HOUSE OF COMMONS

ORAL EVIDENCE

TAKEN BEFORE THE

TREASURY COMMITTEE

BANK OF ENGLAND JUNE 2012 FINANCIAL STABILITY REPORT

TUESDAY 17 JULY 2012

SIR MERVYN KING, LORD TURNER OF ECCHINSWELL, PAUL TUCKER, PAUL FISHER and DONALD KOHN

Evidence heard in Public Questions 1 - 195

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 17 July 2012

Members present:

Mr Andrew Tyrie (Chair)
Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr Pat McFadden
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Sir Mervyn King**, Governor, Bank of England, **Lord Turner of Ecchinswell**, Member, Financial Policy Committee, Bank of England, **Paul Tucker**, Deputy Governor, Financial Stability, Bank of England, **Paul Fisher**, Executive Director, Markets, Bank of England, and **Donald Kohn**, External Member, Financial Policy Committee, Bank of England, gave evidence.

Q1 Chair: Perhaps we could carry on where we left off when the Division bell went last night, Lord Turner. You told us: "Over the weekend…Marcus Agius decided that he should himself resign." I am reading from the uncorrected transcript. "I thought that was an honourable decision. It was, however, a decision that surprised me." Had you made it clear in your conversation with Marcus Agius that you were referring, in your expression of concerns about Barclays, to the chief executive?

Lord Turner: Yes, absolutely clear. The discussion I had with Marcus Agius was about the position of Bob Diamond. I said, "I'm sure you are considering whether you can continue with Bob Diamond as CEO," and I said, "Let me be clear. We have not found anything against Bob Diamond, so we are not in a position to give, and we are not giving, any instruction or direction that we do not consider him fit and proper or appropriate to do this job, but you have to think about whether he"—it was very clearly "he"—"is the right person to lead the substantive change which is required in the culture, given his association with some of the things in the past." I also stressed—I think it is an important thing—that they needed to think about whether they thought he was capable of leading that substantive change substantively, but also about whether the external world would perceive that, because I think perception is part of the reality in these circumstances and it was something they had to take into account. I said, "You have to think about whether that is something which Bob Diamond will find impossible to do," and, as I said last night, he said, "Or simply too difficult to do." So it was absolutely clear we were talking about the role of Bob Diamond.

Q2 Chair: You may not always be brief, Lord Turner, but I think it's fair to say you're nearly always clear. Was there any scope at all for a reasonable man to misunderstand what you were saying?

Lord Turner: No. That we were talking about Bob Diamond was absolutely clear. I can remember one thing I said, which stuck in my mind. I said, "One thing you'll have to think about is whether Bob as a brand is just holed below the water." I don't know whether I used the phrase "holed below the water", but I basically said "whether Bob the brand is now something which isn't going to work." So there can have been no doubt that we were having a conversation about whether Bob Diamond was the person substantively to lead the change which was required and—I did stress this—that they also had to consider whether the external world would believe that was the case, even if they believed it was the case, because I think that is an important factor in these circumstances.

Q3 Chair: So you were handing the chairman of Barclays a revolver and you were telling him to go and shoot his chief executive?

Lord Turner: No, I don't think that is quite right. I think that's an arresting way of putting it. I think I was doing precisely what I've said I was doing. I was saying, "We are not giving you a direction, but this is the issue you have to think about as a board."

Q4 Chair: On the basis of what you said, though, where is the scope for the bullet to miss? What course of action—

Lord Turner: I think if they had really come back with a compelling answer as to why they believed that Bob Diamond was right, we might have been convinced by that. I have to say, and I said last night to you, that at the end of that conversation—I had discussed in advance with Andrew Bailey what I would say and I rang him fairly immediately afterwards and said, "Look, I would be quite surprised if the net effect is not that Bob Diamond resigns."

Q5 Chair: So you thought that you probably had handed over a revolver?

Lord Turner: I thought that the most likely result would be that Bob Diamond would resign.

Q6 Chair: But in fact he did take the revolver and he decided to shoot himself.

Lord Turner: Yes, and as I said last night, I think that was an honourable thing to do. I think Mr Agius thought it was the right thing to do. It was not what I was expecting him to do, and I have to be blunt: I did not think it was the most sensible decision in the circumstances. But we were not informed beforehand of his intention to do that. Indeed, I think it came out that it had actually leaked out already, even before he had completed the full discussion with his board, or something like that. It leaked out, and I first heard of it as a fait accompli.

