than other countries. Broadly, all countries recognise that they have different structures to deal with banking and insurance regulation. For a long time we were out of kilter with the majority in taking this away from the central bank. I don’t have a particularly strong argument to say why it has to be in the central bank, but the Prime Minister and Chancellor put to me reasons why they wanted it in the central bank. After the experience of the past four years I thought they were pretty compelling reasons. It makes sense to go down the road which the Bill proposes, but the choice is yours.

Q769 David Mowat: My final question is about the Capital Requirements Directive and the way we co-ordinate with Europe on that. At one time it looked as though it might

make it difficult for us to impose higher capital requirements on our institutions than the Europeans would find acceptable.

Sir Mervyn King: It is still a problem. The Commission's current proposals still want to impose maximum harmonisation. I am completely baffled as to why they want to do it. I can think of no logical or economic reason why you would want to have maximum harmonisation, other than a theology of convergence for the sake of it. But the whole spirit of the agreement under Basel I, II and III was to have a level playing field in terms of common minimum requirements. No one could conceive of any reason why you would object to a country wanting to impose higher requirements, for example to protect their taxpayers. At the European Systemic Risk Board the vast majority of the people round the table were equally baffled as to why there was a case for maximum harmonisation, and I believe that an increasing number of governments in Europe will come to the same view. This is a problem.

The Commission takes the view that some of the things we want to achieve by implementation of the proposals of the Vickers Commission, or macro-prudential regulation through the Financial Policy Committee of the Bank, could be done through what is known as pillar 2 of the capital requirement. Again, that seems rather bizarre to us, because it is clear from the legal basis of pillar 2 that this is for individual institutions, but clearly that is not macro-prudential. Macro-prudential is something that applies to all banks, and that is naturally pillar 1. I cannot see any reason why anyone should object to a country using pillar 1 to have higher capital requirements. I absolutely agree there need to be common minimum capital requirements, and it is good that Europe is now taking this through the European Parliament to get European legislation. We are ahead of other countries in this respect, but I am completely baffled as to why they see any need or reason for having maximum harmonisation.

Q770 Baroness Drake: To stay with that point, we have seen Mr Enria. His evidence to us prompted your letter to Mr Lilley in which you clearly expressed your concerns about the approach to maximum harmonised regulation. To put the blunt question, in your view does the directive as currently drafted give the UK sufficient discretion on a comprehensive range of tools?

Sir Mervyn King: No, but it has not gone through. This is now a proposal by the Commission.

Q771 Baroness Drake: How confident are you that we can alter this?

Sir Mervyn King: There will be a period of almost 12 months during which this will be debated before Heads of Government decide in the end what the legislation will say, so there is all to play for, but the current proposals by the Commission, for reasons I do not understand, rule out things which most people I know in Europe think are eminently sensible.

Q772 Baroness Drake: How confident are you that those 12 months will lead us to a position that will allow the UK to apply the kind of macro-prudential approach to regulation that it would wish?

Sir Mervyn King: I am not in a good position to answer that, because it will depend on the political negotiations among all the members of the European Union. I know that the Government are very aware of this issue and will be taking it forward, but that is not a judgment for me; it is for you and your parliamentary colleagues.

Q773 Baroness Drake: Is it possible to come up with a definitive set of recommendations on macro-prudential tools before that issue is resolved?

Sir Mervyn King: Yes. At European level the European Systemic Risk Board has proposed a set of amendments to the Commission's proposals that would make our ability to conduct macro-prudential regulation much easier. At the level of the Financial Policy Committee we will be putting to the Government by next spring some suggestions about the instruments that we recommend the Treasury put before you in Parliament to be delegated to the FPC.

Q774 Chairman: When we asked Mr Enria to justify the proposal that there should be a maximum, he put forward a novel explanation. We have subsequently written to him to question him about it, but I would be interested in your observations. He said if one country or individual countries were allowed to set prudential requirements higher than the minimum it could in some way siphon off capital from subsidiaries in other countries to wherever the parent company was domiciled, and that could weaken those other banks.

Sir Mervyn King: No; that is false. There is no fixed lump of capital allocated across a particular group. If supervisors say that more capital is required, the bank can obtain it. I don't think that holds any water at all. To take the example of HSBC in this country, which has not been as involved in some of the problems in Europe, or the subprime mortgage market—it has many activities in Asia—for quite a long time it has had a high capital ratio, often higher than many of its competitors. No one has argued that somehow it is unfair and wrong for HSBC to have a higher capital ratio and therefore it is attracting business because it looks a more sound or strong bank. That is what we want banks to do. It is very peculiar that this argument should be used.

The whole point of Basel, to go right back to the beginning, was that people were worried that in some countries regulators were tempted to lower the minimum capital requirements, to attract business and banking to their shores. The Basel framework is designed to prevent that by having a common playing field to set minimum requirements. What happens above that is something individual banks should decide within a country. We are not going to impose a regulation to say that if a particular bank in Britain wants to have double the capital requirement we should tell it to stop. It is a bit like the idea that children cannot be allowed to play the piano because some are better than others. At one level the whole approach is mad. When we discussed it at the European Systemic Risk Board all the central bank governors round the table raised their eyebrows. They could not understand the economic logic of it. I think the Commission members have got themselves into a position from which, for reasons of theology to a large extent, they find it hard to back off. I very much hope they will reconsider it, because I don't believe that abandoning maximum harmonisation would in any way undermine the single rule book, what they are trying to achieve in Europe, a common European regulatory framework or the role of the ESAs. I cannot understand why this is an argument that people are pursuing at this stage.

Q775 Mr Mudie: In June you came before the Treasury Committee and said that, in relation to the Court, you were content that they were not experts in policy. There is a view that it would be hard, if not impossible, for them to hold the executives to account unless they had a degree of expertise in policy. I understand the view you have expressed that you cannot have them second-guessing the executives, but is there not a middle ground between having no expertise and second-guessing? Is there not a middle ground that should be explored, and what are your views on that?

Sir Mervyn King: There is certainly a middle ground to be explored in terms of the kind of people on it, but it would be a mistake to think that a body like the Court should be the vehicle for holding us accountable for policy. It seems to me that we should be accountable to Parliament and the public for policy decisions of the MPC, FPC and PRA. There is a large

range of vehicles of accountability. As you said on the Treasury Committee, in terms of monetary policy we have a good track record of accountability in that respect. I see the role of the Court as primarily one of saying, "If you have an independent central bank, there has to be some accountability for the use of resources, remuneration and so on." That should not be directly to the Treasury or Government, because that undermines independence, and that is enshrined in European treaties which apply to us. But there has to be a body which will determine the Bank's budget; the remuneration of everyone in the Bank, but particularly the remuneration of senior members of the Bank; and indeed to deal with questions about the procedure of the committees. If any individual member of those committees is unhappy about the resources to which they have access, or about the way the committees are working, they can turn to the Court. Certainly, the individuals on the Court have to be people who are experienced, senior and know something about the issues, but in my view they are not there to say to the MPC, "You made the wrong decision on interest rates"; to the FPC, "You made the wrong decision on capital requirements"; and to the PRA, "You made the wrong judgment on that bank." That is something for the Treasury Select Committee, or whatever is the parliamentary vehicle for accountability. The Federal Reserve and European Central Bank have absolutely nobody like the Court at all. The executives run the bank and on policy they are accountable to their parliaments.

It makes sense to have a body like the Court. It is good practice in the public sector that we do not set our own salaries, that there is transparency about all that and to have a governing body to manage the affairs of the Bank, but it makes no sense to extend that to policy decisions. That is where we should be accountable to Parliament, and it is for you to decide what the right vehicle for that is.

Q776 Mr Mudie: The business of not reviewing policy leads to the current argument between the Chairman of the Treasury Committee and the Court on the release of documents relating to the review of the Bank's actions during Northern Rock in 2007. Was a review conducted, and if so, why are the minutes and full documentation being denied to the Treasury Committee? If you are saying that it is the Treasury Committee and Parliament that must conduct the exercise of accountability, why are these documents being refused?

Sir Mervyn King: There are two separate issues: one is about the minutes, and the other is about reviews. There were several reviews of the Bank's actions and behaviour during the financial crisis. The most important and in-depth one was conducted by you on the Treasury Committee under Lord McFall. It was not just the Northern Rock report; there were several other reports. You had all the information; you asked us questions; it was a challenging process.

Q777 Mr Mudie: This was of you directly in the Treasury Committee?

Sir Mervyn King: Yes, absolutely.

Q778 Mr Mudie: The question that exercised the Committee was that the Court, the governing body, were asked whether they had conducted a review, and they said yes. The Chairman of the Treasury Committee said, "Provide me with all the documentation, including the minutes", and the Court is refusing. Do you think that is proper behaviour by the Court in terms of Parliament being able to exercise accountability?

