

# **BANK REGULATION: CAN WE TRUST THE VICKERS REPORT?**

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## **EXECUTIVE SUMMARY**

- The Independent Commission on Banking (ICB), chaired by Sir John Vickers, was set up to advise the government on how to improve UK financial security without damaging the banking industry or the economy. It had another, tacit brief: to find ways to avoid future government bank bailouts.
- The ICB made two substantive recommendations:
  - (1) ring-fencing of High Street banks, which would retain government guarantees; and
  - (2) raising capital ratios above those being considered by the EU and globally by Basel III.
  - There were also some detailed, but ultimately insubstantial, recommendations on competition.
- The Chancellor, George Osborne, immediately accepted the Commission's report as the basis for action, albeit some time in the future. However, we believe the proposals deserve much deeper and wider public debate.
- The ICB misdiagnosed the problem – focusing on structure and proposing more regulation, when in fact the financial crisis was caused by poor decisions by bankers (made on the bank of a long government-led expansion of money and credit), and by inadequate supervision by regulators who were divided and confused about their responsibilities.
- The report says nothing about improving bankers' decision-making, banking supervision, or money and credit policy. What proposals it does make will jeopardise UK banking by reducing its global competitiveness and will harm the UK economy by reducing the funds that the banks have available to lend to small and medium-sized enterprises (SMEs) and raising the cost of finance for their customers.

### **Ring fencing**

- Ring fencing can be traced back to the idea of 'narrow banks' floated by the Bank of England's Kevin James before the banking crisis. He saw them as easier to regulate and less likely to need government bailouts, being allowed to invest only in safe assets. We see some merit in this approach. Unfortunately, the Commission has loaded this simple idea with such complex regulation as to make it unworkable.
- We propose instead a simple market-led form of narrow banking – Trust Banks, separately licensed and supervised by the Bank of England. Trust Bank status would be seen by the public as a kite-mark for security. The threat of this kite-mark being withdrawn by the Bank of England would focus Trust Banks on remaining secure.
- New or existing banks would be free to create Trust Banks, using a variety of business models, providing only that the Bank of England is

satisfied that their assets are safely invested, their customers' deposits are secure, their capital ratios are adequate, and they do not grow 'too big to fail'.

- Trust Banks would be subject to frequent and unannounced inspections. They would be the only banks qualifying for the government's £85,000 guarantee to depositors; but Trust Banks may go further and offer additional security through third-party deposit insurance.
- Trust Bank directors would face major penalties in the event of their bank's failure, including long-term disqualification and the return of their recent bonuses. This again will focus Trust Bank executives on maintaining the security of their institutions.
- Trust Banks could be part of larger banking groups, but the Bank of England would have to be satisfied that they could survive as stand-alone entities in the event of their parent or sibling companies' failure.
- An ever-changing global economy needs financial innovation, in which London's banks should be able to play a leading part. The regulation of Trust Banks can be simpler than today's all-embracing bank regulation. At the same time, the regulation on non-Trust banks can be eased, given their more financially sophisticated customer base and the fact that government guarantees would be limited to Trust Banks.
- Our proposals will therefore simplify and ease regulation, which is not only a cost but a major barrier to entry. This in turn will promote innovation and diversity.
- Trust Bank status should be attractive to newer, smaller banks such as the supermarket banks and Virgin Money. Our proposals will therefore boost competition in a market where, at present, the 'big four' banks hold 72% of personal current accounts and 85% of small business accounts.

### **Capital ratios**

- The ICB's proposals on capital ratios would damage UK banking and the UK economy. Banking is a global market, and any market needs just one set of regulations, in this case Basel. The UK banking industry can only be damaged if it has to bear heavier capital ratios than those required of the rest of the world by the Basel Committee, as the ICB proposes.
- We see no reason for Trust Banks to be more restricted than the Basel rules provide.
- The higher capital ratios proposed by the ICB would restrict UK banks' ability to lend to businesses, particularly small and medium-sized enterprises (SMEs). Since these are the prime drivers of the UK economy and employment, economic growth and GDP would be even more damaged by the ICB proposals than from those coming from Basel and the European Union.

## Other recommendations

- Trust Banking licences should be given to UK companies only, not to branches of European Economic Area (EEA) or other overseas companies. This may require some negotiation with Brussels; but it would not challenge open market principles, since any foreign company can have a local subsidiary. Brussels is aware of the problem with Icelandic bank branches in the UK which were not supervised by the FSA or anyone else. In other words, foreign banks would have to follow the same rules as UK banks so far as their UK operations are concerned.
- Bank auditors should be appointed by and answerable to audit committees made up of shareholders, not directors.
- The functions of the Consumer Protection and Markets Authority, the Financial Ombudsman Service and the Office of Fair Trading clearly overlap; they should be brought closer together (if not integrated) in order to improve coordination with the Bank of England.
- Unlike the Tripartite Committee that met just once in 12 years, the Treasury should annually review the Bank of England's supervisory performance, as well as the consumer protection agencies, in a transparent fashion. As recommended by Lord Sassoon, a sufficient number of senior Treasury staff should have senior banking and senior Treasury experience, both long enough to ensure that the examination of the Bank's performance is forensic.
- Making banking rules is one thing; ensuring that they are equally implemented in the 200 countries around the world is quite another. The Bank of England, supported by the Treasury, should press for a monitoring system that can identify and report failures in implementation. The global monitor should report annually on inspections and outcomes.

## 1. BACKGROUND AND APPROACH

When the Coalition came to power in May 2010, they were under pressure to ‘do something’ about the banks. They created a Commission, the Independent Commission on Banking (ICB), led by Sir John Vickers to report by September 2011.

The ICB comprised Sir John Vickers (Chair), Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf. Their *Final Report* (‘the Report’) sets out the Commission’s recommendations on reforms to improve stability and competition in UK banking (p.7).<sup>1</sup>

In its Report, the ICB expresses the hope that its recommendations will bring all manner of desirable outcomes: greater resilience against future financial crises, removing risks to the public finances from the banks, and greater effectiveness, efficiency and security; while vigorous competition will deliver the services required by well-informed customers. These goals for UK banking, says the Commission, are ‘wholly consistent with maintaining the UK’s strength as a pre-eminent centre for banking and finance, and are positive for the competitiveness of the UK economy. They [will] also contribute to financial stability internationally, especially in Europe. The international reform agenda – notably the Basel process and European Union (EU) initiatives – is making important headway, but needs to be supported and enhanced by national measures’ (p.7).

The simultaneous achievement of all these ideals would be remarkable indeed, and there is no hint that some may be trade-offs for others. (For example, the arrival of new entrants into banking would increase competition but not necessarily stability.)

The recommendations are basically two-fold:

- (1) High Street banks (serving private customers and small businesses) should be ring-fenced so that they are unaffected by the collapse of their parent companies and/or siblings; and
- (2) High Street banks should have higher capital (equity: debt) ratios – similar to the Basel II proposals but with higher requirements.

There were also recommendations on competition.

### **Outline of the present paper**

Section 2 explores the context of the ICB’s work and whether its objectives were the right ones in terms of finding solutions to potential future problems. In particular it argues that the Commission failed to

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<sup>1</sup> Unless otherwise stated, all references are to the Independent Commission on Banking, Final Report Recommendations, September 2011.



recognise the global nature of finance and the ongoing EU and international regulatory initiatives.

Section 3 questions how far the ICB's recommendations would in fact have prevented the UK's experience of the banking crisis of 2007-9.

Section 4 outlines the ICB's proposals on ring-fencing, capital enhancement and competition, making specific criticisms of some of these proposals.

Section 5 provides wider criticism of the ICB's proposals, or lack of them, on the regulatory structure, industry structure, capital requirements, competition and the corporate governance of banks.

Section 6 sets out suggestions of what the Report should have said.

Section 7 summarises our own recommendations.

## 2. CONCERNS ON THE CONTEXT OF THE REPORT <sup>2</sup>

### Misdiagnosis and wrong prescription

In a definitive history of banking crises,<sup>3</sup> Reinhart and Rogoff show that the duration of banking crises extend from four to over twenty years.<sup>4</sup> They note that: 'A high incidence of global banking crises has historically been associated with a high incidence of sovereign defaults of external debt.'<sup>5</sup>

They show peak-to-trough declines in real housing prices extending over up to seventeen years (Japan, 1990-2007); real equity prices over up to seven years (Thailand, 1997-2004), growth over up to four years (Finland, 1991-1995, Argentina, 2001-2005 and the US, 1929-1933); and sovereign ratings over up to fourteen years (Japan, 1991-2005). They also show peak-to-trough increases in unemployment extending over up to eleven years (Japan, 1990-2001) and an average increase of fiscal indebtedness of 186% in the three years following banking crises.

This suggests that the UK may be only in the early stages of a long crisis. Sadly, history suggests that any such downturn is most likely to be addressed by policies that are irrelevant, inconsistent, ill-timed, inexpert or opportunistic, if not out-and-out dysfunctional. Our fear is that the ICB has misdiagnosed the problem and offers prescriptions that will not work and that will actually put back the UK's recovery.