Q7 Chair: Why was it, given that you are the regulator, that the Governor of the Bank got involved?

Lord Turner: I think it is completely appropriate—

Q8 Chair: I did not ask you that; I asked you why. I did not ask you about appropriateness. Why didn’t you take this process through to its conclusion? Why did the Governor of the Bank become involved, Lord Turner?

Lord Turner: On the Monday, the Governor and I had a conversation. The Governor was of the opinion that he should also have a meeting with Mr Agius and, in fact, Mr Rake, and I thought that was a perfectly sensible thing to do. The Governor has regular meetings, and always has had regular meetings, with the chairman and chief executive of major banks. This was also an issue, by the way, of our appropriate approach to this issue, which we had discussed—the Governor, myself and Andrew Bailey—on the Thursday when we were doing the rehearsal for the FPC press conference on the Friday. We had decided the appropriate line that we should all take at that time, and you will see that reflected in what Mr Andrew Bailey—

Q9 Chair: This is helpful additional background, but my question is quite direct: why didn’t you handle this issue to its conclusion as the chairman of the FSA?

Lord Turner: I thought it was appropriate for the Governor to see Mr Agius and to put over a message as well, and it was a message which the Governor and I discussed in the course of —

Q10 Chair: Why? He has no regulatory authority.

Lord Turner: The role of the Bank of England, in terms of the need for banks to feel that they have the confidence of the Bank of England, I think is something which has continued, despite the regulatory changes of 1997. I think it is appropriate. I think it is one of the reasons why we are absolutely right to do what we are going to do next year and bring prudential regulation back next to the Bank of England—into the Bank of England—because I think the issue of whether the Bank of England, as a liquidity provider to the banks, has confidence in the banks is integrally linked with the appropriate regulatory stance. I do not see a problem with the Governor of the Bank of England choosing to see the chairman and chief executive, if they want, or the chairman in this case, in order to express a point of view—a point of view which we had discussed in the course of the afternoon and were fully agreed on.

Q11 Chair: Well, that was long as a reply, but rather less clear—

Lord Turner: I hope it was clear, sorry.

Q12 Chair: Rather less clear than some of your earlier replies. Let’s just have one more go: you are the regulator; you have the statutory authority to perform this function, but you pass it to a body that does not have the statutory authority to do this. Why?

Lord Turner: Let’s be clear: neither I nor the Governor were giving a regulatory instruction, and I think that has been clear and that has been clear from—Both of us were giving a consistent message that they needed to think very clearly about whether Bob Diamond could have the confidence, not only of the market, but of the external world, to make this substantive change, and that we were not certain that that was the case.

Q13 Chair: But that is obfuscating the essential point, which is that once you had turned up with this revolver and handed it over, it was perfectly clear what you were expecting him to do with it, and you have just told us that. Even though you do not like the image, that is in fact what was going on. And you are the regulator with the authority to make those sorts of remarks, aren't you?

Lord Turner: It is not our authority, except in positions where we have found somebody to be not fit and proper, to actually give a direction.

Q14 Chair: Again, this is refuge in technical issues, really.

Lord Turner: No, I think it is also worth saying that the role of the Governor is—

Q15 Chair: What other institutions do you think might go around telling chief executives of major institutions that—

Lord Turner: None, other, in the financial space, than the FSA or the Bank of England.

Q16 Chair: Not the Chancellor of the Exchequer, for example?

Lord Turner: No, I don't think so. I think this should fall between the FSA and the Bank of England. And a thing I would stress is that the fact that the FSA became the regulator in 1997 did not change the legitimate role of the Governor of the Bank of England in having a point of view on the confidence of the Bank—the Bank of England—in the leadership of the major banks, given, crucially that the Bank of England has to decide whether it is willing to provide liquidity support for banks. That should be something where a measure of confidence is required.

Q17 Chair: That may be true of the Treasury, but I do not think there is merit in pursuing that line of questioning further. However, it might be worth asking this. Before you took this decision to make these points to Marcus Agius, what governance process took place in the FSA to consider the correctness of the decision?