Sir Mervyn King: It is perfectly reasonable for any body to withhold minutes written and constructed on the basis that they would not be put into the public domain. They contain statements about individual members of the Court. I think these are minutes which were constructed in the knowledge that they would not be publicly revealed. We have put into the public domain the internal reviews of the Bank on its provision of liquidity. This was

presented to the Court and received and approved by them. We published those two reports in our new red books in both January 2008 and October 2008. We completely reviewed what happened. Like every central bank, we changed our method of liquidity provision. We reviewed what went wrong, explained it to the Court and they approved it. This was published in October 2008. There have been reviews and they have been published.

Q779 Mr Mudie: In the last few days a prominent banker has had a breakdown and has been given medical leave for six months because of the pressure of running a bank. In the proposed changes, there is a view that too much power, but above all responsibility, is being placed on your individual shoulders—I don't want to make it personal; it is not your shoulders but the post's shoulders. You are going to be part of the design, but you are handing over to who knows. Are you quite adamant that the holder of the post can chair and participate in various international and national regulatory matters? If there is a view that changes would have to be made because it is too much to put on someone's shoulders, do you have a view on what changes should be in the field for consideration?

Sir Mervyn King: Yes, I do. I certainly don't want to be adamant on anything. It is already a big job and, to be honest, it has changed in the last three years. We are already in a position where I have to spend a lot of time on monetary policy, the Financial Policy Committee and the PRA—we are spending a lot of time on designing and constructing the PRA—plus the international commitments. How am I coping with this, and what are we doing in terms of the post? Before the crisis, I chaired all the minutes meetings of the Monetary Policy Committee, where we drafted the minutes. That I delegated to Charlie Bean, so I do not chair all the meetings of the MPC that I did before. On the Financial Policy Committee, the driving of the work is the responsibility of Paul Tucker, and he chairs the Bank's Financial Stability Committee, not me. In terms of the PRA, most of the work is done by Hector Sants and Andrew Bailey, and the Governor will be involved only in a question about a major institution.

I say two things in conclusion. First, I am convinced that if there were to be a major problem in any of these areas and these responsibilities were in the Bank of England you would want to call the Governor of the Bank of England before the Treasury Select Committee and ask what went wrong. I don't think you can do that unless the Governor is chairing those bodies. I would draw a distinction between chairing the bodies and the amount of time involved. It is not just an additive thing. Most central banks are involved in these things. We would be returning to a more conventional central bank portfolio. The reason my view has changed since 1997 is that my experience of the crisis has led me to believe that when you have a financial crisis like this the central bank is inevitably and inextricably involved with the liquidity and capital position of banks, macro-prudential measures and monetary policy. You have to construct a mechanism by which a lot of the activities that the Governor was doing before 2007 are now delegated to the Deputy Governors, of which there will be three. This year one of the major strategic objectives in the Bank of England is to tell the whole of the Bank that each level will be delegating more authority down, because we have to do that for the Bank to function.

Secondly, if you are not persuaded by that argument, the right thing to do would be to take a responsibility away from the Bank of England completely, not try to pretend that you can have—

Q780 Mr Mudie: For example?

Sir Mervyn King: The only one you could conceivably take away that would make sense would be the PRA. The FPC and macro-prudential is inextricably linked with the sort of issues that central banks are bound up with. If your opinion is that it is too much, then the

PRA is the body you should take away from the Bank of England. I would recommend that it should then be a separate stand-alone body, but if you would like the Bank of England to do it, it is manageable, provided it is understood that the Governor will delegate many of the responsibilities he was doing before.

Q781 Mr Mudie: The Bank oppose practitioner panels. In view of the sensitivity of the additional powers, there is an argument that practitioner panels could save you from decisions with unintended consequences. Is the opposition still firm, or is any rethinking going on about the possible use of practitioner panels?

Sir Mervyn King: We are opposed to statutory practitioner panels but not consultation. We have a very good track record in engaging in a great deal of consultation: in 2008 on our money market operations; in 2009 on the way the asset purchase facility operated.

Q782 Mr Mudie: We won't go there.

Sir Mervyn King: We won't go there, but we did consult. We are currently doing a consultation with firms about a big increase in the range and type of collateral in all our operations. It is important not to set up a panel with a fixed membership of nine, 10 or 15 people, but each time we consult we do so very widely with the people doing the jobs about the issue on which we are trying to consult. That will be a different group of people each time. We are very keen to get away from a lot of the apparatus that has grown up around FSA which is highly bureaucratic, in large part legalistic and does not generate particularly useful responses.

The key point I make to you is that there is a big difference between consultation and accountability. We should not be accountable to the industry but to Parliament and the public. We should consult the industry, and you should be able to ask the industry, "Do you think the regulator is doing its job? Did it consult you appropriately? Is it carrying out its task in a fair and sensible way?" I do not think we should be accountable to the industry; that is the slippery slope to regulatory capture which was one of the major problems leading up to the crisis.

Paul Tucker: This would be a change in mindset for the supervisors.

Q783 Mr Laws: I want to ask one question that follows up Mr Mudie's questions about the Court. I understand your arguments about the Court. You have explained that it has an important but relatively modest role.

Sir Mervyn King: No, it is not modest. It is a well-defined role in terms of the management and resources of the Bank. Perhaps I may give one example. The audit committee of the Court meets very frequently, is pretty intrusive into the activities of the Bank and does a very good job in ensuring we use our resources, public money, efficiently. We report to the Court every three months with a detailed set of papers about the financial position of the Bank. The members of the Court, who are senior chairmen and chief executives of FTSE100 companies, have said to us that those papers and reporting mechanism are as good as anything they have seen in a FTSE100 company, so we are held to very high standards in comparison with much of the public sector.

Q784 Mr Laws: But when we turn to the letter from Mr Tyrie documenting the Court meetings that have taken place and see the period during the financial crisis taking off in September 2007, the Court met six times during that month and seems to have been discussing the most sensitive and difficult issues which you were dealing with in the Bank at that time. They related to policy, the state of the markets and the actions you were taking to

stabilise the banking sector. That is not what I would have expected to happen given the strategic role that you have been suggesting.

Sir Mervyn King: They were not discussing policy but the use of the Bank of England's balance sheet. Their responsibility is to ensure that the Bank of England's balance sheet is used in a sensible way, so their decision at the end of this would never be, "Do we carry out the operation or not?" because almost all of these were decisions for the Chancellor given that public money was at risk. All of those operations were decided by the Chancellor. The question was: should the Court recommend that the Bank of England request an indemnity from HM Treasury for that activity to protect the Bank of England's balance sheet? That is their locus in this, because as a board of the organisation they have a responsibility for the finances of the Bank, and obviously the balance sheet of the Bank is very large.

Q785 Mr Laws: That was a decision you would not have been able to make without them signing off?

Sir Mervyn King: If the Chancellor decided that we would do the operation then we would do it. What I would say to the Chancellor is, "The Court's view is that the Bank of England needs an indemnity in order for them to carry out the operation." Take the extreme case of a lender of last resort loan to Northern Rock. The Court could not have said, "We don't think you should give the loan to Northern Rock." The Chancellor has the final word on that. That was very clear at the time; it is clear under this Bill. Neither I nor the Court could say no. What the Court could say is that in its view it would wish the Treasury to give an indemnity to the Bank to protect their balance sheet. The Treasury does not have to do that but the Court would subsequently reveal that they had requested an indemnity.

Q786 Baroness Wheatcroft: To pursue that line of questioning and talk about the Court, several of those who have come to give evidence to us have said it is time for the Court to metamorphose into the same structure as a traditional company. We have heard your views up to a point on the role of the Court. Alistair Darling, for instance, was quite open in his view about how it should be restructured. I understand what you are saying about accountability to Parliament and to the people, but that is after the event. If you look at a corporate structure, the idea is that the chairman and chief executive have a body of outsiders, non-executives, to whom they can talk before doing things. Can you see any merit in changing the role of the Court to provide that sort of sounding board before the Bank take drastic actions, or are you confident that having non-execs on the FPC and the other committees is sufficient?

Sir Mervyn King: It would be dangerous to regard the Court as a body that should try to influence the policy decisions of the Bank, and you in Parliament ought to be extremely worried about that. You appoint through the Government the officials of the Bank and can hold them personally accountable. We certainly consult with a wide range of people, but it should not be restricted to a small group. The Court has no responsibility for policy; it is not held accountable for policy, so why should it have a special ex ante input into it? The right form of accountability for an independent central bank is ex post; that is what "independence" means. There is clearly a natural tension between independence and accountability, but it can be dealt with. If you look at what happens to central banks overseas, you will see that the Court here play a bigger role than central banks overseas normally experience, but their role should not be in the area of policy. It should be for us to come and defend our policy decisions directly to you. We cannot turn round and say, "We rather sympathise. We did not think it was a very good idea but the Court thought it was so we had to do it." I don't think that would be very satisfactory at all.