As the Financial Services Authority eventually acknowledged, the financial crisis was more a failure of *regulators* than of *regulation*. The government failed to coordinate the work of the Financial Services Authority and the Bank of England, and both failed in their regulatory roles. The Bank of England ignored one of its two main responsibilities, financial market stability, and focused only on the second, monetary stability. Yet the ICB focuses only on the structure of the banks and ignores what the Bank of England and regulatory authorities could and should have done to prevent the last crisis, and what it could and should do to prevent future ones.

### Unintended consequences

Following a crisis, policymakers are urged to do something and feel they need to do so. Whether their actions are prophylactic or themselves create similar or different problems becomes clear only in the longer term. The usual solution to a crisis is more regulation; but already, as

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2 We are grateful to contributors for the contextual and other concerns with the Report. Apart from those who asked to remain anonymous, their names are listed as Appendix B.

3 *This time is different*, Carmen M. Reinhart and Kenneth S. Rogoff, Princeton 2009, figures 14.1 to 14.6, pp.227-233.

4 *Banking Crises: An Equal Opportunity Menace*, Carmen M. Reinhart, University of Maryland, NBER and CEPR; Kenneth S. Rogoff, Harvard University and NBER, December 17, 2008. p29.

5 *Ibid*, p.9

Professor Tim Congdon told us: 'Banking regulation has become a disaster, and is a major threat to the market economy and free society. Any intellectual response has to be root-and-branch if it is to make any headway.'<sup>6</sup>

Lord Lawson has argued that banks would try to 'game' the ICB's proposed ring-fencing to their advantage.<sup>7</sup> Top City accountant, Eric Anstee expressed the same view to us.<sup>8</sup>

Banks deserve defending to the extent that they allocate capital better than governments; but we should be concerned with what is best for the economy as a whole and less fixated with feather-bedding the banks to reduce the risk of future bailouts. In other words, the Commission was ill-conceived: it would certainly be good to protect the nation from more emergency cash injections, but economic growth and strong SMEs and financial services are more important.

Professor Patrick Minford was critical of the Report and concluded: 'By raising costs it has also set back entry and so competition.'<sup>9</sup> John Redwood MP amplified this, stating:

'The weakened banks are now under a regulatory cosh to improve their balance sheets. They are told they must have more cash and capital to back up a given quantity of lending. They are doing so not by raising more capital but by lending less. This constrains recovery.'<sup>10</sup>

Banks are widening their margins so that small and medium-sized enterprises face a double whammy: less finance being available, and at a higher price. This problem exists already; it will be increased by Basel III, and compounded further if the ICB recommendations for even higher capital ratios are enacted.

### **A Little Britain approach**

The Report takes a cursory look at international issues, but not in any depth. Under EU law, for example, the Report's recommendations cannot be applied to branches of banks headquartered outside the UK but within the EEA. The Report does not consider what would happen if, as a result of the additional regulation it proposes, UK High Street banks moved their headquarters to (say) Dublin, leaving on branches in the UK. It is remarkable that EEA branches get virtually no attention, given that Icelandic banks proved to be such a major part of the 2008 problem.

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6 Email to authors 14 October 2011

7 Harry Wilson 'Lord Lawson 'astonished' at ICB report on ring-fencing banks,' Daily Telegraph 19 Oct 2011

8 Anstee now has his own City practice but was previously Chief Executive of the Institute of Chartered Accountants in England and Wales; email to authors 4 October 2011

9 Email to Adam Smith Institute, September 2011.

10 Email to Adam Smith Institute, September 2011.

Tony Shearer, CEO of Singer and Friedlander when Kaupthing took them over, is scathing about the complete failure of the Commission to analyze the causes of the crash or the lessons to be learned from overseas.<sup>11</sup> His own analysis is similar to that summarized here. On the international front he wrote:

'The report contains no analysis of other countries whose banks did better or worse than the UK, or why some UK banks did better or worse than others. As a result it makes suggestions for reducing the risk of future banking crises without any understanding of the global lessons from the banking crisis.'<sup>12</sup>

The Report argues in effect that whatever happens at the international level, the more regulated the UK is, the more attractive it will be to foreign investors. This is patently false. Global players want a global playing field and, failing that, will look for opportunities to take advantage of regulatory differences. For example, when US regulation increased after Enron and Worldcom, New York business transferred to London. The increase in regulation under the resulting Sarbanes-Oxley cost the US economy \$5.5 billion a year.<sup>13</sup> No sane business would transfer to a more difficult and more costly financial centre unless those costs could be passed on as premiums and more business would flow. In a competitive global market, that is most unlikely.

Yet the Commission nowhere suggests that there is something special about the UK that makes their recommendations suitable for the UK but not elsewhere. If there is nothing special about the UK, then the Commission's solutions can simply be tested by recommending them to the Basel Committee and seeing how many, if any at all, would be accepted or even considered globally. To the extent that they would be rejected, the UK would be hobbling its crucial banking industry, raising costs for UK SMEs and weakening the UK economy all for no good purpose. Lord Myners (Financial Services Secretary from October 2008 until May 2010) expressed this point as follows:

'I don't think anybody else in the world is going to copy Vickers, so either we are the only ones in step, or we have to ask whether Vickers has provided the answers. If we persist with this, HSBC would want to consider moving its holding company. If I was the director of HSBC, I would simply cease to do business in the UK through HSBC plc which is the old Midland bank, and I would instead do it through CCF, their French bank, which can be passported into the UK, and thereby avoid all the extra capital requirements that Vickers is putting on me, and also

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11 According to Geoffrey Gardiner: in 1976, at an Institute of Bankers conference in Cambridge he 'asked a senior official of the Bank of England if his staff ever went abroad to study other countries capital systems and see what could be copied and improved upon. He went ballistic. 'Of course not. We might go abroad occasionally to tell the foreigners what to do.'" Comment on Professor Kotlikoff's article, see below, FT website, 24th October 2011.

12 Response to the 'Interim Report of the Independent Commission on Banking,' Tony Shearer, 30th May 2011.

13 Roland Hefendehl, 'Enron, WorldCom, and the Consequences: Business Criminal Law Between Doctrinal Requirements and the Hopes of Crime Policy,' Buffalo Criminal Law Review 8:51, pp.51-88

avoid the UK bank levy. And it's so blindingly easy to find those sort of loopholes in Vickers, and I'm afraid we have to say that at best, as a professor, this work would get no more than a beta.'<sup>14</sup>

Lord Flight, previously Shadow Financial Secretary, commented equally forcibly:

'Because of the importance of the banking industry to the UK economy I also believe it would be madness for changes to UK banking structures not to move in line with the other main banking centres – New York, Frankfurt, Hong Kong, Tokyo, Singapore, etc. A more expensive operating base in London will simply serve to transfer speedily international banking business (and many jobs) to other major banking centres. I regret to comment that I think it is economic irresponsibility to argue that the UK should act independently here.'<sup>15</sup>

The UK financial services sector is subject to regulation at three levels: global (Basel), EU and UK. Given the transfer of financial regulation from London to Brussels, one must question why the UK should now regulate banks at all. The UK is responsible only for the supervision of our conformity with Brussels and Basel regulation.

As Lord Myners has said (above): 'The Commission's recommendations are very unlikely to be matched anywhere else.' The ICB failed to give enough attention to this international context and may be faulted on that ground alone.

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14 Transcript of panel discussion at the Association of Corporate Treasurers 'Spotlight on the Vickers Report - the real world effect,' Cass Business School, 28th September, p.16

15 Email to authors 26th September 2011



### 3. WOULD THE ICB HAVE PREVENTED THE CRASH?

The ICB Report devotes considerable attention to whether the recommendations, applied earlier, would have prevented the crash (Box 2.1 p.31). In essence, the claim is that it would have done so. But this is based on a misunderstanding of the origins of the crash. The Commission's and our reasons for the bank failures are compared below.

<b>Northern Rock</b>	
<p><b>ICB Report</b></p> <p>In June 2007, following balance sheet growth of &gt;20% p.a., only 23% of [Northern Rock's] funding was from retail deposits, with the majority being wholesale funding (e.g. securitisations, covered bonds). As wholesale funding markets froze in autumn 2007, the Bank of England provided emergency liquidity assistance before [Northern Rock] was taken into public ownership in 2008.</p>	<p><b>The reality</b></p> <p>This overlooks the fact that Northern Rock was a high-profile standard-bearer for the banking ambitions of Newcastle and the regeneration of the northeast in general. It had excellent relations with the government and senior regional parliamentarians. It pursued the UK's most aggressive bank funding policy, combined with the opacity of off-balance sheet SPVs.<sup>16</sup> It was brought down because of its overexposure to the interbank market and was nationalised a few hours ahead of the UK's first retail bank-run in 140 years. Warning signs were noted by the FSA but no one followed them up. The government was obliged to over-react because the banking monopoly had successfully resisted proposals to pay for private insurance for depositors; and the UK lacked regulatory experience with a 'resolution regime' for winding up failed retail banks.</p>
<b>Bradford and Bingley</b>	
<p><b>ICB Report</b></p> <p>Silent, other than a throw-away comment on competition. This overlooks the failure of a business which would lie within the proposed ringfence.</p>	<p><b>The reality</b></p> <p>In a less noisy way, Bradford and Bingley was also a standard bearer for the banking and regeneration ambitions of South Yorkshire. It pursued the UK's most aggressive house-lending policy, leading to overexposure to high-risk property loans. It also suffered from poor quality capital which was reliant on high-risk paper. After a failed rights issue, it lost its independence to</p>