Lord Turner: It was entirely based on conversations between myself and Andrew Bailey. Andrew—

Q18 Chair: Was there a meeting of a sub-committee of the board, of the most senior executives?

Lord Turner: No, we did not do it in that fashion.

Q19 Chair: Why not?

Lord Turner: I think it is reasonable in these circumstances for the head of the Prudential Business Unit, the most senior regulator, the person who had been directly involved, as was described yesterday, in the statement to the board in February, and myself to make a decision. Let's be clear. If it had been a direction—if we were finding him not fit and proper—we would have had to go through a legal process.

Chair: You have made that point several times.

Lord Turner: But given that that was not what we were doing—we were encouraging them to think very clearly about the challenge that they faced—I think it is reasonable for us to have made that decision on the basis of myself and Andrew.

Q20 Chair: So if you do it through a power of direction, you should use a formal route, but if you don't do it through a power of direction, it is reasonable to make remarks like this to a chairman informally. Is that your view?

Lord Turner: It would have been very odd if I had done it myself without discussing it in considerable depth with Andrew—

Q21 Chair: So you agree that there needs to be some process?

Lord Turner: Yes, I agree. If it had been a formal direction, it would have been essential to have a formal process set down, with an executive committee—

Q22 Chair: This is a recipe for arbitrary power, isn't it? Lord Turner, we have confidence in the decisions that you're taking, but what about some successor—who will be in the Bank—at some future time who may get a bit dyspeptic about some chief executive and who may exercise this power on this informal basis for which you've now set a precedent? This means that any chief executive may be hanging by a thread if you have a couple of bad dinners with him.

Lord Turner: Part of the appropriate challenge to that is precisely what is going on here. It is the role of your Committee. If that occurs, you have an absolute right to ask searching questions about it. But I think it is difficult—

Q23 Chair: So we are all that stands between you exercising this informal power and the chief executive being booted out on a whim?

Lord Turner: I don't think this was a whim; I don't think people think that it was a whim; and it was not—

Q24 Chair: I haven't said it was a whim. I said that, at some future time, that might occur, unless we put in place some proper governance. There doesn't seem to have been a governance process in place before you exercised this power.

Lord Turner: I can see the point you are making and I think the appropriate checks and balances are important. In this case we were dealing—

Q25 Chair: I wasn't talking about this case. I'm talking about what the consequences of this case will be for the future and for precedent. You are agreeing with me that this is something that needs to be thought through and addressed?

Lord Turner: Yes, I think I can agree with you that this does raise some issues about the future governance of these sorts of situation. It is of the nature of this that when you end up in these sorts of situation and you haven't written down a clear governance process in the past, you make sensible judgments about what you think is appropriate in the circumstances. Actually, I am agreeing with you on that.

Q26 Chair: We are making policy on the hoof, and I don't think there's any point in taking that further. What about the duty of care that you might acquire, if you start shooting chief executives, to the shareholders of the institutions that lose their top man? Did you consider that?

Lord Turner: We were certainly aware that we would not want a degree of destabilisation which was harmful to the shareholders. Indeed, that was one of the things which the board needed to think about. Realistically, if Bob Diamond had stayed on, and given the extensiveness of the calls for his resignation from politicians and press, I strongly suspect that that would have been to the disadvantage of the shareholders as well. There was almost certainly a change in shareholder attitude as the debates developed over the weekend.

Q27 Chair: Governor, at a press conference for the latest financial stability report you said: "I'm not the supervisor or the regulator; it'll be next year before that happens… So I can't give comments on issues to do with fitness and properness." You can dance on the head of a pin about fitness and properness, but why in practice were you sending a message of a very similar nature, and we have just had an extensive discussion on that? Adair Turner is nodding his head in agreement. Why did you change your mind five days later and apply pressure, and get involved in applying pressure, for Bob Diamond to go?

Sir Mervyn King: I don't think it is just dancing on the head of a pin. There is a difference between the legal question of whether someone is fit or proper, which is for the FSA to determine, and the events that led up to the conversation I had with the chairman and senior independent director. On the Sunday, late afternoon early evening, I discovered that the chairman had resigned. I first of all wanted to find out whether either Lord Turner or, indeed, the Chancellor had been involved in discussions that led up to that and I discovered that all three of us had learned from the BBC website of the resignation of the chairman, which I found rather odd.