Q787 Baroness Wheatcroft: Is that why you are happy with the arrangement at the moment for the Financial Policy Committee to have a minority of outsiders on it? Several people have suggested to us that there should be a majority of outsiders. I know that the chairman of the FCA will be on it, but I am not sure there will be six outsiders.

Sir Mervyn King: There ought to be. They are quite different institutions with different responsibilities. It is six/five. The MPC has worked very satisfactorily with five/four. There is something slightly odd about a Bank of England committee having only a minority of Bank of England people on it. It is almost an outside committee with some Bank of England representation. We have gone further than any central bank in the world in having outsiders on our committees, which has been a success, but once you have a majority you are changing very much the character and nature of it. The executives of the Bank do have a natural concern about the continuing reputation and existence of the institution and that is part of our responsibility, which we should always be seen to carry out.

Q788 Baroness Wheatcroft: It is a big responsibility, as you said at the beginning. Perhaps I may ask you about the overwhelming responsibility for financial stability that you are taking on. The Bank has always had a financial stability objective. Are you confident that as a group we are clear what financial stability actually is? Opinions seem to differ. Would it help if there were firmer objectives as to what financial stability might be?

Sir Mervyn King: Let me say what I think broadly financial stability is and why I don't think that a precise definition is something on which we should pin every hope. Financial stability is about ensuring the financial system can play its role in three areas: the payments system, so that people can make payments all the time; the transfer of savings into investment, providing savings vehicles that can be used to finance corporate investment; and the allocation of risk in the economy towards those who are most willing to bear it. That is the social role that all financial markets play.

The reason I was unhappy about the Bank's financial stability role before the crisis was that, although no one could define financial stability terribly clearly, what mattered more to me was that we had no tools to do anything about it other than write financial stability reports. What matters in terms of holding the FPC accountable is that you in Parliament will decide what instruments we will have. They could be counter-cyclical capital requirements; some people think they could be loan-to-value ratios. There has to be a public debate about this, and you in Parliament will decide what instruments we will use. They will be delegated to us and you should hold us accountable for the use of those instruments and the commentary of the FPC in the financial stability report. For the first time we will have some instruments we can exercise, and the main focus of accountability should be to say, "Why did you change or not change those capital requirements?" and, "Explain yourself in terms of the instruments we gave you to use."

Q789 Baroness Wheatcroft: Perhaps I might ask Mr Tucker a question. Financial stability was one of your main roles under the previous regime. Is it always easy in a boom to spot the time at which financial stability might require intervention to calm things?

Paul Tucker: It is very difficult with absolute certainty, but a lot of misleading stuff is said about this. The world was full of bankers who thought there was a dangerous boom. There was a massive problem of collective action. In a way, it was a rather old-fashioned problem, in that no individual big bank was brave enough to say, "We will stop lending into this boom", because if they were wrong and it was not an unsustainable boom they would destroy their business by handing their franchise over the road. People were saying that kind of thing in 2006 and 2007.

Q790 Baroness Wheatcroft: They had to keep dancing?

Paul Tucker: Quite so. He is being ridiculed for that, but it is a rather good piece of analysis about the nature of the problem. The classic role is for someone to stand outside the private sector and say, “This needs to slow down.” One thing that will help that is to put analysis into the public domain. We did that in the past, but there is a hell of a difference between somebody who has instruments giving a warning and somebody without instruments giving a warning. People read our inflation report not because it is a terrific analysis of the outlook for inflation but because we, and only we, set sterling interest rates. The market will be much more heedful of analysis and warnings in the financial stability review coming from the Financial Policy Committee if and when they see that the FPC can act. Over time, the Financial Policy Committee would need to demonstrate that it was prepared to act. That goes back to what the Governor said about accountability.

The proposal under the Bill is that the directive instruments for the FPC will be set out in secondary legislation, and the Treasury Committee and commentators more widely will be able to say, “Given the FPC’s, the public’s and the market’s analysis of what is going on, why are they not using these tools?” or, “Why are they using this rather than that tool?” Just as in 1997 the level of debate about monetary policy shot through the roof, this kind of framework will change the debate about financial stability in this country in a durable way. The durability of it will make a huge amount of difference. The worst kind of boom is one that brews slowly over a very long time. It is much harder. That is what makes everybody complacent. Having the Financial Policy Committee appear regularly before the Treasury Committee or wherever, and no doubt before a committee in the Lords as well, will keep not only the FPC on its toes but also those issues in the public mind when otherwise people would tend to lose interest in them.

Q791 Baroness Wheatcroft: Are you nervous at all that you might come under some political stress not to calm things down, presumably? I am very conscious of the Governor saying regularly that the pricing of risk was wrong but nobody wanted to listen.

Sir Mervyn King: We will certainly come under pressure—there is no doubt about that—and that is why you have an independent central bank trying to resist that pressure.

Paul Tucker: This will be the point at which bankers and perhaps politicians, public and businesses all find themselves in agreement about something and disagreement about the FPC. As the Governor said, that is precisely why society has an independent central bank but framed in a way that Parliament chooses.

Q792 Chairman: Perhaps I may carry further the comparison between the Monetary Policy Committee and the Financial Policy Committee. The Monetary Policy Committee has not only an instrument but a fairly clear remit, ultimately set by Treasury and Parliament, for an inflation objective which is measurable and therefore it is easy to hold it to account. By contrast, the objective of maintaining financial stability is not easily measurable until you have failed, which we hope does not happen, and you know it is not there. It has been suggested to us by HSBC and Barclays that it would be helpful to have a more measurable objective to maintain a sustainable supply of credit. What are your observations on that?

Sir Mervyn King: That should not be the objective of the FPC, simply because I don’t think they can deliver it given the sort of policy instruments that will be available. What does “sustainable supply of credit” mean? If it is zero, which is where we are now, that is certainly sustainable, but that is not desirable. The natural supply of credit will vary over the business cycle. What matters is that the committee should focus on the resilience of the financial system. Just as we say in monetary policy that the best contribution it can make to economic growth is to provide a backdrop of price stability in the long run, equally the best contribution

that the Financial Policy Committee can make to ensuring there is an adequate supply of credit is resilience of the financial system. For example, if you start to see that leverage ratios of banks are rising rather more rapidly, or to levels that look to us to be excessively risky, that is when the FPC should step in and slow down the whole process and maybe reverse the rise in leverage ratios. It is that sort of policy decision that is important and which is the best contribution that can be made, but, just as monetary policy cannot abolish the business cycle, so the Financial Policy Committee will not be able to avoid the fact that there will be ups and downs in sentiment and expectations which are bound to lead to movements in asset prices.

Q793 Chairman: They were not talking about asset prices but the supply of credit.

Sir Mervyn King: It is the supply of credit, too.

Q794 Chairman: The rationale appeared to be, first, that the problem was caused ultimately by an excessive expansion of credit and, therefore, that needs to be moderated, which is implied by this; and, secondly, that in a recession the danger is that there is not enough growth of credit and there should be an obligation on the FPC to try to get credit going. They also thought that the tools available in the Pacific countries, which are much more interventionist where central banks have powers to set almost a corset on credit growth, possibly were necessary to control credit, which perhaps was rather surprising coming from bankers.

Sir Mervyn King: We can debate this, and no doubt over time we will get more experience. To the extent that “supply of credit” is used in a rather vague sense, what you have just described is exactly what the FPC will try to do, because credit is another way of looking at the size of the balance sheet of the banking sector. Certainly, the role of the FPC is to behave symmetrically, which is to slow things down in a boom but to try to make clear that the buffers of capital and liquidity that banks hold can be run down in a downturn. We now go to enormous lengths in the debates in Europe to make clear that when we ask European banks to hold more capital, it is not the same as saying that the capital requirement has gone up, but that if you put more capital into a bank it has a bigger buffer above its minimum capital requirement, which can be run down when times are bad.

I totally accept the idea that we should be responsible for a symmetric response. It is just that I worry about a rather mechanistic definition of “credit”, and it certainly cannot be credit to the real economy, because that will move up and down according to many factors outside the control of the FPC. I believe that if we had a Financial Policy Committee that has some success in moderating extreme movements in the size of the balance sheet of the banking system that would mitigate the credit cycle and help the Monetary Policy Committee, because it would relieve it of some of the pressures that made monetary policy rather difficult in the run-up to the crisis.

Q795 Mr Ruffley: Governor, to return to your answers relating to accountability, you very much downplayed the role of the Court in scrutinising the policy decisions of the executives of the Bank, which I understand. You said that they ask some basic questions but they don't get into the area of, “Did you make the right policy decisions?” Is that a fair statement?

Sir Mervyn King: Yes.

Q796 Mr Ruffley: You have also said that you and the executive decision makers on the MPC, and soon to be the FPC, are accountable to Parliament. In the Commons, that is the Treasury Select Committee. In the course of your cross-examination by that Committee, what papers did you produce of an internal kind that were not otherwise in the public domain?