<sup>16</sup> Special Purpose Vehicles aka Derivative Product Companies. According to Investopedia, 'A corporation can use such a vehicle to finance a large project without putting the entire firm at risk. Problem is, due to accounting loopholes, these vehicles became a way for CFOs to hide debt. Essentially, it looks like the company doesn't have a liability when they really do. As we saw with the Enron bankruptcy, if things go wrong, the results can be devastating.' <http://www.investopedia.com>

	Santander in a fairly orderly process.
<b>Dunfermline</b>	
<p><b>ICB Report</b></p> <p>Also silent as above</p>	<p><b>The reality</b></p> <p>The misfortunes of Dunfermline, a mutual building society, were largely eclipsed by bigger stories elsewhere.</p> <p>'It has made £648m of commercial property loans in Scotland and the North of England. Of that, around £500m of these loans were made in the past three years - which means, in view of the collapse in commercial property prices, that losses on these later, top-of-the-market loans are likely to be very significant. In addition, Dunfermline acquired £274m of buy-to-let and self-cert mortgages from the likes of defunct Lehman Bros and from GMAC.'<sup>17</sup></p> <p>It was drawn into high-risk commercial property deals and bought a book of self-certified retail loans at the top of the market. The authorities presided over its takeover by Nationwide, also in a fairly orderly process.</p>
<b>Lehman Brothers</b>	
<p><b>ICB Report</b></p> <p>[Lehmans] was heavily exposed to US sub-prime mortgages and over 30 times leveraged – a combination which led creditors to stop providing funds as large losses began to materialise. When in late 2008 it ran out of liquid assets to sell to meet this withdrawal of funds, it filed for bankruptcy.</p>	<p><b>The reality</b></p> <p>This is true as far as it goes, but fails to engage with US regulatory failure (specifically, government policies aimed at increasing sub-prime lending). Lehmans invested in property (mortgage) assets which they believed to be sound when they bought them. If you are less charitable, they knew they were worthless and were just unlucky to be left holding the parcel when the music stopped. In any event, the story has nothing to do with the ICB or the UK, which had no jurisdiction over Lehmans' core operations, upon which ring fencing would have had no effect. The story has no place in the report, in which it serves simply to draw attention to the risks of investment banking.</p>

<sup>17</sup> [http://www.bbc.co.uk/blogs/thereporters/robertpeston/2009/03/how\\_dunfermline\\_fell.html](http://www.bbc.co.uk/blogs/thereporters/robertpeston/2009/03/how_dunfermline_fell.html)



## RBS

### ICB Report

[RBS] bought most of ABN AMRO under a largely debt-financed deal which left it with limited equity at end-2004% of risk-weighted assets (RWAs) – 1.2% of assets. It suffered large losses from proprietary trading, structured credit, derivatives and write-downs of goodwill from recent acquisitions. It raised £12bn of new equity from existing shareholders in 2008 but this proved insufficient. The Government injected a further £45bn of equity and insured some assets against extreme losses.

### The reality

This gets the sequence completely wrong. RBS was one of the two principal standard-bearers for the proud history of Edinburgh banking. Its CEO, Sir Fred Goodwin, became close to the government of the day and Gordon Brown in particular. Under his leadership, the bank followed an extraordinarily aggressive combination of funding, lending and acquisition policy. It ended up overexposed to a portfolio of high-risk activities including property loans. It also relied upon funding from the interbank market and was the sole major UK victim of ‘alphabet soup’ products, in that it imprudently bought them to improve its margin. The Commission’s proposals would do nothing to address this. Warning signs were noted by the Financial Services Authority but no one followed them up. Already weak, it was brought down one year into the crisis, after it qualified for the ‘winner’s curse’ by paying top dollar for the investment bank operations of ABN Amro. It was recapitalised by ministers spooked by the Northern Rock affair a year earlier and the more or less coincident TARP<sup>18</sup> proposals in the US.

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18 Troubled Asset Relief Program. Investopedia explains: ‘A government program created for the establishment and management of a Treasury fund, in an attempt to curb the ongoing financial crisis of 2007-2008. The TARP gives the U.S. Treasury purchasing power of \$700 billion to buy up mortgage backed securities (MBS) from institutions across the country, in an attempt to create liquidity and un-seize the money market’ <http://www.investopedia.com>

<b>HBOS</b>	
<p><b>ICB Report</b></p> <p>At end-2007, 56% of [HBOS'] funding was wholesale (more than half of which was short-term) and it had a very thin layer of equity capital: less than 6% of RWAs and only 2.7% of assets. Increasingly unable to replace maturing wholesale funding, it was acquired by Lloyds TSB in early 2009.</p>	<p><b>The reality</b></p> <p>This misses most of the story. Bank of Scotland was Edinburgh's second standard-bearer. It merged with Halifax, which had a similar role to Bradford and Bingley in its ambitions for regeneration in West Yorkshire. The merged bank, HBOS, embarked on the country's most aggressive combination of funding and lending policies. This left it overexposed to the usual combination of dud property loans and funding from the interbank market. The Commissions proposals would do nothing to address this. Its purchase by Lloyds is mysterious: perhaps Lloyds CEO Sir Victor Blank felt that that he couldn't say no to the government a second time – Lloyds had declined to rescue Northern Rock a year earlier and Gordon Brown was leaning on them hard. In return Lloyds got the extraordinary concession of an agreement to waive a Competition Commission referral, though in part this has been rolled back by the European Commission, which called for the group to divest at least 600 branches. Once Lloyds discovered the full extent of HBOS' distress, it too had to be recapitalised by government.</p>

Our conclusion is that two-thirds of the disaster arose from the usual run of business for building societies – namely mortgages – which the ICB proposals would do nothing to address. The Commission seems to have fallen for the widespread but mistaken view that it was the investment banks that collapsed and dragged down their retail siblings. Lehman Brothers apart (and that is a US matter that UK regulation would not have changed anyway) our analysis shows that the reverse was the case.

Over-exposure to the wholesale market should not have been an issue as the Bank of England should have provided money to see institutions through a liquidity crisis, provided they were solvent and trading profitably. Many, such as Professor Tim Congdon and Stuart Wheeler, an experienced City hand, expressed the view to us that this 'lender of last resort' role is what a central bank is for.<sup>19</sup> But the Bank of England failed in this role.

As the Financial Services Authority has since conceded, the truth was that the *regulators* were to blame for the crash, rather than the *regulations*. Andrea Enria, head of the European Banking Authority (the oversight regulator for the European Union) told a recent *Financial Times* breakfast debate on the future of banking that extra capital is important, but 'it's important that we strengthen supervision. I think we

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<sup>19</sup> Email to the authors 3rd October 2011.

have a major task ahead in dealing with [systemic risk].”<sup>20</sup> In other words, supervision matters more than regulation.

Regulation, in fact, can make matters worse by giving everyone the illusion of security. It also adds complexity and contributes to uncertainty in terms of the interpretation of complex rules. This was a major contributor to the Northern Rock debacle in particular: the Bank of England was inhibited, probably wrongly, by concerns that interventions would break the Takeover Code or EU rules on government interventions, while the Treasury was anxious about breaching EU rules on state aid and state-owned banks. The European Commission has since indicated that the concern was unnecessary.<sup>21</sup>

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20 Patrick Jenkins, *Banks locked in vicious circle as regulators debate tougher rules*, Financial Times, 23 September 2011

21 Tim Congdon, *Northern Rock and the European Union*, Global Vision, June 2008.

## 4. CONTENT OF THE REPORT

### Principles of ring-fencing

The ICB outlines five principles underpinning its ring-fencing proposal.

(1) First, only ring-fenced banks or building societies can provide 'mandated services', which 'currently comprise the taking of deposits from, and the provision of overdrafts to, individuals and small and medium-sized organisations' (p.36).

The line between a consumer loan and an overdraft is narrow but is not explored. And the Commission specifically declines to define other traditional High Street business such as mortgages, loans, and retail credit as 'mandatory'; in other words, these should be open to non-ring-fenced competition.

(2) The second principle prohibits ring-fenced banks from activities that increase their exposure to global financial markets or are not integral to the provision of core customer services. They would not be allowed to provide services to customers outside the EEA, could not generally expose themselves to a non-ring-fenced financial institution, could not do things that would result in a trading book asset or a requirement to hold regulatory capital against market risk, and could not deal in derivatives or secondary markets (p.52).

(3) The third principle permits 'ancillary activities', i.e. those that are neither mandated nor prohibited but do not involve too high a proportion of the bank's business. Much of this is rather vague.

(4) The fourth principle defines 'ring-fencing' itself:

- a) 'ring-fenced banks should be separate legal entities – i.e. any UK regulated legal entity which offers mandated services should only also provide services which are not prohibited and conduct ancillary activities;
- b) any financial organisation owned or partly owned by a ring-fenced bank should conduct only activities permitted within a ring-fenced bank. This organisation's balance sheet should contain only assets and liabilities arising from these services and activities;
- c) the wider corporate group should be required to put in place arrangements to ensure that the ring-fenced bank has continuous access to all of the operations, staff, data and services required to continue its activities, irrespective of the financial health of the rest of the group; and
- d) the ring-fenced bank should either be a direct member of all the payments systems that it uses or should use another ring-fenced bank as an agent' (p.67).