Q28 Chair: You were also very concerned that the wrong man had got shot.

Sir Mervyn King: I felt that the consequence of that was that the firm was now in a very difficult position and although, as Lord Turner said, it was an honourable decision of Mr Agius to resign, he had inadvertently put any prospective new chairman in an impossible position. Either they would have to demand the removal of the chief executive as a condition for taking the job or they would have to buy into the chief executive with serious worries that, down the road, with further inquiries, possible criminal prosecutions, and who knows whatever else might be revealed over the next year or so, if the chief executive were subsequently to depart, it would tarnish the reputation of a new, incoming chairman. So I thought that they had not thought through the consequences of this.

Indeed, it turned out when I had the meeting on the Monday that the board on the Friday night had discussed the position of the chairman, in his absence, properly, and actually asked him to stay on. So the board itself was taken aback when Mr Agius resigned, and as Lord Turner intimated, this leaked out and became a fait accompli before the board had a full discussion on the Sunday evening. So I decided that it would be a proper thing for me to do to have a conversation with the chairman and senior independent director, precisely because—I made it very clear to the two of them—I was not speaking for the Government, although I informed the Chancellor that I was having the meeting but I made it clear to the Chancellor and Mr Agius that I was not speaking for the Government and I was not speaking on behalf of the FSA as a regulator. But I wanted the chairman and the senior independent director just to be very conscious of the concerns which the regulators had raised.

Adair Turner and Andrew Bailey had shared with me for many months their concerns about Barclays. If you read Lord Turner's letter of April to Mr Agius it could hardly be clearer. It is a very powerful and strong letter. When I met the two of them it became clear to me that they had not really taken on board the loss of confidence of the regulators in the executive management. The point of my meeting with them was to say, "Look you really need to understand the depths of the concerns that the regulators have about the executive management. I want you to go away and reflect on that."

Q29 Chair: Why didn't you say, when consulted, "Fine to be consulted; I agree with the course of action; Lord Turner, get on with it"? Why did you allow yourself to be dragged into this when you have no statutory authority?

Sir Mervyn King: Because I think what had happened over many months was that the board of Barclays had been in something of a state of denial about the concerns of the regulators. I wanted to make sure that they understood that those concerns had been shared with the Bank. They were not just the kind of comment that was made with one letter or in a meeting. These were genuine and deep concerns and they really ought to take them seriously.

Q30 Chair: It seems to me that, whatever the merits of this specific case, we urgently need some governance put in place both in the FSA and the Bank to offer some protection against arbitrary meetings of this type taking place.

Sir Mervyn King: I don't share that view, for the following reason—

Q31 Chair: What governance is in place in the Bank? Did you discuss this at all with anybody else in the Bank?

Sir Mervyn King: I discussed it with our chief legal adviser. I could not discuss it with my two deputy governors, as I would usually do.

Q32 Chair: So even the deputy governors were not involved in this?

Sir Mervyn King: Well, they couldn't be. It would have compromised Mr Tucker—because of the nature of the allegations that had been made—to involve him in it.

Q33 Chair: What about the chairman of the court?

Sir Mervyn King: No, it is not a matter for the chairman of the court.

Q34 Chair: So there is nobody with whom you should consult?

Sir Mervyn King: I spoke to the chief legal adviser before I did it, and I spoke to Lord Turner and Mr Bailey.

Q35 Chair: This has revealed yet another gaping hole in the governance of the Bank, hasn't it?

Sir Mervyn King: No, it is not a gaping hole in the Bank—not at all. You don't need to have a governance situation in order to decide to have a conversation.

Q36 Chair: This is not just about a conversation: "Hi! What's the weather like? Did you get to Wimbledon?" This is about handing someone a revolver and telling him to go off and shoot his chief executive.

Sir Mervyn King: No, it's not. There was no suggestion. I do not like these firearms analogies, and they are false. The question was left absolutely with them. I made it very clear and finished the meeting by saying, "I would like you to make clear to the board that the regulators have expressed these concerns. The board as a whole needs to know that they are very concerned and have lost confidence in the executive management." I did not know what the outcome of that meeting would be. It was left to them to discuss it with their board.