Sir Mervyn King: We wrote papers at the specific request of the Treasury Select Committee. Whenever we were asked to write a paper we did so. That was a paper that had not existed before and was not in the public domain.

Q797 Mr Ruffley: How many substantive pieces of work did you produce which revealed things to the Treasury Select Committee that were not already in the public domain?

Sir Mervyn King: I cannot remember the number of papers we produced—maybe Lord McFall can—but we certainly produced whatever we were asked to produce. I remember that when the Treasury Select Committee was chaired by Lord McFall I always made an opening statement which was not in the public domain and gave an update of the views of the Monetary Policy Committee that had within it some real policy substance.

Q798 Mr Ruffley: Have you any idea how many questions you answered before the Treasury Select Committee in relation to the Bank's decisions in the financial crisis?

Sir Mervyn King: I should think hundreds, if not thousands.

Q799 Mr Ruffley: You answered thousands of questions.

Sir Mervyn King: Let me tell you one fact that I do know, and of which I am completely confident. This is the 31st parliamentary hearing that I have attended in four years, which means seven or eight a year. I suspect that is a record compared with anyone else, but I have not checked it. That is a very large number. If you add to that that I now give six televised press conferences a year on the MPC and FPC, and four speeches, that is a very high degree of accountability, which I think exceeds anything else.

Q800 Mr Ruffley: I am not doubting your diligence in attending parliamentary committees.

Sir Mervyn King: We answer the questions that you put to us.

Q801 Mr Ruffley: I am aware that you come regularly and hardly ever miss. My reason for asking these questions is simply this: you will also be aware that an incredibly detailed review was carried out by a leading accountancy firm of the decisions made by the FSA in relation to RBS. You are aware that a very substantial piece of work was done.

Sir Mervyn King: Indeed, and I have seen it.

Q802 Mr Ruffley: Yes, and after a great deal of reluctance on the part of the FSA, the Treasury Select Committee is seeing bits of it. But here's the thing. As I understand it, that piece of work involved large numbers of accountants crawling over what the FSA were doing. They were calling for papers and cross-examining people. I suggest that there is no way of earth that the Treasury Select Committee, or even a Lords committee, has the same level of access to your decisions and minutes that a big accountancy firm has had in reviewing the decisions of the FSA. Do you understand the analogy I am drawing?

Sir Mervyn King: I don't think it is a good analogy.

Q803 Mr Ruffley: Why isn't it a good analogy?

Sir Mervyn King: Because in relation to the FSA and RBS, it is a report about an individual institution and its activities.

Q804 Mr Ruffley: And the FSA's decisions in relation to that institution. That is what we are talking about: individual executive decisions by the FSA. To my understanding, that is an incredibly detailed piece of work, pulling out the wiring. Parliament, with the best

will in the world, has not had access to the policy decisions and how they were arrived at in the case of the financial crisis and your executive directors.

Sir Mervyn King: The Bank had a very different set of responsibilities, for which there is no parallel. Everybody involved in taking those decisions at one time or another appeared before the Treasury Select Committee. You can ask them whether they agreed with the decision or were party to it. We were not taking specific decisions vis-à-vis individual institutions of a regulatory kind at all. All our operational activities were done through publicly stated facilities, the terms and conditions of which were made publicly available. That cannot be done by a supervisor. The supervision by FSA of RBS was something which by its nature could not be made public. All our operations were made public.

Q805 Mr Ruffley: I take the point. A final question, Chairman, if I may. We have already heard from Mr Mudie that the Court has refused to provide the Treasury Select Committee with minutes of the Court relating to the financial crisis. Summarising it, you said in reply to Mr Mudie that this would be terribly unfair to the individuals because they were giving advice, exchanging opinions and did not think that would ever be made public. Is that a fair summation?

Sir Mervyn King: Cabinet minutes are not published; even the private discussions that you have on the Treasury Select Committee are not published. When you have a private discussion where it is clear that for internal purposes a detailed verbatim record of the discussion is made, which is clearly not intended to be made public, it does not make sense ex post to expect that to be made public.

Q806 Mr Ruffley: I don't understand how, in the new era that you seem to be applauding of transparency, openness and accountability to Parliament, you are comfortable with the Court falling back, as I understand it, in relation to the Treasury Select Committee's request, to the position that it is not covered by FOI. It should not be for Parliament to listen to arguments from the Court saying, "This is not FOI-able information." Should you not be willing on an agreed basis to make these minutes available so the Treasury Select Committee can see them, in camera if necessary?

Sir Mervyn King: Every document we have sent to you you have put in the public domain almost immediately, so that is a deliberate flouting of FOI. I go back to the basic point.

Q807 Mr Ruffley: Are you suggesting that the Treasury Select Committee has behaved improperly?

Sir Mervyn King: No, but you have not offered to keep it in camera. We asked about that.

Q808 Mr Ruffley: If the Chairman of the Treasury Select Committee, Andrew Tyrie, and other members—Mr Mudie and I are also on that committee, as you will know—in the interests of accountability to Parliament, asked to see the minutes of the Court relating to the financial crisis, a request that has so far been refused, and offered to look at them in camera and not release them, you would support our request?

Sir Mervyn King: I am not going to make a comment.

Q809 Mr Ruffley: Why not?

Sir Mervyn King: Because I am not chairman of the Court.

Q810 Mr Ruffley: You are the Governor of the Bank of England.

Sir Mervyn King: But according to the accountability of the Court, Mr Ruffley, I am not chairman of the Court. I thought you applauded that.

Q811 Mr Ruffley: You don't think the Court would take cognizance of what the Governor of the Bank of England says? I am putting you on the spot here, Governor, for one very simple reason. I am taking you at your own word. You are saying you want the Bank, a very important institution of this country, to be accountable to Parliament, and we applaud that, but on the first test where we say, "Make available the detailed minutes and we, the Treasury Select Committee, will look at them in camera", you are telling me you will not suggest to the Court that this is a good idea?

Sir Mervyn King: No, I am not. Let me tell you exactly what the analogy is. If you turn to me today and say, "Will you make available the verbatim transcripts of the meetings of the Monetary Policy Committee, as chairman of that committee?", I would say no, because there is no authority under which we should release the verbatim discussions. The committee could never work if you asked to see the verbatim discussions. What we do produce is a set of minutes that we publish, with a record of everyone's views and votes, after 13 days. That is a sensible degree of transparency. It is not sensible to require that every discussion be written down verbatim and published, and that is one reason why Cabinet minutes are not published. The minutes of the Court in the era to which you refer are exactly analogous to that. If you think in future the minutes of the Court should be published, I would be strongly in support of that; I would say yes, and we should do it, but you cannot go back and change the rules of the game retrospectively.

Chairman: Those questions are somewhat tenuously related to the function of this Committee, and I can only hope that the Treasury Select Committee will do some of our work in future and save us some time.

Mr Ruffley: It is accountability to Parliament.

Chairman: I said "tenuously related", not "unrelated".

Mr Ruffley: It is not even tenuous. This is accountability to Parliament.

Q812 Chairman: Thank you, David. I allowed you to ask the questions. Perhaps we can continue the train of questions.

I was asking about the objectives of the Financial Policy Committee. There is another alternative on the table for defining the objective and that is the objective of the European Systemic Risk Board, of which you are vice-chairman: it is controlling systemic risk across the financial system as a whole. Might that be a more meaningful definition of the objective which could be inserted in the Bill?

Sir Mervyn King: It could be. The difficulty is that that is shared with the PRA, because the purpose of the regulation of banks is not to worry about the individual institutions as such. We must get to a point where the failure of an institution is not seen as a failure of regulation but of the management. Indeed, we want to be in a position where banks that are badly run do fail. The worst position to be in is the one we have almost got to where the regulators believe that if any bank on their watch fails this is a sign of failure by them, so they will prop up and keep in existence bad managements and badly run banks. It is very important that Parliament understands that the purpose of regulation is about ensuring that the system as a whole is safe and that banks that are badly run do fail, but that their failure does not jeopardise the rest of the system. That has to be the objective, and that is why the resolution approach—one of the great achievements of the Treasury Select Committee was to push hard for the resolution framework—is so important. It enables us to allow banks that are badly run to fail.

Paul Tucker: Perhaps I may add one word to that in terms of the Bill. It is not so far away from the ESRB definition but it has the more precise language of legislation. Summarising the objective of the FPC, it is to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the financial system. “Systemic risk” is defined as meaning a risk to the stability of the UK financial system as a whole, which is the language of the ESRB, or to a significant part of that system. I suspect that the language “the system as a whole” comes from very old Bank of England documents; it is very much a Bank of England phrase. I don’t think we are so far away from that, but in language suitable for legislation rather than a less formal committee.

Sir Mervyn King: I understand and applaud the wish to have as clear a definition as possible, but that does not resolve the problem. The best way to hold us accountable is to say, “These are the instruments at your disposal. How did you use them, or not use them?”