On their face, these are clear except for (c) which seems to imply that the ring-fenced entity need not have its own staff, operations etc., but only continuous access to them.

(5) Fifth:

‘Economic links. Where a ring-fenced bank is part of a wider corporate group, its relationships with entities in that group should be conducted on a third party basis and it should not be dependent for its solvency or liquidity on the continued financial health of the rest of the corporate group’ (p.72).

This duplicates the ‘stand alone’ fourth principle. The most significant feature is that the board of the ring-fenced bank must be independent of the parent board even though there may be some joint directors.

### **Capital enhancement rules**

Things get complicated when the Report moves to its second main recommendation, namely increases in banks’ capacity to withstand shocks. In the Report’s words:

#### **4.132 Equity**

- Ring-fenced banks with a ratio of RWAs [Risk Weighted Assets] to UK GDP of 3% or more should be required to have an equity-to-RWAs ratio of at least 10%.
- Ring-fenced banks with a ratio of RWAs to UK GDP in between 1% and 3% should be required to have a minimum equity-to-RWAs ratio set by a sliding scale from 7% to 10%.

#### **4.133 Leverage ratio**

- All UK-headquartered banks and all ring-fenced banks should maintain a Tier 1 leverage ratio of at least 3%.
- All ring-fenced banks with a RWAs-to-UK GDP ratio of 1% or more should have their minimum leverage ratio increased on a sliding scale (to a maximum of 4.06% at a RWAs-to-UK GDP ratio of 3%).

#### **4.134 Bail-in**

- The resolution authorities should have a primary bail-in power allowing them to impose losses on bail-in bonds in resolution before imposing losses on other non-capital, non-subordinated liabilities.
- The resolution authorities should have a secondary bail-in power to enable them to impose losses on all other unsecured liabilities in resolution, if necessary.

#### **4.135 Depositor preference**

- In insolvency (and so also in resolution), all insured depositors should rank ahead of other creditors to the extent that those creditors are either unsecured or only secured with a floating charge.

#### 4.136 **Primary loss-absorbing capacity**

- UK G-SIBs [Globally Significant Important Banks] with a 2.5% G-SIB surcharge, and ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more, should be required to have primary loss absorbing capacity equal to at least 17% of RWAs.
- UK G-SIBs with a G-SIB surcharge below 2.5%, and ring-fenced banks with a ratio of RWAs to UK GDP of in between 1% and 3%, should be required to have primary loss-absorbing capacity set by a sliding scale from 10.5% to 17% of RWAs.

#### 4.137 **Resolution buffer**

- The supervisor of any (i) UK G-SIB; or (ii) ring-fenced bank with a ratio of RWAs to
- UK GDP of 1% or more, should be able to require the bank to have additional primary loss-absorbing capacity of up to 3% of RWAs if, among other things, the supervisor has concerns about its ability to be resolved at minimum risk to the public purse.
- The supervisor should determine how much additional primary loss-absorbing capacity (if any) is required, what form it should take, and which entities in a group the requirement should apply to, and whether on a (sub-) consolidated or solo basis' (p.121).

### **Capital rules explained**

One might wonder how many UK bank directors, who failed to understand the toxic assets they were buying, will comprehend these proposed principles, never mind the detailed legislation that would be needed to implement them. To translate:

**Equity ratios.** The Vickers report defines equity as ordinary shares (4.7) whereas Basel III, more correctly, includes retained earnings. If Vickers meant to include retained earnings, this should be clarified. Vickers distinguishes between the largest ring-fenced banks, as Basel III does not. The latter calls for eight percent for all banks, though this is to use a broader definition of equity so as to include subordinated debt. "The Commission proposes to increase further the equity ratios of large UK ring-fenced banks to at least 10% of RWAs." (A3.40 p.281) This fails to acknowledge economies of scale in banking.

**Leverage ratios.** Basel III proposes that in addition to the equity tiers 1 to 3 ratios versus risk-weighted assets, there should be a three percent Tier 1 capital requirement versus unweighted assets, not least because of the uncertainty of risk assessment. Vickers proposes the same for UK banks in general except that larger ring-fenced banks should have a sliding scale up to 4.06% (*sic*). The difficulty of risk-weighting assets is

beyond the scope of this paper, but the ICB's differences with Basel III on this score are trivial, based upon algebra as questionable as any risk-weighting itself, and may be discarded.

**Bail-in and depositor preference.** Bail-in is a new idea for avoiding full insolvency by imposing losses on some creditors but not others. Regulators in the UK and EU have been discussing these powers independently from the ICB. Bail-in follows the long established concept that certain classes of creditor, e.g. employees and secured creditors, should have preference in the event of liquidation. What the Commission is trying to do is to protect depositors without calling on public funds, i.e. by dumping the losses on other creditors, including secured creditors. That would give rise to legal problems, and the arguments against bail-in, coherently set out in the Report, seem far more compelling than the arguments in favour, which seem almost perverse. The inevitable consequence of bail-in is that banks nearing the limits of liquidity will find credit more difficult and more expensive and will therefore be more likely to be pushed over the edge. The Report calls this a 'death spiral' (4.69). The application of bail-in may well be counterproductive.

Following a similar line of thinking and similar practice overseas, the Financial Stability Board (FSB) is considering dividing depositors into four groups (Box 4.7, p.107) for preference purposes in the event of a company's collapse, i.e. the order in which any remaining funds are distributed. The EU has similar proposals. This issue has nothing to do with ensuring banks' financial stability but only with the consequences of liquidation. It might have some marginal effect on the cost to public funds of supporting the vulnerable. The Commission does not add value to the FSB's ongoing consultation and the matter should remain with the FSB. And once again, the problem may be more simply solved through properly financed depositor insurance schemes.

**Primary loss-absorbing capacity.** Basel III is not extended additionally to G-SIBS (Globally Significant Important Banks) although that is under consultation at a lower level (1% - 2.5% surcharge) than that proposed by the ICB (a sliding scale of 10.5% to 17% total for the large banks). Paragraph 4.124 is revealing:

'The Commission recommends that this requirement for minimum primary loss-absorbing capacity of 17% of RWAs apply to the biggest UK-headquartered G-SIBs and all large UK ring-fenced banks (and, on a sliding scale, some smaller banks). Unless this proposal is adopted internationally, however, the Commission does not recommend that the UK subsidiaries of non-UK-headquartered G-SIBs should need to meet this requirement (unless those subsidiaries are themselves UK ring-fenced banks). The Commission takes this view on the assumption that the UK taxpayer would not have any significant exposure to such an institution. Were this to be in doubt, the question would need to be revisited' (p117).

This indicates that the Commission is not looking for bank stability, still less the health of the banking industry, but merely trying to limit risk for the Treasury.

**Resolution buffer.** Not content with all that, the Report recommends giving supervisors the power to require yet another 3% (making 20%) capital, where they perceive a risk to the public purse. Since that risk would only arise when the edge is near, the requirement would surely tip the bank over, i.e., it would be a death spiral.

It is hard to believe that the members of the Commission have any experience of the realities of distressed banking. A bank near death for liquidity reasons but otherwise solvent requires new funding, probably from the Bank of England and certainly with conditions, plus new management. If it is insolvent and has a bad business model it needs to be sold or liquidated. In either case it is a fantasy to expect it to increase ordinary share capital when investors are least likely to invest, or to call in loans at a bad time for the borrowers and the economy.

**Impact on economy.** The Report's next chapter (5) considers the impact on the economy and concludes that the costs are well off-set by the reduced chances of another crash:

'5.72 Taken together, these approaches yield a range of costs from around £1bn to £3bn of annual GDP (or around 0.1% to 0.2%). That means that the recommendations would have to reduce the probability and impact of crises by between one fortieth (2.5%) and one thirteenth (7.5%) to deliver net GDP benefits. The Commission believes that £3bn is likely to prove a considerable over-estimate of GDP cost, but it is notable that even if the actual costs were double this estimate, for instance, the recommendations would only have to reduce the probability or impact of future crises by around one seventh (15%) in order to be worth pursuing' (p.144).

The Commission accepts that the cost estimates are based on speculative assumptions, and the benefit estimates still more so, but concludes: 'the reforms would deliver net benefits if they reduced the probability or impact of financial crises by any more than one tenth (10%)' (p.144). It turns out that the Commission relied upon brokers' estimates; in other words, these figures are completely unsupported.<sup>22</sup>

So far as competitiveness is concerned, the ICB's argument is that:

'Targeted reforms that focus on the parts of the sector to which the UK Government is particularly exposed should therefore enhance both the City's international reputation and the UK's ability to attract investment' (5.85 p.147).

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22 Transcript of panel discussion at the Association of Corporate Treasurers, 'Spotlight on the Vickers Report - the real world effect'; Cass Business School, 28th September 2011.



To turn round the famous quotation about General Motors, Vickers evidently believes that ‘what’s good for the UK Exchequer is good for UK competitiveness’. Hardly.

## Competition

Part II of the Report goes beyond the original brief by devoting ninety pages to competition. It states:

‘8.76 The current reform of financial sector regulation presents a unique opportunity to change the nature of regulation in this sector, to ensure that regulation is directed at improving competition and choice to the benefit of consumers’ (p.227).

This said, the proposals fail to engage with the oligopolistic structure of UK retail banking, but instead becomes entangled in prolonged detail.