Q37 Chair: When we asked you, Governor, about the run-up to the crisis over Northern Rock, the problems with RBS and the takeover of ABN AMRO, you told us that the Bank's position was heavily legally circumscribed and that it was very difficult for you to take quick action on account of that. Here, you seem to have involved yourself without any legal cover in something that was clearly of a regulatory nature on which you had no statutory authority.

Sir Mervyn King: That is not true at all. I spoke to our chief legal adviser to find out very carefully what I could and could not say. The world has changed. We will now be the regulator and, as of—

Q38 Chair: I am not talking about after the legislation.

Sir Mervyn King: May I finish?

Chair: Yes, you may, but we are talking about now. You do not have that statutory authority.

Sir Mervyn King: I am trying to explain, if you would let me finish. What has changed is that in the past 18 months, the regulatory part of FSA has worked very closely with me and others in the Bank to move towards a new regulatory framework so that we are already involved. Prior to 2010, I would not have felt able to carry out this conversation, because I would have known nothing about the letter that Lord Turner sent, the conversation that Andrew Bailey had, or, indeed, their concerns that had been building up, and I would have had no basis of information on which to carry out that conversation.

Now, we have been fully informed and we have been involved in these conversations. I think that all of us involved have built up a genuine concern that it is possible to sail close to the wind once; you can sail close to the wind twice—maybe even three times—but when it gets to four or five times and becomes a regular pattern of behaviour, you have to ask questions about the navigational skills of the captain on the bridge. That is what Lord Turner and Andrew Bailey made very clear to the board. It seemed to me that the result that the chairman had resigned meant that the board as a whole had not fully understood the nature of the concerns, and I thought it would be helpful to play a role in making sure that it did understand.

Q39 Chair: The scope for misunderstandings seems to be virtually infinite in this LIBOR scandal. Even this conversation in which, you told me, Lord Turner, left no room for doubt seems to have generated a good deal of confusion. It sounds as if the confusion is on the part of the regulated community in this case.

Sir Mervyn King: No, that is absolutely false again, Mr Tyrie. The Barclays board—this was true in my meeting, too—was deeply reluctant to face up to the concerns that Lord Turner and Andrew Bailey suggested. I think it thought that it might be able to tough it out. It was not convinced that the regulators had lost confidence. I put it to it very clearly and the senior independent director said to me, "Until today, we had not, and I, as senior independent director, had not been fully aware of the loss of confidence of the regulators in the executive management."

Q40 Chair: But Lord Turner has told us that he made it absolutely clear.

Sir Mervyn King: To Mr Agius. I am referring to the views of the senior independent director, who said, "We had not realised until today how serious the concerns of the regulators were."

Q41 Chair: That is clear, but it means that there was a failure of communication between the senior independent director and the chairman of Barclays.

Sir Mervyn King: That is for others; I cannot answer for that.

Chair: It is just another part of the sorry tale of miscommunication that took place in this saga.

Q42 Michael Fallon: Again, I remind the Committee of my registered interest as a non-executive director of Tullett Prebon.

Governor, can we turn to the e-mail you were sent by the New York Fed on 1 June 2008? What did you do about that?

Sir Mervyn King: I solicited it, which is the first part. I spoke to Tim Geithner in Basel a few weeks before. After that, I think it was on 19 May, his deputy, Bill Dudley, telephoned Paul Tucker and said that Tim Geithner wanted some advice on feeding views to the BBA, who are responsible for LIBOR. Should he write to the BBA, copied to me? Or should he write to me, copied to the BBA? Whatever.

I sent a message back through Paul saying, "Write to me. We will look at your letter, and if we agree with it, we will endorse it and send it on to the BBA." So we solicited that e-mail, which arrived late one evening when I was in Frankfurt. I sent a message back saying that staff should give a view on it. I got that the next evening when I was back from Frankfurt, and the next day we wrote to the BBA, forwarding the e-mail memo from the New York Fed, saying that we wanted them to take account of this in their forthcoming consultation.

Q43 Michael Fallon: That e-mail conveyed serious concerns about the integrity of LIBOR. How did you ensure that work was followed up by the Bank?