Q813 Mr Laws: If the Chancellor said to you, as somebody who is going to be very busy in the future with all these new responsibilities, that you might prefer to have a single MPC/FPC body rather than two bodies with rather overlapping personnel and functions, would you object to such a change?

Sir Mervyn King: I would try to set out the pros and cons of it. It would be closer to the way the Federal Reserve operates. It would be very difficult to maintain the voting structure and behaviour of the MPC and to have externals with the degree of expertise that they have. The reason the MPC works is that there is one proposition on which to vote: what is the level of bank rate now? What is the level of asset purchases? Hence, it is possible to have a voting system with a clear majority and minority. Once you start to extend the responsibilities of a committee to cover a whole range of instruments there is no longer a single proposition. Each member of the committee might have his own preferred bundle, and you just have to move towards a more consensual approach. The Financial Policy Committee operates in such a way, because we operate consensually in order to get to the point where we think “This is the question this month.” We can then vote on that question, but we have to operate consensually to say, “Well, this is the question this month.”

Voting plays a much smaller role in the Federal Reserve FOMC than it does on the Monetary Policy Committee, and the board of the Federal Reserve even more so. What you would lose if you went to a combined committee is the ability to have on it monetary policy experts who do not have financial sector expertise, and they would not be able to be part-time externals. I do not think you would get people from academic life. They would find it harder to give up their employment for a longer period to be on the committee to acquire the expertise. Equally, the people we now have on the FPC, who have great financial sector expertise, would not be natural candidates to set interest rates. You would end up with more generalists. You can certainly do that. I can see the attractions of saying, “Rather than go into two set of committee meetings, let’s just have one, and it is easier to organise”, but I think you would lose something.

One of the contributions of the Monetary Policy Committee—I look to members of the Treasury Select Committee here as to what they think about it—is that members of the committee have been willing to stand up in public and say, “My expertise in monetary policy leads me to think of a different approach from the one the majority wants.” They have the self-confidence to do that. They can vote against it, and those votes are recorded in public. If you had one committee you would be forced towards a more consensual approach. People would find it harder to speak for their own position because it would be less clear, and we would lose a lot.

Q814 Mr Laws: Do you think that at the moment you don't have the expertise on the MPC which would allow that committee, if it was the model, to do the FPC's job as well?

Sir Mervyn King: The external members on the FPC, together with at present Adair Turner and Hector Sants, bring to the FPC knowledge and expertise that the MPC could not bring. Another advantage we have on the FPC at present is that Adair and Hector are on the FPC so when we say to them, "As a group, do we think it would be a good idea to make a recommendation to the FSA to do the following: raise or lower counter-cyclical buffers for banks? Could you actually do it? How would it mesh with your current responsibilities?" they can say, "Yes, we think it is a good idea; we would support it", or they can say, "We do not think legally you can do it unless you framed it in this particular way." Those conversations have proved very useful. That is part of the constitutional arrangements proposed for the new FPC. We would lose a lot of expertise on the FPC if we had to have a group of people doing both.

Q815 Mr Laws: Thinking about how the new system will work and whether it will lead to much better policy outcomes, perhaps I may ask you to replay history for us. You took over the Bank in 2003. If when you took it over you had had the structure proposed in the Bill, the FPC as well as the MPC and the macro-prudential powers, and you also had foresight of everything that happened beyond that so you did not have to answer in relation to judgments you might have made, what would you have done differently in terms of economic policy, particularly macro-prudential policy, from 2003 onwards to avoid the problems we have today?

Sir Mervyn King: I cannot say with any confidence what we would have done.

Q816 Mr Laws: Assuming you had known the future.

Sir Mervyn King: Let's suppose we did not know the future but just the facts which were evolving. I think the FPC would be sitting round reading the analysis and warnings in the draft financial stability report. Supposing we had the authority, for example, to move up the leverage ratio of banks and set a requirement that it could not go up above a certain limit, the committee would have been forced to confront the issue of whether it was sensible to allow banks to raise their leverage from, say, 20 to one to over 40 to one. I don't know what the committee would have done, but it would have been impossible to avoid that question, whereas the question never arose in the Bank.

Q817 Mr Laws: Ignore the rest of the committee. With all your expertise and knowledge of what has happened, what would you have done?

Sir Mervyn King: I would have put a limit on the leverage ratio of banks and simply prevented the balance sheet from expanding so quickly. One of the lessons from this is that both the ECB and ourselves asked the question, "Do we think that the growth of broad money, double-digit rates—sometimes 15% or more—threatens the inflation target?" In most post-war periods we would probably have said yes, but we judged that it did not threaten the inflation target. I think we were right. What we failed to do was ask the question, "Well, if it does not threaten the inflation target, what does it threaten?"

Q818 Mr Laws: Without going back into too much history, at that time you were not looking for other tools to deal with the problem you could see emerging but you could not deal with through monetary policy.

Sir Mervyn King: We had been given very clear tools by Parliament and our responsibility was to use them, and responsibility for dealing with banks had very clearly been given to the FSA.

Q819 Mr Laws: Would you have targeted any particular sectors? We had a house price boom across a lot of the western world at that time. You have talked about constraining banks in general. Would you have wanted to do anything to hit particular sectors and constrain them?

Sir Mervyn King: If I had been asked to constrain a particular sector it would have been the financial sector, because two thirds of the total lending by the banking system in the five years running up to the crisis was not lending for house purchase or companies for investment but to other institutions in the financial sector.

Q820 Mr Laws: Do you think the controls you would have used would have ended up being a rather blunt instrument that might have damaged credit to parts of the economy that you would have wanted to keep flowing?

Sir Mervyn King: I do not think that having a limit on the leverage ratio would in those circumstances have damaged the flow of credit to the real economy. It would have been profitable to lend to the real economy, and we would have been trying to diminish lending to the other parts of the financial sector. It is a question that I cannot answer with any certainty. Any instrument you use to try to slow down the growth of the banking sector's balance sheet runs the risk that a particular project that might have got finance would not.

Q821 Mr Laws: We would still have had a house price boom in those circumstances.

Sir Mervyn King: We would, for the simple reason that right around the world long-term interest rates fell to extraordinarily low levels. I don't believe that the UK on its own could have prevented that. We could have tried to lean against it; indeed, if you go back to the debates in the Monetary Policy Committee in the late 1990s and 2000s—you see it from our speeches and minutes of the meetings—there was debate in the MPC about whether we should keep interest rates somewhat higher in order to dampen down the imbalance that was emerging in our economy between rapid domestic demand growth and weak net trade. That would have gone some way to help, but with an open financial system where the level of real interest rates across the world is being depressed by a very high level of world saving, particularly coming from Asia, it is very hard for us to do anything about the level of long-term real interest rates, and that is a major driver of asset prices.

You can try to have a higher interest rate at home than overseas by pushing the exchange rate up to a level where people then expect it to fall, but clearly that would have damaged the real economy. That was the debate going on. Is it worth accepting slow growth for low target inflation for a period to avoid the damage that might be done from these imbalances growing? That is a matter which monetary policy makers and economists will debate for much of the next 10 to 20 years. I don't want to say there is a simple answer to it, but, rather than sacrifice the objective of maintaining steady growth with low inflation and price stability within the inflation target, it is worth considering how far our experience with the instruments given to the FPC can mean we do not have to face this unpalatable choice of saying that we will sacrifice growth and steady inflation in order to prevent imbalances in the financial sector moving up.

Paul Tucker: If I may add to the answer to the previous question, because the Governor has talked about the cyclical response of reducing the maximum leverage ratio. I am not sure that is really hindsight. I think we would have been focused on whether the structure of the credit markets was adequate. You can see a flavour of this. We have had two meetings in the FPC. In one of them we said there was a boomlet in the exchange-traded fund market. It has moved from being purely a vanilla market to something more complex and sophisticated, and we made some pretty concrete points that have resonated in a quiet way across the official

sector around the world, as well as with the FSA. The analogy about a decade ago was the biggest revolution in capital markets for probably a quarter of a century: credit becoming tradable. In a world where there are derivatives on credit and credit can be bundled up into securitisations, it took a long time for the authorities to ask whether that market had an adequate structure. I am saying this because in the Bill and the papers that the Treasury have published the FPC is asked to focus on two dimensions: one is the cyclical dimension of whether you can slow down a boom and make the system more resilient against a bust, but the other is to focus on vulnerabilities, the structure of markets and fixing those. If you have the biggest change in the structure of capital markets in a generation that is the kind of thing the FPC would have focused on. That is one of the reasons why the Bank will be involved in the supervision of clearing houses, which is one of the big reforms going on across the world at the moment.

Sir Mervyn King: We did draw attention to these points in speeches in the FSR before the crisis. We were very clear that structured credit products were creating real risks. I said in a speech that the label on the champagne might refer to an increasing number of triple-A structured credit instruments, but by the time investors got to what was left in the bottle it could taste rather flat.