**Market investigation reference** The ICB does not recommend an immediate market investigation reference to the Office of Fair Trading (OFT), as some, including Jon Moulton, contend it should have done.<sup>23</sup> Such a reference is contemplated according to how events turn out in the next few years, upon criteria based upon the Report’s recommendations, specifically:

- ‘a strong and effective challenge... from the LBG divestiture;
- ease of switching...transformed by...a robust and risk-free redirection service; and
- a  
strongly pro-competitive FCA [Financial Conduct Authority]....demonstrating progress to improve transparency and reduce barriers to entry and expansion for rivals to incumbent banks.’ (pp18, 158, 235, 241)

and then going on to say:

‘If one or more of these conditions is not achieved by 2015, the Commission recommends that a market investigation reference should be considered if the OFT has not already made one following its proposed review in 2012 of the PCA market.’ (pp. 240-243)

We question whether failure to comply with one or another aspect of ninety pages of detail will suffice to impel the authorities to make a reference, after the ICB itself declined the challenge. We explore this by looking at the detail:

**Financial Conduct Authority.** The Commission welcomes the Government’s commitment to give the forthcoming Financial Conduct Authority (FCA) a new primary duty to promote competition. Thus, the Commission recommends that the FCA’s draft objectives be amended so

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23 Telephone conversation with the authors on 17th October. Other references to Jon Moulton in this Review are to the same source.

that the efficiency and choice operational objective is replaced by an objective to 'promote effective competition'. It argues that this would be consistent with promotion of efficiency and choice as they are advanced by effective competition. The duty to discharge its functions in a way which promotes competition (Chapter 1B, point 4 in the draft bill) should also be kept, to make clear that in pursuing any of its operational objectives – not just the competition objective – the FCA should use competition as a means of achieving them wherever possible. In addition, the Government should reconsider the FCA's strategic objective to provide greater clarity on the fundamental issue of making markets work well – in terms of competition, choice, transparency and integrity. We join with the Commission on this.

***Switching and transparency.*** The Commission calls for a free, guaranteed and comprehensive redirection service for current accounts by September 2013. We give a flavour of the report's immersion into detail, by quoting its expansion of this simple point. The Commission states that a redirection service should:

- 'catch all credits and debits going to the old (closed) account, including automated payments taken from debit cards as well as direct debits;
- be seamless for the customer, so that throughout the process they have complete, problem-free use of their banking services and are not inconvenienced by debits or credits going to the wrong account;
- last for at least 13 months, to catch annual payments;
- continue to send reminders and provide support to direct debit originators to ensure that they update their details for people who have switched accounts;
- guarantee that customers will not suffer loss if mistakes occur in the switching process; and
- be free to the customer' (pp.218-9).

The Commission recommends that the OFT and the FCA (once established) should seek to improve transparency across retail banking products. As a first step, it recommends that interest foregone relative to the Bank of England base rate should be incorporated into the annual statements introduced in response to the OFT's initiatives on personal current accounts (PCAs).<sup>24</sup> The FCA should carry out research to identify the best way to present the data, which should appear on bank statements as soon as possible, and in any event no later than January 2013. The Commission recommends that the FCA should then improve

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24 See OFT, 2009, *Personal Current Accounts in the UK: A Follow Up Report*. Available at: [http://www.ofc.gov.uk/shared\\_ofc/personal-current-accounts/OFT1123.pdf](http://www.ofc.gov.uk/shared_ofc/personal-current-accounts/OFT1123.pdf). Note that it is not the Commission's intention for this recommendation to replace or delay any of the OFT's existing transparency initiatives.

transparency further, specifically (and in another example of the Report's detail) by:

- 'making account usage data available to customers in electronic form, enabling it to be used as an input by price comparison sites;
- requiring product ranges to include an easily comparable standardised product;
- improving price comparison tools for PCAs and creating a code of practice for comparison sites; and
- developing comparison tools for non-price product characteristics' (pp.240-241).

This level of detailed direction reads like a report from the OFT, of which Sir John Vickers was previously Chairman, without the benefit of banking involvement.

***Market structure and barriers to entry.*** The Commission recommends that the Government reaches a divestiture agreement with Lloyds Banking Group (LBG), with tremendous specification about its character. For example, it says that the divested entity should have a funding position at least as strong as its peers, as evidenced by its loan-to-deposit ratio at the time of the disposal; and a share of the personal current account (PCA) market of at least 6%. Rather typically of the Report as a whole, the prescription is far too detailed, and therefore unworkable, and goes beyond the brief that the ICB was given.

The Commission also recommends that the Prudential Regulatory Authority (PRA) work with the OFT to review the application of prudential standards for capital and liquidity so they do not 'unnecessarily' limit the ability of new entrants to enter the market safely and to grow. In particular, it should ensure that a standardised approach to calculating risk weights does not penalise banks with an 'unnecessarily' high fixed initial costs. It is by no means clear what this might mean in practice.

**Conclusion.** The Report's ostensible emphasis upon competition is welcome, but we fear that the ICB has allowed itself to become entangled in Lilliputian ropes of detail. More disturbing is the assertion that greater financial stability, through higher capital ratios and other means, is necessarily good for competitiveness. A competitive market cannot be totally stable, in the sense that customers and market shares can always move. Regulation may be necessary for orderly markets, but the question not considered by the Commission is the point at which regulation becomes over-regulation, i.e. costs are increased and passed on to customers while the regulations create higher barriers of entry.

## 5. MORE GENERAL CRITICISMS OF THE REPORT

### Regulatory structure ignored

The report's silence about the Bank of England is surprising. Before the creation of the Financial Services Authority (FSA) and the tripartite (Treasury, FSA and Bank of England) regulatory arrangement of 1997, the Bank had a clear responsibility to anticipate and prevent banking risks that might prove terminal. The Bank of England disliked the new arrangements and, metaphorically, retired sulking to its tent. In fact it retained responsibility for financial as well as monetary stability but chose to concentrate only on the latter.

In March 2009, James (now Lord) Sassoon presented his report on Gordon Brown's tripartite system of financial regulation, concluding that liaison between the FSA and the Bank was defective. He made forty recommendations (listed as Appendix A) with which we broadly concur, but upon which the ICB is wholly silent. Notwithstanding that Sassoon was looking primarily at the *structure of regulation* and the ICB was looking at the *structure of banking*, we believe that the two issues are so intertwined that the ICB ought to have overtly taken the changes arising from Sassoon into account. Sassoon did recommend (#11) that a Commission consider narrow banking, but the ICB chose to consider only one model of that. Professor Laurence Kotlikoff was furious that 'Limited Purpose Banking', a variant on the narrow bank, which is supported by a long list of US luminaries, was dismissed in seven sentences: three, he complained, said nothing and the other four were wrong.<sup>25</sup> Kotlikoff crossed the Atlantic to explain the option to the Commission, but was unimpressed at their reception, concluding that the Commission had 'failed the UK as well as the world.'

It is almost as if the Report was written to shield the Bank of England from its inept handling of the lead-up to the crash and its future responsibilities. Professor Tim Congdon puts it this way:

'Vickers – who was appointed the Bank of England's chief economist on King's personal say-so – shares the same mistaken premises as King and his senior Bank of England colleagues. They all have an obsessive and ideological attitude towards bank capital and the supposed imperative to de-risk the banking system; they do not care enough about the implications of their decisions for the quantity of money. The message must be reiterated. If banks are required to hold more capital relative to their assets, the quantity of money will stagnate and the economy will struggle to grow.'<sup>26</sup>

The simplest solution to the prevention of future banking collapses would be for the Bank of England to reassume its role as banker to the bankers. The ICB Report gives attention to the FSA, and its successor

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25 Boston University, article in the Financial Times, 20th September 2011.

26 *Standpoint*, September 2011, p.40.

the FCA, but barely any to the Bank of England.<sup>27</sup> It refers to the ‘new’ Financial Stability Committee, overlooking the fact that such a responsibility was there all along. It is extraordinary that the classic role of a central bank can be overlooked in the UK when even the central bank in Lebanon,<sup>28</sup> along with other banks in larger countries such as Canada, foresaw the dangers of the banking crisis and escaped the losses.

### **Ring fencing complexity**

Some believe the myth that the financial crisis arose because the ‘casino’ banks gambled too widely and brought down their sibling retail banks in consequence. The reality in the UK is the reverse: retail banks provided mortgages to home owners who could not service their debts, and got into liquidity problems as a result of using the wholesale market rather than their own depositors. They also invested in assets, largely US financial instruments, that they did not understand, believing them to be low-risk when they in fact proved to be highly toxic.

The ICB specifically declines to define other traditional High Street business such as mortgages, loans, and retail credit as ‘mandatory’; in other words, these should be open to non-ring-fenced competition. This means that the proposals would do nothing to prevent mortgage lenders financing themselves on the interbank market, which was an important contributor to the 2007-9 crash. Indeed, the Commission asserts that a ring-fenced retail bank would survive the total annihilation of its siblings and parent company. Others are not convinced. Here is Lord Myners:

‘And there’s nothing really in this report that leads one to believe that a failed investment bank would be able to collapse without that doing great damage through connectedness of the sort we saw with Lehmans. Put simply BarCap under this model if it separated from Barclays Bank Plc would still be a bank of such international significance that its failure could not be absorbed and handled without huge economic consequences.’<sup>29</sup>

The proposals are also silent about the contagious effects of shared equity. In other words, a ring-fenced bank will find it difficult to raise funds at the very moment it might need them most – that is, when its investment banking affiliate has got into trouble, depressing the secondary-market price of the equity which forms much of the tier-one capital of both operations.