Sir Mervyn King: Before we had received that, after consultation with me, Paul Tucker had talked to the BBA and urged them to have a widespread consultation on LIBOR and its fixing. The important aspect was that this wasn't a UK issue—it wasn't regulated in the UK. The real thing was whether the users of LIBOR around the world had confidence in the setting of LIBOR. First of all, we urged the BBA to do this globally, not just in the UK. Secondly, we urged the banks themselves—Paul spoke to the banks—to put senior people in charge of the consultation.

Q44 Michael Fallon: How did you ensure that that actually happened?

Sir Mervyn King: Well, it did happen. We followed it up. The Bank and the FSA went to various meetings with the BBA. On 30 May, the BBA published their annual report on LIBOR, which seemed to me wholly inadequate. I wrote a note to that effect and asked Paul and Mr Cross at the Bank what we would do about it. They formed a team of people that liaised right through that summer with the BBA, the FSA and the New York Fed to ensure that the consultation was wide-ranging and that all the ideas that the New York Fed had put forward were incorporated in the consultation document. So it was a proper consultation.

Q45 Michael Fallon: Mr Tucker, last week when we asked you specifically about LIBOR integrity, you said, "We thought the underlying markets were dysfunctional, sporadically illiquid, much less reliable than normal, but we did not have suspicions of dishonesty". Yet the paper from the New York Fed recommends work with LIBOR banks to establish procedures designed to prevent deliberate misreporting. There is a whole section in this note on the need to "eliminate incentives to misreport". They were clearly concerned about misreporting. Did you really not have any suspicion of dishonesty?

Paul Tucker: In my discussions with Bill Dudley of the New York Fed, it was not framed in that way; it was framed as eroding confidence and credibility, particularly in dollar LIBOR, which was being set lower during London hours than it was subsequently trading in New York. We were very concerned about this piece of global infrastructure losing credibility. As the Governor said, we urged the BBA to review everything, particularly its governance, and to do so on a global basis. No, the note did not set off dishonesty alarm bells.

Q46 Michael Fallon: The penny didn't drop that the phrase "deliberate misreporting" might imply some degree of dishonesty?

Paul Tucker: No, it didn't.

Q47 Michael Fallon: Why not? What did you think "deliberate misreporting" was?

Paul Tucker: I am not sure I addressed my mind to it.

Q48 Michael Fallon: You didn't address your mind to the note from the New York Fed that we are discussing?

Paul Tucker: We were very focused on ensuring that there was a completely open-ended review of the way that LIBOR was run and constructed, and of some technical issues, as well. We were less interested in the technical issues than in the overall governance of the process. I think that we acted pretty firmly to ensure that that review occurred. The annual review that the BBA published was on which banks would be on the LIBOR panel, and we had made it clear to the BBA that that regular review of the LIBOR panel would not be enough.

Q49 Michael Fallon: This is not about credibility. Is "deliberate misreporting" dishonest?

Paul Tucker: Well, it turns out with hindsight that, yes, it was, but it did not set alarm bells ringing at the time, I am afraid.

Q50 Michael Fallon: But how could "deliberate misreporting" be honest?

Paul Tucker: I understand the question, Mr Fallon, but all I can say is that it did not set alarm bells ringing. We were very concerned about the credibility of LIBOR as a piece of global infrastructure and we acted.

Q51 Michael Fallon: But you must have realised at the time that there were considerable incentives for banks to underreport and to protect their positions, given what was happening to Barclays.

Paul Tucker: As I said last week, LIBOR seemed to move in a broadly sensible direction, given the strains in the market. The period that we are discussing now is one where sterling LIBOR and the LIBOR spread were rising. There were rumours about HBOS and about it approaching us for funds. We were very much focused on sterling LIBOR because we are the sterling lender of last resort. There was then this emerging concern in particular about dollar LIBOR. We were very concerned about the loss of credibility, but we did not seize on it in terms of dishonesty.

Q52 Michael Fallon: But you yourself chaired the Money Markets Liaison Group six months earlier—15 November 2007—where the minutes say that several group members thought that LIBOR fixings had been lower than actual traded rates. You were the chairman of that group.

Paul Tucker: As I explained last week, we were concerned that the underlying money markets were dysfunctional from time to time. We understood that banks were having to make judgments about where they would be able to borrow. Again, as I said last week, that did not set off alarm bells of dishonesty, but we were concerned about the eroding credibility, which is why at that meeting we turned to the BBA and asked them what they were doing. Nobody came to us afterwards and said, "You are not doing enough. You have missed the point here."