Q822 Mr Laws: When was that speech?

Sir Mervyn King: That was the Mansion House speech in June 2007—many years.

Paul Tucker: We published our first articles on credit derivatives, CDOs and so on at the beginning of the decade. I don't want to say that we saw everything at all. My point is that part of the job is to identify the right terrain. The capital markets are doing extraordinary things all the time. You have to identify those markets where you need to drill down further and ask, "Is the structure of this market adequate?"

Q823 Mr Laws: There is clearly a risk that you could have one committee with its foot on the brake and another with its foot on the accelerator at the same time. There could be quite a conflict between the macro-prudential and monetary policy tools. Are you confident of your ability to resolve those tensions? Is it essentially the overlap in personnel that allows that, or is it something else?

Sir Mervyn King: I don't see that it is a question of brake and accelerator. The virtue of the FPC is that it can remove dilemmas that the MPC might face and would be worried about. For example, the MPC was worried to some extent that the imbalances in the economy and expansion of the banking sector balance sheet was an argument for raising interest rates by more than would be justified by the need to maintain inflation close to the target, and hence steady growth. If the FPC can deal with that problem and remove the dilemma it will make the job of the MPC easier. Far and away the most likely outcome is that the existence of the FPC will make the MPC's job easier, not more difficult because there is a tension between the two.

Q824 Chairman: Could there conceivably be occasions when the MPC and FPC are pushing or pulling in different directions?

Sir Mervyn King: The FPC is going to be focusing on a particular aspect of the financial system, and dealing with that does not pose challenge to the MPC; it makes the job of the MPC easier. I find it very hard to come up with convincing examples where they would be taking steps that would make the other committee's job more difficult. Maybe it is possible to imagine such examples, but I do not find any of those put up so far very convincing. There is overlapping membership, and there are all kinds of other ways in which we can ensure the

MPC members talk to FPC members. We are all in the same building. I don't see that as a being a major question.

Q825 Lord Newby: You talked at some length about the relationship between the Bank and Parliament. Could you look at the relationship between the Bank and Treasury both in peacetime and wartime, as it were. In peacetime the setting of the macro-prudential tools will be very much the role of the Treasury. It seems to me they are in the driving seat because they have to propose to Parliament what the tools will be. Once Parliament has passed the secondary legislation it is in effect passed across to you. Are you happy, first, about your input into the setting of the tools, and that the Treasury is going to listen to you when you say, "We'd like one of those, please"; and, secondly, co-ordination thereafter?

Sir Mervyn King: There is no reason to be unhappy at this stage. It is too soon to tell, but we will be publishing our views. We have been asked to give our views publicly, so I am sure the Treasury will listen very carefully, and you or various parliamentary committees can quiz them on why they did or did not listen to the advice of the Financial Policy Committee. We will be publishing a consultation paper around the turn of the year which will set out the various types of instrument one could imagine being among the instruments about which the FPC will make recommendations. The FPC will make recommendations in the spring. I do not see any obvious reason to suppose that the interests of the Treasury are different from those of the FPC. They set it up and it was their wish to create the committee, so I cannot see why they would want to make it impossible for it to operate.

Q826 Lord Newby: Looking back, one of the reasons the tripartite arrangement did not work was that, at least according to some participants, the relationship with and views of the Treasury and Bank diverged. That depends crucially on a relationship between the Governor and the Chancellor. Under the legislation you would be required to meet the Chancellor every quarter. First, do you think that is an adequate formal requirement? Secondly, at the moment how often, as this process is developing, do you see the Chancellor to talk about these issues?

Sir Mervyn King: Very regularly, and I did with the previous Chancellor too. We always pencilled in a regular monthly meeting, and other meetings were held as well. I have a private meeting with the Chancellor at least once a month. At present I seem to spend most of my weekends with the Chancellor. Typically, we discuss other things on those weekends, but we can also take the opportunity to discuss domestic matters. There are also meetings with other groups of officials, including the FSA, that take place regularly. We are not short of meetings. The quarterly meeting is not a good guide to the frequency of actual meetings; it is a statement of how often I have to tell him clearly and officially whether we think there are developments that would threaten public funds.

Q827 Lord Newby: Moving on to wartime when there is a crisis, the main onus for decision making rests with the Bank with which, on your evidence, you are clearly very happy. The relationship with the Treasury seems to be that you tell them what you are doing and say, "We may need some cash", and, "Please can we have the cash?" During the last crisis when the question of who was in charge was raised, those of us who were asking questions of Ministers felt that at the end of the day the Treasury was in charge because it did have the cash. Is there not a tension here in that your formal responsibility is to be in charge but the paymaster, which is the Treasury, is always in charge?

Sir Mervyn King: Yes, and that is the truth. There was a lot of confusion about this issue which all came up in the context of Northern Rock. People wanted to know who was in charge in the sense of who could take action vis-à-vis Northern Rock. The answer is that no

one could because there was no legislative framework that enabled anybody, whether it be FSA, Bank or Treasury, to resolve a failing bank. I am very pleased to say that the Treasury Select Committee pushed very strongly for a proper resolution framework, and it was introduced in 2009. We have a resolution framework, and it is very clear how that operates. It is also absolutely clear that any decision that involves the use of public money is taken by the Chancellor. That was true then and it is true now, and it would be true under the new arrangements. There is no ambiguity about that at all.

Q828 Baroness Drake: Under the new framework and with the proposals in the Bill, if there is a crisis which part of the proposals makes it clear that if there is a disagreement between the Chancellor and the Governor that the former's view will prevail, so we are clear as to why you think the new proposals would give that absolute clarity?

Sir Mervyn King: In one part of the Bill or another, in one of the many pages, it states that decisions on putting public money at risk are for the Chancellor and the Governor will have a statutory obligation to inform the Chancellor well before there is any question of a decision having to be made. The concern of the Treasury, quite rightly in my view, is that they do not want the Governor to turn up at five o'clock in the afternoon and say, "A big bank is about to fail. It is your choice, Chancellor, but you have 15 minutes to decide whether to put in £40 billion." You cannot do that to a chancellor; you have to make sure that all the way through the Treasury, the Chancellor and his officials are informed about how things are developing. Indeed, right through the Northern Rock crisis, and every other episode we have been through in this financial crisis, that was the case. Whether it was Northern Rock, Bradford & Bingley, or the resolution framework—the new framework applied to Dunfermline Building Society—the decision about how much public money was committed was always that of the Chancellor.

Q829 Baroness Drake: That is the point at which the Governor takes the view that he expects a call to be made on public funds so that would clearly trigger a shift to the Chancellor, but one of the issues is the extent to which there can be any greyness about the judgment made by the Governor as to when that potential call on public funds arises. How far does it have to go before that shifts towards the Chancellor?

Sir Mervyn King: The framework we have—it was true throughout the crisis—was that information was always fully shared. I believe the FSA told the Chancellor when they were concerned about individual institutions, and we would do that. There is a statutory obligation in the draft legislation.

Paul Tucker: The language is quite careful. Cutting through it, essentially the Bank must immediately notify the Treasury at the point at which it might reasonably be expected by the Bank, the Secretary of State and the Chancellor that public money might be used. The language is "reasonably be expected" and "immediately", so the Governor cannot hang around.

Sir Mervyn King: The discussions that we have now with the Chancellor, as with the former Chancellor, are very often of the kind, "We don't expect this to require public funds, but I am worried that in this situation it could deteriorate in such a way that it might lead to the potential use of public funds. We must make some contingency planning; we must put some arrangements in place in case this deteriorates." That is very much the subject-matter of our conversations now. We are discussing a whole range of contingency arrangements.

Paul Tucker: The Bank and FSA have said that they will introduce a system where each institution is staged: No.1 is "okay"; No.5 is "dying and needs to be resolved", and all the intermediate cases. What we will do with Treasury officials is work out a framework whereby, if you reach stage x , there has to be communication at staff level. The existence of

the PIF, the Proactive Intervention Framework, is already making it easier for the Bank's resolution team and the FSA to work together. It will provide a good platform and put structure around Treasury and Bank staff as well.

Q830 Mr Brown: I want you to say something to the Committee about the risks and difficulties in scoping what is happening in the shadow banking markets worldwide, but perhaps focusing on the United States of America because of the very large sums of money that seem to be involved there. Before I do that, I was very much struck by what you told us about the accountability arrangements. The Bill does not propose any change to the accountability arrangements as they affect Parliament; accountability is through the Chancellor and Treasury Ministers and to Select Committees, essentially the Treasury Select Committee and the parallel arrangements in the House of Lords. Do you identify a need to have something separate and specific so there is some form of public oversight and dialogue in your new role as regulator?