The proposed restrictions on ring-fenced banks have not been thought through. Retail banks and their customers need to hedge risks, notably exchange risks, and derivatives are not some dubious practice to be

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27 Apart from a reference in the Northern Rock fiasco and as the source of much of the data, the Bank of England is only mentioned in two or three technical areas, e.g. ‘Bank of England, in collaboration with the Financial Conduct Authority (FCA) and OFT, should monitor access to the payments system’ (8.45 p. 217)

28 Cited by the Lord Flight in an email to the editors, 26th September 2011

29 Association of Corporate Treasurers, *op cit*, p.16.

curtailed or left to exotic specialists but are now a common part of financing at all levels.<sup>30</sup> How will ring-fenced banks be able to help their customers in this area? The Report does not even mention currency exchange, a key service for individuals and SMEs. We had this point from a number of sources, one of whom, Mark Austen, went on to say:

‘All this will do is to add to capital needs, introduce mega complexity, add further to the costs of banking and leave the regulators with an even more impossible job. This all because the regulators and Parliament failed to govern in the first place.’<sup>31</sup>

Reading through the Report, one is left with the impression that an emotional commitment to ring-fencing and increased capital commitments has coloured everything else. The extent to which the Commission focus on their own preferred solutions and ignore alternatives is remarkable. Lord Myners again:

‘Of course banks were inadequately capitalised and they should have more capital. But...bad management can burn through capital very quickly. So increasing capital is not the answer. Improved governance, improved management, improved oversight of boards of directors by shareholders will play a critical part as also will a more penetrative approach by regulators.’

On the other hand, some observers see such arrangements as providing a competitive advantage for the UK. Jon Moulton takes the view that higher capital ratios do not, in fact, correlate with lower profitability.<sup>32</sup> This is consistent with the ICB’s view that their recommendations will not make UK bankers less competitive.

## **Capital and liquidity concerns**

**Capital and size.** The ICB distinguishes between the banks by size, as Basel III does not. Basel III calls for eight percent for all banks, though this is on a broader definition of equity that includes subordinated debt, and, as noted under the discussion of equity ratios above, the ICB calls for at least two percent more. Vickers advances no reason for UK ring-fenced banks having higher capital requirements than other banks in the EU or the rest of the world (though as a further complication we note that European regulators are now close to contemplating equity ratios of nine percent). The Commission’s assertion that it would be safer to have more equity *pro rata* should be balanced against the greater difficulty of raising equity if the returns on equity are reduced. More equity for the same profit makes bank equity investment less attractive with the consequence that less lending is available for businesses and individuals.

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30 Wharton survey of financial risk management by US non-financial firms. Bodnar, Gordon M.; Hayt, Gregory S.; Marston, Richard C. *FM: The Journal of the Financial Management Association*, Winter 98, (27 4), pp.70-91.

31 Email to authors September 2011.

32 Telephone conversation with the authors, 17th October 2011

Furthermore, the ICB's attempt to define the size of global banks in relation to the home economy is specious. It would mean that the same bank would be 'large' if based in Iceland, Liechtenstein or Andorra, but 'small' if headquartered in London. We understand that once governments assume guarantee obligations for bank liabilities, then the ratio affects the scale of risk borne by the Exchequer; and that is what the Commission is focused on reducing above all else.

It makes little sense to increase percentage capital buffer requirements with size when size itself provides the "loss absorption capability", i.e. security. Indeed, banks have merged over the last 200 years simply to provide greater security and stability: so, other things being equal, the percentage buffer should decrease with size. Other things, however, are not equal since the pursuit of stability and economies of scale through mergers would, and arguably already has, unacceptably reduced competition. Once herding occurs, size may make for a concentration of risk. This would argue for competition, both between enterprises and regulatory regimes, the latter very much at odds with the thrust of the Report and current regulatory thinking in general.

**Mark to market.** Lord Flight notes the importance of the 'mark to market' rules:

'A highly important territory which needs addressing urgently and which was a major contributor to the banking crisis is the ill-conceived IFRS 'mark to market' rules. This has resulted in banks capital and profits being 'overstated' in boom times and understated in subsequent recession.<sup>33</sup> This also touches on the important role auditors should play in 'whistle blowing' which still occurs to some extent in Switzerland but was markedly absent in the UK banking crisis.'

Too much weight is given to the concept of Risk Weighted Assets, or rather, the ability to quantify risk. Clearly the inclusion of the concept of risk is important for both financial and non-financial firms in managing investments and exposure. The question, however, is the extent to which it can reliably be quantified in practice, still less reduced to a single number for a single asset. Risk is multi-dimensional and context-dependent. An investment in Greek sovereign debt, for example, may be low risk in some decades and high risk in others. Various factors, all moving according to current circumstances, will reduce or increase risk and cannot all be traded off because they are of different natures.

**Source of capital.** The calls for more capital as being a key part of the solution, whether from Basel or the Commission, do not address the question of where the capital will come from or the question of the banks' businesses shrinking in order to reach the proposed ratios if new capital does not appear. With lower share prices, raising new equity on the Stock Exchange will be expensive. The more likely alternative is for banks to reduce lending or price up loans (especially to SMEs, since they are seen as being more risky). Lord Myners put it thus:

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33 See the House of Lords Select Committee on Economic Affairs 2nd report of Session 2010 – 11 - Auditors: Market Concentration and their Role.

'On capital I think the ICB has failed to ask serious questions about whether this capital is available. The bail-in debt market is almost non-existent and yet Vickers assumes without any evidence that very substantial amounts of money can be raised, seven to ten percent of capital in the form of a new instrument with no serious consideration as to trigger events for the operation of the bail-in and how that might in turn be gained by markets.'<sup>34</sup>

The ICB did look at the additional costs that would arise from their plans but they seem to have underestimated the costs when added to Basel III. Johann Kruger of Lloyds explained:

'It was the Basel committee itself that recognised that one pound of Basel II capital, is only worth 50 pence of Basel III capital. If you then double, also, the common equity tier one requirement, and then you add an additional, what is called in technical terms, a CVA RWA, which probably has another multiplier of about two, you end up with two to the power of three, in terms of cost of providing these services to our clients. Now, obviously banks can find ways of reducing that, and certainly we're working on it. However, recovering from an eight times increase in the cost of doing something, is actually quite difficult.'<sup>35</sup>

**Wider economic damage.** Removing access to Over The Counter (OTC) derivatives would also increase the costs of retail banking. In short, the Report would be damaging to SMEs, and therefore the economy, in two ways: reducing the availability of funding and making it more expensive.

The avoidance of risk and the requirement for more capital will not only damage SMEs, but also the housing market. It is hard for banks to raise new equity from the market while they remain targets of negative propaganda. So, as noted already, lending will have to be curtailed and rationed through higher interest rates. That may prolong economic recovery: the housing market was a driver of the recovery from the financial doldrums of the 1980s. As Professor Congdon notes:

'Risk assets include the bank lending to small and medium- size enterprises about which so many crocodile tears are shed. But they also include mortgage loans for the purchase of houses by the British middle classes. If Vickers' recommendations are adopted in full and without reservation, banks and building societies will be more reluctant to help 'middle Britain' to acquire its favourite asset.'<sup>36</sup>

### **Inadequate competition proposals**

At first sight, it is encouraging that the Commission has exceeded its original brief by devoting ninety pages to competition. It seeks to promote competition through reorganising various aspects of the UK banking system, in particular through the government's holdings in the

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34 Association Of Corporate Treasurers; *op cit*, p.6

35 Ibid. p.12.

36 *Standpoint*, September 2011, p.40.



Royal Bank of Scotland and Lloyds Banking Group. But it seems not to have engaged with the actual structure of UK retail banking, which has consolidated further as a result of the crisis.

The Report also makes assertions about competition that are not supported by logic or evidence. For example:

‘The recommendations in this report will be positive for UK competitiveness overall by strengthening financial stability’ (p.15).

US regulators claimed the same glib assertion for the Sarbanes-Oxley Act, but were proved wrong. One sign that the assertion is false is that banks are not prohibited from employing higher capital ratios than current regulations require. If they thought a higher ratio would increase their competitive edge, they would adopt it; but they do not.

The Report fails to have regard to the conflict between increased regulation and the openness of the banking sector to new entrants. They call for both without recognising the incompatibility. Lord Flight notes about the small bank with which he has been involved:

‘The capital requirements for new banks are too great – Metro Bank still had first a 300% add on to our ICAAP requirement and then this was multiplied up by a further 125%! New banks cannot participate in the EFG small company loan scheme because they do not have a 2-year track record of small company lending. Also they do not qualify for any form of public sector/Government business: this is to some extent understandable, in the wake of Landsbanki, but also effectively communicates that the Government does not have faith in its own regulatory arrangements.’