Q53 Michael Fallon: So you were aware that LIBOR fixings were lower than actual traded rates. You had seen the warning from the New York Fed that rates might be deliberately misreported and you continued to believe that this was an honest market.

Paul Tucker: As I said last week, we use LIBOR in the fee structure for the special liquidity scheme, which was our biggest intervention in the whole of this crisis period. I really do not think that we would have done so had we had suspicions of dishonesty. We thought that LIBOR was flawed, but we thought that it was the best measure of unsecured funding costs for the banks.

Q54 Michael Fallon: Governor, at what point did the penny drop with you that LIBOR was not just dysfunctional but was actually being manipulated dishonestly?

Sir Mervyn King: There were two dates. I was informed of the allegations that Barclays had made in connection with the conversation between Mr Tucker and Mr Diamond in April 2010, but the first I knew of any alleged wrongdoing was when the reports came out two weeks ago. Perhaps I could take you back to the document that Mr Geithner sent.

Q55 Michael Fallon: Do, but I just want to be clear: you had no suspicion until two weeks ago that anything had been going wrong in the LIBOR market?

Sir Mervyn King: No, we have been through all our records. There is no evidence of wrongdoing or reporting of wrongdoing to the Bank. The memo from Mr Geithner that you referred to was, if you like, a constitution for how LIBOR should operate. It already had a set of operations. This was a self-reporting scheme. Any self-reporting scheme has to have a provision about deliberate misreporting. That is not the same as saying that they believe that there was deliberate misreporting.

Q56 Michael Fallon: So why would he want you to work on procedures designed to prevent deliberate misreporting?

Sir Mervyn King: Because any LIBOR scheme had to have it. It was already there and indeed the result of the consultation was to improve the reporting and monitoring of the rates that were being submitted, but at no stage did he or anyone in the New York Fed raise any concerns with the Bank that they had actually seen or had evidence of wrongdoing. I do not believe that that constitutes it, because that is a suggestion for how the rules should be written.

Last Friday, we issued the funding for lending scheme rules. It has provisions against misreporting. We did not do it because we thought we had evidence of misreporting; we did it because any scheme of this kind has to have such rules, and I think Mr Geithner was sending that to us as a suggestion for how these rules should be constructed, and we agreed with him. Neither of us had evidence of wrongdoing.

Q57 Michael Fallon: So he was suggesting a section entitled, “We should eliminate incentives to misreport”, because there was not any misreporting going on? Is that really credible?

Sir Mervyn King: Of course it is credible. When you design any self-reporting scheme, you have rules to prevent misreporting. That is not the same as saying that you have evidence that there is misreporting, and nor did the Fed or anyone else send us any evidence of misreporting.

If you go back to the money markets liaison group meeting, the regulator and the BBA were present at the meeting. The minutes were published on the website. No journalist interpreted those remarks as, “Gosh, we have a smoking gun of wrongdoing.” The regulator did not look at it and say, “This is wrongdoing.” There was enormous concern at the time about what the submissions of LIBOR actually meant in circumstances when the market was dysfunctional, and indeed I discussed it with this very Committee.

Q58 Michael Fallon: But the penny didn’t drop with you until two weeks ago?

Sir Mervyn King: It is not a case of the penny dropping; we discussed this—I discussed this with your Committee in November 2008. Everyone was concerned about what LIBOR meant at that stage. Your Committee discussed it. We discussed it. The press discussed it. That is a million miles away from saying that is the same as deliberate, deceitful manipulation of submissions in order to make financial gain. That is my definition of fraud. There was no suggestion of fraudulent behaviour or wrongdoing in anything that we saw.

Q59 Michael Fallon: There was no suggestion of fraudulent behaviour, but the New York Fed sent you a paper designed to stamp it out.

Sir Mervyn King: No they didn’t design—any system designed to deal with a self-reporting scheme has to have procedures to deal with misreporting. That does not add up to an accusation that, at that moment, any individual has been suspected of doing it. They are quite different things. After all, it did take the regulators three years of going through millions, if not billions, of words and e-mails in order to discover evidence of the fraud that lay behind the reports that were published two weeks ago.