Sir Mervyn King: Let me answer the question on accountability and then perhaps pass the question on shadow banking to Paul, or perhaps Andrew, who has been here all this time, will come in. On accountability—I hesitate to tread on the toes of what you do in Parliament—it is really for your arrangement. Congress uses its existing committee structure to hold regular sessions with the Federal Reserve. The Treasury Select Committee does that with us. As to whether there should be a separate committee for the Bank of England, or a sub-committee of the Treasury Select Committee that deals with regulation, that would be a very sensible step forward, but it is not for us to decide. I would certainly welcome that. We have always said that because the responsibilities of the Bank will be extended, or if they are, you have to look carefully at the governance and accountability of the Bank, and, to be very clear, we would expect that to be increased. It would be very natural for the Treasury Select Committee to have separate hearings on regulation. They could be hearings to which it would be natural to invite Hector and Andrew; they could be hearings on the macro-prudential instruments. Paul could share that. I do not have to go to all these sessions. It would be good if people started to meet more of the executives of the Bank because they are the people doing a lot of the work. I would welcome that expanded accountability. It is a greater burden on the Treasury Select Committee, but I am sure you will find a way through that. I do not think it is something you can delegate. You are there representing the public to hold us to account. I meet lots of people who say that they saw me being grilled by the Treasury Select Committee. I will not tell you what they say, but it is something they take very seriously, and you are there to do that.

Andrew Bailey: There is a general sentiment that the FSA has been less accountable to Parliament than the MPC. That comment is often made. That must undermine the ability of the FSA to do these functions; it is a criticism which must be taken seriously. As the Governor said, it is important to have better accountability. To go back to one of Mr Ruffley's points, you ought to think about how to deal with the fact that in micro-supervision you are handling a lot of very sensitive commercial information. You may want to consider the question of how you have a robust in camera process to do that. It would concern me if the accountability mechanism was in some sense compromised by the inability to talk about the things that you really need to talk about.

Q831 Mr Brown: That is very helpful.

Paul Tucker: Shadow banking is a very hot international topic. The summit of leaders in Cannes which is going on over the next few days will conclude, I think, one big batch of reform in the area of banks' capital and resolution. It will tell the Financial Stability Board to get on with its work on shadow banking, and a paper and pretty big work agenda on that was

published a few weeks ago. First, domestically the Financial Policy Committee will have the power, if the Bill passes, to make recommendations and to give directions to the FCA where lots of the shadow banking system will reside, if it is obviously not in the PRA. Secondly, the FPC is given the duty under the Bill to make recommendations to the Treasury about when the perimeter of regulation should be changed so that something that lies outside both the PRA and the FCA can be brought inside in some way, or some reshuffling between the PRA and FCA can go on. We need information to do that. The market intelligence function of the Bank will be absolutely vital. My personal very strong belief, which the Governor shares, is that this system will not work over the years and decades unless the markets area of the Bank and its market intelligence capability are completely engaged in that, which they are at present.

The next question is about information powers. The PRA and FCA have information powers. The Bank has the right to ask the PRA and FCA for information, but we are working up some ideas to take to the Treasury about the Bank/FPC having an information power to require information for bits of the system beyond the regulated perimeter in order to support any recommendations to the Treasury that the perimeter should be changed. If we ever find ourselves wanting to recommend that the perimeter be moved we will need an evidential basis for it, not just chatter.

Q832 Chairman: Could the Committee have a note on what you are putting to the Treasury?

Paul Tucker: Yes.

Q833 Mr Brown: The total sums of money involved in this are huge.

Paul Tucker: They are.

Q834 Mr Brown: As a lay person, the financial service products seem to me fiendishly complex. I am not certain I could adequately describe how they work and what they do. Are you certain that you have a grip on everything that is done, not just the complexity of the instruments but the actual products that underpin them and make them up?

Paul Tucker: We have access to sufficient people both in the official sector and around the world to do that. Will we occasionally miss things? We will. Will we occasionally miss big things? If we keep this market intelligence function over the years and decades I would truly be hopeful of not missing the big trends. One of the great things about the financial markets is that they love talking about what they are doing. Even though they make mistakes they are gripped by what they do and effectively reveal to the official sector what is going on. It does not come through the hard data, but you need to be intelligent about how you turn an anecdote into a solid evidential base.

Andrew Bailey: I give you an example. We have just been through this. You have to see through complexity to some pretty straightforward principles. The Governor talked about leverage. Unfortunately, I had to spend the whole of this weekend dealing with MF Global. When you cut through it all, that firm was over-leveraged and essentially had a funding model that could not withstand the stress. It could not withstand rating agency downgrades and it blew up. There was an enormous amount of complexity about how they were doing it; there were reverse repos here and there—all sorts of things—but, when you get down to it, it was leverage and the inability of the management to see they had constructed a model that could not withstand a pretty simple stress.

Q835 Mr Brown: What is the public interest defence for this complexity? How is it in the public interest?

Sir Mervyn King: An awful lot of the complexity you see at present is to get round detailed rules and regulations.

Q836 Mr Brown: I rather suspected that.

Sir Mervyn King: That is why we feel so strongly that the culture of regulation needs to get away from this game in which the regulators write ever more complex regulations and the banks and their lawyers write new products, which are essentially the same as the previous ones but are defined in such a way as not to be caught by the latest rule and regulation. This leads to a very expensive and unnecessarily complex system. There are two very important things we have to do to get over this. One is to make sure that regulation is about judgment so that the examples I gave you earlier about complexity, opacity and simple leverage developments, are ones in respect of which Andrew can say to a bank, “Look, frankly we do not understand why your organisation needs to be so complex. We cannot work out what you are doing, so you will have to change it. You have not broken a rule, but too bad; you have to change it.” If you do not want regulation of that kind I do not think you will ever get any proper regulation.

Secondly, we have to recognise that regulators cannot regulate everything; there is a limit to what regulation can do. In my judgment it comes pretty quickly. Once regulators get bogged down in excessive detail they will never be a match for the banks, so we have to have a framework in which most of these firms can fail. If they screw up, we just let them go; they are bust. We must have a system that enables us to allow the failure of a firm not to undermine the rest of the system. That is why MF Global this time was quite a good example of a company where, frankly, there was no public interest in saving it. The public interest was in making sure that it was possible to administer the failure of the institution without it causing damage to the rest of the financial system. That was what we did not have when Northern Rock failed, and that is what we have now. As to the very large global cross-border institutions, we have not yet solved that problem but we are working on it at international level, and maybe we will find a solution down the road.

Paul Tucker: The leaders will make a big announcement on this in the next few days, unless they decide not to. There is a big package of measures coming out.

Q837 Chairman: From whom?

Paul Tucker: The G20 summit; it is part of the package.

Q838 Mr Brown: Is the amended legislation that we have under consideration here fit for purpose, or is there anything you would say to us about strengthening your hand in these matters as regulator?

Sir Mervyn King: There are two things. This is not an easy Bill to read because it has been constructed in the form of amendments. I am sure you are expert at reading documents like this.

Q839 Mr Brown: We have been given a crib which is the full legislation with the amendments inserted.

Sir Mervyn King: Lucky you! When I get a document that has two completely different sets of page numbers, one at the top and one at the bottom, it is a world I am not used to. First, the Financial Policy Committee needs stronger powers to obtain data. We have to do it at present through the PRA which can really obtain data that are relevant only to their regulatory purposes. We would like a power for the Financial Policy Committee and the Bank itself to obtain data. Secondly—this is most important—as to the recommendations or directives that the Financial Policy Committee can make to the PRA after the legislation

comes into effect, it cannot say the means and time over which those can take place. This seems to us a bit bizarre, because if we say, for example, that we think that the capital requirements on banks need to go up to slow things down we want to be able to say, “It is important that you do it within six months”, but we cannot do that under this legislation. We also want to be able to explain that it should be done in such a way rather than for the PRA to decide themselves. Those are the two areas where some strengthening of the powers of the Bank and the FPC would be appreciated.

Paul Tucker: We also want to make clearer the threshold conditions to be authorised as a bank clearer. One of you—perhaps you should draw lots—should read the existing threshold conditions and ask whether this be comprehensible to a CEO, CFO or member of the public. We want to get back to a statement in fairly plain language of what you need to pass to be a bank and, separately, to be an insurer. I know that Hector Sants agrees with me about that.

Q840 Mr Brown: If I asked you to send us a note setting out your views in comprehensible language, would you do that?

Paul Tucker: Yes.

Sir Mervyn King: We would be happy to do that.

Q841 Chairman: On the question of information, should the power to obtain data be modelled on the US Office of Financial Research? As a related question, you once said, Governor, that you did not want to impose onerous obligations on banks to provide endless information every day but you want them to be in a position to have the data so that when you phone up to ask, “How much Greek debt do you have?” they can answer without having to spend three weeks looking for it. Do you need any powers to ensure that banks have the information?