### **Governance issues overlooked**

Finally, the Report gives little or no attention to ensuring that bank directors act responsibly. Lord Flight expresses the point as follows:

‘It is observable that at least two major banks – HSBC and Standard Chartered - came through the banking crisis with little damage and without requiring any tax payer support. A report like Vickers should have focussed on the management of both these banks and why it was that they were run properly. Equally, the main UK problems were with HBOS and RBS, both run by dangerous, maverick Scots, with the ‘ear’ of the Chancellor, (subsequently Prime Minister). The crucial question is why did the boards of both banks plus the Bank of England not stop such reckless activity? There should be real penalties on failed directors of failed banks – at least disqualification to be a director in the future.’

## 6. WHAT THE REPORT SHOULD HAVE SAID

The financial crisis was not caused by any lack of regulation, but by poor governance by bank directors and a lack of supervision by regulators. Excessively easy monetary policy on both sides of the Atlantic also played an important part by encouraging over-optimistic business decisions by bankers. It is astonishing that none of these causes were seriously considered in the Report, which focused almost entirely on banking industry structure.

Accordingly we believe that many other kinds of reform should be considered. In this section, we outline proposals for bank governance and audit, for reforming the regulators, for narrow banks, competition, the role of the Treasury, and international relationships.

### 6.1 Bank directors and auditors

**Directors.** The public is amazed that bank directors, individually and collectively, have emerged unscathed from the crisis. Phone number salaries and bonuses continue much as before, while only a very few bank directors have lost their jobs.

Part of the problem is that benefits are lopsided. Success is highly rewarded, but failure carries no penalty. As noted above, Lord Flight believes that the directors of failing banks should be disqualified from future directorships. Stuart Wheeler goes further: directors of failing banks, he told us, should repay salary, bonuses and any profits taken on options over the last five years, and be disqualified as company directors for ten years.

**Auditors.** Auditors have a duty to ensure good housekeeping by their clients. Yet auditors have escaped without a scratch. The Economic Affairs Committee of the House of Lords was clear that ‘the complacency of bank auditors was a significant contributory factor [to the financial crisis]. Either they were culpably unaware of the mounting dangers, or, if they were aware of them, they equally culpably failed to alert the supervisory authority of their concerns.’<sup>37</sup> Part of the trouble is that auditors are appointed by, and responsible to, the boards of their client companies. Their annual appointment at Annual General Meetings is a pure ritual.

Given the oligopolistic nature of the big accounting firms, like the banks, replacing an auditor would be difficult. Nevertheless, we would like to see bank auditors being appointed by and answerable to audit committees made up of shareholders, not directors.

More generally, as Dr Steve Priddy of the London School of Business and Finance points out, companies only reluctantly provide any information about going concern viability or their business models.

“corporations are not going to *push* such information out into the public domain; it needs to be *pulled* by actively engaged investors, analysts and proactive external auditors.”<sup>38</sup>

## 6.2 Reforming the regulators

Regulation demands clarity and enforcement. If rules are too complex to be understood or if they are not enforced, they are worse than useless. The creation of the FSA was a good move in some ways because it swept many segmental regulators, who were arguably too close to the businesses they regulated, into a single independent organisation. Unfortunately, the FSA was so independent from financial services businesses that it did not understand the institutions it was supposed to be regulating. At the same time, it was *not* so independent of government as to be free of political pressures.

We should return banking supervision to the Bank of England. To some extent this has been done, but we believe the remit should be clearer and more comprehensive.

The word *supervision* is important, as financial *regulation* has now been passed over to Brussels, leaving member states with only a supervision role.<sup>39</sup> We agree with Lord Sassoon that international negotiations on regulations should be handled exclusively by the Bank of England, supported by the Treasury.

The extent to which the Bank of England requires separate subsidiary units (like the Prudential Authority, successor to most of the Financial Services Authority’s functions) needs to be worked out in practice and should not concern outsiders. What matters is the clarity between the Bank of England and the banks.

There is another group of regulators who look after consumer interests, namely the Consumer Protection and Markets Authority (another successor to the rest of the FSA), the Financial Ombudsman Service (which has been growing exponentially) and the Office of Fair Trading. Clearly these interests overlap; they should be brought closer together if not integrated.

## 6.3 Narrow banks

Greater transparency in retail banking operations does have some merit, though the ICB’s proposals on this are unworkably prescriptive and complex.

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38 Dr Steve Priddy, London School of Business and Finance, 28 June 2011, submission to the enquiry by the Financial Reporting Council into accounting for going concerns and liquidity, “Sharman Committee”, p.3.

39 This was agreed by the Brown government as part of persuading President Sarkozy to attend the London G20 in April 2009. The evidence for that is a letter from Alastair Darling to his French counterpart conceding the French wishes. We remain astonished that this handing over of financial power to the EU was not challenged by the City or opposition parties.

Before the banking crisis, Kevin James, a senior economist at the Bank of England, made a compelling case for establishing ‘narrow’ banks, which would provide a restricted range of services compared to ‘broad’ banks, and so would be easier to regulate.<sup>40</sup> The ICB’s ring-fencing ideas stem from this early proposal.

We agree that banking groups should run their retail subsidiaries at arm’s length, publishing separate accounts and capitalising them as if they were independent banks according to Basel III. It should then be simple for the Bank of England to supervise them separately from their siblings and parent companies. And such separation allows state guarantees to be concentrated on retail banks, instead of taxpayers’ funds going to support investment banking institutions and their more financially aware customers.

However, the excessive and legalistic restrictions on ring-fenced banks that the ICB proposes make its version of this narrow banking idea unworkable. The key test of arm’s length status should be, more simply, whether the retail subsidiary could be sold as a going concern if the rest of the group failed.

**Trust Banks.** We propose, therefore, a new market-led form of narrow banking – Trust Banks. As explained in our Recommendations section below, these would be licensed and supervised by the Bank of England, separately from other banks.

New or existing banks would be free to create Trust Banks. However, the Bank of England would have to be satisfied that their assets were safely invested, their deposits were secure, their capital ratios were adequate, that they were not ‘too big to fail’, and that they could survive as stand-alone entities in the event of the parent company’s (or sibling’s) failure. They would be subject to unannounced inspections, and the threat of their status being withdrawn – plus severe penalties on directors in the event of a Trust Bank’s failure – would focus them on maintaining their security. Trust Banks would be the only banks qualifying for the government’s £85,000 guarantee to depositors, though they would be free to offer additional security through third-party deposit insurance.

### 6.3 Competition

Though the ICB focuses on structural reform as a way of avoiding future government bailouts, we agree with others that ‘removing explicit and implicit state guarantees except for [narrow banks], is only one step towards establishing a structure where no financial institution is “too big to fail”’.<sup>41</sup> A further important step is the promotion of fresh competition within the UK’s oligopolistic banking sector.

The regulation of our Trust Banks can be made simpler than today’s all-embracing bank regulation. At the same time, the regulation on non-

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40 Kevin R. James, *The Case for Narrow Banking*, Presentation in Sao Paulo, May 2007.

41 Michael Mainelli and Bernard Manson, *Small Enough To Fail: A Systems Approach To Financial Systems Reform*, awaiting publication by Journal of Risk Finance.

Trust banks can be eased, given their more financially sophisticated customer base. Our proposals therefore simplify and ease regulation, which is not only a cost but a major barrier to entry.

Our proposals therefore promote innovation and diversity. Trust Bank status should be attractive to newer, smaller banks such as the supermarket banks and Virgin Money. Our proposals therefore boost competition (at present the 'big four' banks hold 72% of personal current accounts and 85% of small business accounts). And competition, we believe, is the best regulator.

## **6.4 The Treasury**

A contributory factor in the build-up to the crash was that no one quite knew who was responsible for what. The Financial Services Authority thought, rightly, that overall financial stability was a matter for the Bank of England, though the Bank itself did not. The Tripartite Committee that was supposed to coordinate the system met only once in 12 years.<sup>42</sup> Liaison between the FSA and the Bank was poor.

James (now Lord) Sassoon's review of the Tripartite system is revealing. The 40 recommendations he makes (listed below in Appendix A) have been implemented, barring those overtaken by events, and we broadly agree with them.<sup>43</sup> They seem far more soundly based than those of the ICB. The key recommendation, as is ours, is that supervisory responsibility should be returned to the Bank of England.

In addition, the Treasury should transparently coordinate the Bank and the other supervisors and regulators, and visibly hold them to account for their performance.

## **6.5 International relations**

The Commission paid little attention to the international context of the banking sector; specifically they took no account of the knock-on effects of the upcoming Basel III and EU regulations on their recommendations.

In a global market like banking, regulations should also be global. Ministers should resist rule-making at other levels – EU, national or local. If this second level of rule-making proves inevitable, then financial regulation should be repatriated to member states with a liaison committee tasked with maximising unanimity.

Making rules is one thing; ensuring that they are equally implemented in the 200 countries around the world is quite another. The Bank of England, supported by HM Treasury, should press for a monitoring system that can identify and report failures in implementation.

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42 Tripartite Review, March 2009, p.11

43 Lord Sassoon's email to authors 12th October 2011.



## 7. RECOMMENDATIONS

- 7.1 We propose a simple market-led form of Trust Banks, i.e. narrow or utility banks, under a separate class of bank [deposits] licence, supervised by the Bank of England. People would see the term 'Trust Bank' as a kind of security kite mark, which the Bank of England could withdraw. Trust Banks would be the only banks qualifying for the government's deposit guarantees. None would be 'too big to fail'.
- 7.2 New or existing banks or their subsidiaries would be free to become Trust Banks using a variety of business models, for example payment service only, providing they can convince the supervisor that assets are safe and deposits are secure. Trust Banks would be subject to annual and unannounced inspections.
- 7.3 Trust banks would have the exclusive right to offer additional guarantees, from third-party insurers, for deposits in excess of the now £85,000 sovereign guarantee limit.
- 7.4 Current and recent directors of Trust Banks that went into administration or were liquidated would suffer major penalties, including long-term disqualification and the return of current and recent bonuses and profits, whatever their contracts may say. Directors and their companies would not be entitled to insure against these risks.
- 7.5 Where Trust Banks are part of larger banking groups, the Bank of England must be satisfied that they would survive as stand alone entities in the event of insolvency of affiliates and/or the parent company.
- 7.6 Our recommendations are pro-competitive and should attract new entrants. We propose less regulation (than the ICB proposes) of Trust Banks and new entrants, which in turn will ensure that they take share from the existing High Street oligopoly.
- 7.7 The ICB proposals on capital ratios are excessive. Banking is a global market and any market needs just one set of regulations. In banking, Basel is the global regulator and the UK banking industry can only be competitively damaged by being required to carry heavier capital ratios than those required by Basel. The requirement to build capital would inevitably lead to reduced lending to customers, SMEs in particular. Since SMEs are the prime drivers of GDP and employment, the UK economy would be even more greatly damaged by this than by the proposals from Basel and the EU. Trust Banks should be no more restricted than Basel.
- 7.8 The global economy has an interest in financial innovation, in which London's banks should be in a position to play a leading part. The limitation of depositor guarantees to Trust Banks should allow relatively less regulation for other parts of the banking sector.

- 7.9 Banking licences should be given to UK companies only, and not to branches of EEA or other overseas companies. This may require some negotiation with Brussels, but it would not challenge open market principles, since any foreign company can have a local subsidiary. Brussels will be aware of the problem with Icelandic bank branches in the UK which were not supervised by the FSA or anyone else. In other words, foreign banks would have to follow the same rules as UK banks so far as their UK operations are concerned.
- 7.10 Bank auditors should be appointed by and answerable to audit committees made up of shareholders, not directors.
- 7.11 The functions of the Consumer Protection and Markets Authority, the Financial Ombudsman Service and the Office of Fair Trading clearly overlap. They should be brought closer together (if not integrated) in order to improve coordination with the Bank of England.
- 7.12 Unlike the Tripartite Committee, which met just once in 12 years, HM Treasury should annually review the Bank of England's supervisory performance, as well as the consumer protection agencies, in an active and transparent fashion. As recommended by Sassoon, a sufficient number of senior Treasury staff should have senior banking and senior Treasury experience, both long enough, to ensure that the examination of the Bank's performance is forensic.
- 7.13 Making banking rules is one thing; ensuring that they are equally implemented in the 200 countries around the world is quite another. The Bank of England, supported by the Treasury, should press for a monitoring system that can identify and report failures in implementation. The global monitor should report annually on inspections and outcomes.



## **Appendix A**

### **The Tripartite Review**

#### **A review of the UK's Tripartite system of financial regulation in relation to financial stability**

**Preliminary Report, James Sassoon, March 2009**

#### **Recommendations**

- 1) The Bank of England should have the primary responsibility for evaluating systemic threats to financial stability.
- 2) The Bank of England should have a statutory right to receive such data as it deems necessary for its macro-prudential work; this data should be provided by the micro-prudential regulator.
- 3) The Bank should have a formal duty in the Memorandum of Understanding to be continuously engaged with broad financial markets developments.
- 4) The Bank should write a public letter at least twice a year to the micro-prudential regulator setting out its views on systemic risk. The micro-prudential regulator should submit a public response to the letter stating what actions it intends to take to address the risks identified.
- 5) The letter should include a confidential annex raising any concerns in the Bank regarding specific financial institutions.
- 6) The Bank of England should engage fully in international debates and negotiations on financial stability regulation.
- 7) HM Treasury should consider what, if any, change should be made to the remit of the Monetary Policy Committee to reflect the fact that interest rate policy may impact financial stability.
- 8) The macro-economic side of the Treasury should consider the impact on macro-economic policy development of financial stability concerns.
- 9) Consideration should be given to the micro-prudential regulator writing a public letter to the Bank should it develop concerns that its conduct of macro-economic policy may threaten financial stability.
- 10) In the conduct of a counter-cyclical capital regime, judgements at the market level will be for the Bank and at the firm level for the micro-prudential regulator.
- 11) The Authorities should conduct a full study of the pros and cons of moving to a 'narrow' or 'utility' banking model.
- 12) The Authorities should give further consideration to the need for increased regulation of previously unregulated activities. Clear principles should be applied in each specific case; the relative benefits of

transparency and of indirect regulation versus direct regulation should be considered.

- 13) The Authorities should clarify the constraints on the Financial Services Compensation Scheme funds being used to secure the resolution of failed institutions instead of liquidation and payout under the scheme.
- 14) The Tripartite Authorities should give further consideration to financial institutions, in the future, pre-funding the Financial Services Compensation Scheme on a risk-weighted basis.
- 15) The Debt Management Office's mandate should be reviewed by the Treasury and the Bank of England.
- 16) Consideration should be given to the structure of the micro-prudential regime, with five options meriting particular debate:
  - i. Restructuring the internal organisation of the FSA to put prudential regulation at its centre
  - ii. Restructuring the FSA as in 1 but giving the Bank/Tripartite additional statutory powers to take direct regulatory action in exceptional circumstances
  - iii. Abolishing the FSA and replacing it with two separate regulators, one for prudential and one for conduct of business regulation
  - iv. A combination of 2 and 3, with the Bank/Tripartite able to step in over the head of the micro-prudential regulator in exceptional circumstances
  - v. Under options 3 and 4, the micro-prudential regulator, of banks or of the whole financial sector, being folded into the Bank of England.
- 17) The Bank's executive should consider whether it requires more resources to deliver its enhanced Financial Stability mandate.
- 18) The Bank should strengthen its governance in relation to Financial Stability.
- 19) The Bank of England should produce a public assessment of its own conduct in the period leading up to the collapse of Northern Rock.
- 20) The remit of the Bank's Financial Stability Committee established under the Banking Act, 2009 should be amended to remove any executive function and to make it an advisory group of market experts.
- 21) The Bank should clarify the role and qualifications required for the Deputy Governor for Financial Stability and take steps to plan for the succession of future Deputy Governors.

- 22) The Authorities should consider transferring responsibility for financial crime policy out of the FSA. This could be linked to a wider review of the framework for tackling financial crime.
- 23) The Government and FSA should review the latter's role in relation to consumer awareness.
- 24) The FSA should increase further its ability to recruit and incentivise highly experienced supervisors and policymakers from the private sector.
- 25) HM Treasury should maintain a sufficient financial markets expertise at all times.
- 26) The Permanent Secretary to the Treasury should report annually to Parliament on the appropriateness of HM Treasury's expertise and resources in relation to financial stability.
- 27) HM Treasury should report every three years on the appropriateness of the legislative and regulatory framework for financial stability.
- 28) HM Treasury's Corporate Finance team should be put into the same HM Treasury division as financial services policy.
- 29) The Bank of England, in consultation with the micro-prudential regulator, should maintain a confidential list of systemically important financial institutions.
- 30) The Bank of England should have a statutory right to recommend to the micro-prudential regulator that an institution be placed into the Special Resolution Regime.
- 31) The Tripartite Authorities' Principals should play an active role in communicating with markets and the general public in the event of institutional stress or failure, but the lead role should be played by the Chancellor of the Exchequer.
- 32) Members of the Tripartite Authorities should be given regular training in the rules concerning the handling of price sensitive information.
- 33) The Authorities should consider whether sufficient investigation has been carried out into the leaks of price sensitive information to the media since September 2007.
- 34) The Tripartite Principals should meet formally at least three times a year and have an additional three informal meetings a year.
- 35) The Authorities should strengthen links at more junior levels through a programme of secondments, training, joint briefings and informal meetings.
- 36) The secretariat to the Standing Committee should continue to be provided by HM Treasury.

- 37) The Memorandum of Understanding should reflect all the proposals in this report, making clear which Authority is responsible for each regulatory function.
- 38) The Bank of England should strengthen its working links with international bodies, including contributing to the development of improved collaborative tools.
- 39) The Bank of England should lead the UK's contribution to international policymaking of a macro-prudential nature, with the micro-prudential regulator continuing to lead the UK's contribution on micro-prudential matters, while HM Treasury should lead international political negotiations.
- 40) The Tripartite Authorities should work closely with financial institutions to develop a consensus position to contribute to international regulatory developments.

## Appendix B

### Acknowledgements

We are grateful to those listed below, among others, have made comments and suggestions on this paper. These comments and suggestions have been made in a personal capacity, and individual commentators do not necessarily agree with the views expressed in this paper, which are the authors' own.

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Richard Jeffrey

Professor Patrick Minford

Jon Moulton

Stephen Priddy

John Redwood MP

Lord (James) Sassoon<sup>44</sup>

Tony Shearer

Stuart Wheeler

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<sup>44</sup> Lord Sassoon has only commented on the report in a personal capacity and in relation to his 2009 report.