Sir Mervyn King: The PRA can do that; they have the powers. It is important to go down a route where we do not say to the banks, “You must send us this data every three months”, and nothing is ever taken off the list. During the crisis, and even quite recently, when we wanted information it turned out that the regulators did not have data relevant to the problem at hand. It is a different approach to data collection. It is trying to get away from the provision of a lot of routine information, management reports and detail, which has no relevance to the PRA and no one would ever look at, and focusing on the stuff that we ought to look at. Rather than burdening the banks with a massive data reporting requirement, we should make it clear to them, “We think you ought to know the answers to the following questions, and from time to time we will want to know the data, too, but do not send it to us until we ask for it.” One of the changes in the culture of the supervisors that we are trying to bring about is to get them to think about the data they require to do their job, not take from their drawer a long list of questions they have been given and tick or not tick the boxes but sit down and say, “What do I need to know about this bank to judge whether or not it is too risky?” It will take a long time to change that culture, but those are the kinds of people we are committed to growing, developing and turning into effective supervisors.

Andrew Bailey: From time to time we do it now. I do it in running supervision. We say, “We want this by close of business tomorrow.” Sometimes I get protests from chief executives of banks and I say to them, “Look, I’m not asking you for anything you should not have yourself to run your business.”

Q842 Lord McFall of Alcluith: For the record, I was aware of the demands that the Treasury Select Committee put on you and your staff during the crisis, both in terms of information it required and your appearances before the Committee. Both yourselves and the

FSA, given the structure that existed, were on every occasion very willing to engage. It is important to make that clear. Governor, the position of Greece, the implications for stability and growth across the eurozone but also for the UK are very much in our minds at the moment. Do you believe that the European institutions that have been established for that purpose, the ESRB, of which you are vice-chairman, and others, are structurally sound and are designed to take on the big issues like cross-border resolution in Europe and elsewhere?

Sir Mervyn King: They are. One thing I confess being pleasantly surprised about in the ESRB was the genuine commitment of the senior people around the table to engage in a serious discussion of the issues. In most of the international meetings, when you have 60, 70 or 80 people around a table, you would not want to listen to the discussion. Frankly, it is rather pointless, but this was not. People were very disciplined about the time they took up and were clear about the interventions, I suspect because they realised that what was at stake here was very great. I have been impressed by the way the ESRB have worked. Whether we can translate this into action is a different question, because the ESRB can make only recommendations and it is up to ECOFIN and the supervisory bodies to do something about it.

This is linked to the question of judgment and flexibility. If we were meeting four years ago we would have said, "We have weights to calculate the riskiness of banks, and there is a zero risk weight on sovereign debt. What we really ought to be worrying about is not that but the risk weight on subprime mortgages." Four years on, what seems absurd about the current system is a zero risk weight on sovereign debt when we know that that can be a highly risky instrument. One of the challenges for regulation is that if you want to have an international agreement on risk weights as part of the Basel framework it is very difficult to have something that can change quickly, because often it takes years of negotiation to get to an agreement. Then you find that within a year or two those risk weights look outdated. You need that framework but it needs to be supplemented by discretion at national level which gives supervisors a degree of flexibility and agility to respond to problems.

Q843 Lord McFall of Alcluith: I want to pick up your point about the character of lending in the financial system in the previous five years. We had debates on assisting the real economy, particularly the regional economy. That was important. Will these institutional changes assist that process? If the Bank of England and others are not issuing corporate bonds, who can do that? Who can answer the question that Adam Posen posed when he said that we lack a spare tyre for lending to manufacturing and small businesses?

Sir Mervyn King: I think that is something that the Treasury and BIS can do. The Chancellor has said he wants to make announcements in his pre-Budget statement. We will see what comes out of that, but there is no doubt these are crucial questions for the economic future of the country. It is important they are seen as issues to be debated in Parliament where the Government have responsibility to act.

Q844 Lord McFall of Alcluith: Will the institutional changes assist that?

Sir Mervyn King: I am not sure it will make very much difference to that. That is not a reason for not realising that these are crucially important questions.

Paul Tucker: Indirectly, it will help in the following sense. Part of the economy which gets most badly damaged when the banking system implodes is the part of the economy that depends entirely on banks: SMEs and households. It is indirect, but anything that makes the banking and financial system more resilient will make it less likely that households and small firms will find themselves where they are now. It is exactly as the Governor described when dealing with monetary policy. That is the contribution we can make. It is not the good things in themselves but it is a precondition for having the good things.

Q845 Chairman: Do you envisage that the FPC will have powers to restrict lending to particular sectors, like the financial sector, and direct it to other sectors, which was the implication of the recommendations from HSBC?

Sir Mervyn King: That is to be debated and discussed. I am nervous about that, partly because that trying to second-guess details very often goes wrong. If the FPC could manage to have a major influence on the rate at which the banking sector as a whole was expanding or contracting its balance sheet we would take an enormous step forward. There will be examples of the creation of particular kinds of financial instruments that we think pose specific risks. For example, we talked a great deal about structured credit products and CDOs before the crisis. If we had been able to do something to throw a lot more light on that so people came to the realisation much earlier that they were riskier than they had been led to believe, and to make it more difficult for the ratings agencies to pretend they were triple-A-rated instruments it would have been a big plus, but I suspect that will be more in the area of financial products than in deciding whether we should encourage lending to manufacturing versus services, and so on. That is a slippery slope that is not one on which the FPC have particular expertise and certainly no legitimacy in trying to distinguish between different parts of the real economy.

Paul Tucker: What we have said so far in the record of the FPC meeting is that one instrument we may ask for—it is not concluded yet—is the ability to alter risk weights in particular sectors. To go back to Mr Laws' question, the classic in the boom leading up to the crisis would have been to require banks to hold more capital to lend to other parts of the financial system. That would probably have had the effect of dampening it, but it turned out that that lending was just a lot riskier than anyone had thought when they had initially calibrated the risk weights. It is important to emphasise that this is not to do with a form of active macro-economic management. You write a set of minimum requirements; you do your best to cater for the future but things come along that the international community did not think of, for example, things in Ireland which are different from the UK or Wall Street. You need to be able to flex and say, "We need a greater degree of resilience right now about lending into parts of the financial sector."

Sir Mervyn King: That is why relying on detailed risk weights can be dangerous, because the appropriate risk weights can change over time. The lesson of successful regulation in other industries is the need to focus on robustness and simplicity. If you start to make the regulation too complicated not only will the regulated use their lawyers to get round it but the details will turn out to be the wrong ones. Thinking about robustness and simplicity are the key.

Q846 Baroness Wheatcroft: We are talking about expertise among regulators. You talked about clearing houses. Would there be some merit in putting exchanges under the same regulatory authority as clearing houses? Would that make more sense? Would there be more expertise there? That takes me to a broader point. Judgment-based regulation requires the right people to exercise the judgment. One theme that has cropped up repeatedly as we have talked to people from industry is their nervousness about the quality of the people, not I hasten to add from the Bank of England but those coming from the FSA. They have seen a drift of talent away from the FSA, particularly in this period of limbo, and they are very worried about whether the new structure will have the quality of people to exercise the judgment they want and is required. Should there be some form of compulsory secondment scheme from industry? Do you see any way of getting the right people into regulation?

Sir Mervyn King: At first sight, it seems attractive to put exchanges in with central counterparties. The drawback is that the one kind of regulation that the PRA should not get

involved in is the inevitably legalistic and detailed rule-based regulation on insider trading, compliance and conduct of business. If you could separate the two, maybe. Our present feeling is that it is quite hard. The one thing we definitely don't want is that kind of regulation vis-à-vis exchanges.

On the broader question of people, let me make a general comment first. People often say that you will have to pay vast sums of money to get people to come and be regulators. I do not believe that is true, and if you do pay vast sums of money you get the wrong people. We want to demonstrate that in the Bank of England it is possible to have a public service career where you specialise in being an effective regulator. Two of the most effective regulators I have known in my career were Paul Volcker and Gerry Corrigan. They were people who never got paid very much money during their careers. They were very powerful and effective regulators because they were committed to a life of public service and found it intellectually fascinating, and it mattered for their country. Just as we have managed to do in the area of monetary policy and financial stability, we want to attract people, certainly recruiting them when they are young but others in mid-career, who want to work on public policy. I do not think we want to mimic some of the salary scales of the FSA, nor do I think that we want to attract people who take short-term periods out of the financial services sector to get two or three years' experience and then go back. We want people who want to make careers as regulators. We will need experience and knowledge, but, most of all, we want people who have the expertise to be regulators. It is very striking that in other industries the regulators are not people who take secondments from the industry or have had a career working in the industry; they have expertise as regulators. That is the kind of people we need in the Bank of England.

Q847 Chairman: Governor and Deputy Governors, thank you for your extremely thoughtful and lucid responses to the Committee. They are very helpful to us and will assist us in carrying forward our investigation into this voluminous Bill.

Sir Mervyn King: We wish you well. If you need any other information from us, just let us know.