Q60 Chair: Lord Turner, taking you back a moment to that conversation with Marcus Agius, what was it between the publication of your final notice report and the decision to engage in that conversation that had changed? Why didn’t you say to Barclays at the time they published that final notice—

Lord Turner: On the Wednesday, rather than the Friday? The final notice was published on the Wednesday. My discussion was on the Friday.

Q61 Chair: Why didn’t you have that discussion immediately?

Lord Turner: I think the honest answer is—

Q62 Chair: That's what we like.

Lord Turner: Well, I will give you an honest answer. Andrew and I had not talked it through and decided what precisely our point of view should be to this. We talked it through on Thursday. We talked it through again on Friday.

Q63 Chair: But you'd had months to think about it.

Lord Turner: We had been, as you know, increasingly concerned about Barclays, but we had not come to the point of view—those concerns had not got to the point of view—where we felt that we had to talk about the role of Bob Diamond till this final notice came out.

I repeat the fact that perception is important here, and I am not going to be defensive about that. One of the things I did say to Marcus Agius was that they had to think about the substantive challenge of changing Barclays culture in the way that related to some of the things that we talked about, but that was also about whether the external world would believe that Bob Diamond was the appropriate person to do that.

Those comments, yes, did reflect the scale of the reaction to the final notice coming out, and I think there are some circumstances where it is reasonable to urge a board to think about the scale of public reaction which was going on. That is the honest truth. I was taking into account the extreme degree of focus on the issue of LIBOR. I knew in advance, having read the final notice a week before, that this was going to be a very big public issue. I think even compared with what I expected, this ended up as a much bigger issue than I had thought. I think that is a relevant factor to take into account in deciding the appropriate way forward.

Q64 Chair: You don't think that it is your job to protect these institutions from the vagaries of public pressure?

Lord Turner: Not if they are just random vagaries, but I think the combination of—

Q65 Chair: What you are saying here is that the public were justified in their reaction on this occasion.

Lord Turner: I think the public were justified in their reaction.

Q66 Chair: In which case, why didn't you act on the Wednesday?

Lord Turner: I think—honestly, again—it takes one time to think these issues through, sometimes. That is the answer, which is the correct answer.

Q67 Chair: Governor, you received this note from the Fed in June 2008, and you told us a moment ago that you asked for a staff view. We would be very grateful if we could have a look at the staff note that was produced supplying that, and any other relevant, related papers.

Sir Mervyn King: Of course.

Q68 Mr McFadden: On the same area of the Geithner exchange, Governor, you mentioned a conversation in Basel before the e-mail exchange. Can you tell us a bit more about that? What was the conversation about and who initiated it?

Sir Mervyn King: We meet for a weekend in Basel every two months at the beginning of May.

Q69 Mr McFadden: "We" being the central bank governors?

Sir Mervyn King: Central bank governors. There is a smaller group from the major countries that meets together. Whether it was at that meeting or in a bilateral with Mr Geithner, I no longer remember, but everyone had been concerned about the behaviour of LIBOR. The particular concern was dollar LIBOR, not so much sterling LIBOR or EURIBOR but dollar LIBOR, and that is where the concern was. Through the period '07, right through, ultimately, to October '08, it was moving up and down a great deal.

LIBOR was a bit like the temperature of a patient. It was how you measured the health of the system. It was so volatile in moving up and down that everyone was thinking of ways in which they could introduce policies that would eventually bring LIBOR rates back down to where they normally were in relation to official policy rates. So we had a conversation where I said, "We want the BBA to carry out a consultation. We would like you to submit thoughts and ideas that you have about the future of LIBOR to the BBA or to us, and we will make sure that there is a full discussion of that."

Q70 Mr McFadden: You mentioned concerns and volatility, and you talked about bringing LIBOR rates down, closer to official borrowing rates. That is quite important. Are you saying that there was a policy desire, shared across central banks, to bring LIBOR rates down?

Sir Mervyn King: This is like temperature. When a patient is sick, you want to bring the temperature of the patient down, but there is a world of difference between trying to think of what measures you could adopt to bring the temperature of the patient down and actually tampering with the thermometer. That was nowhere near anyone's thoughts at the time. So, yes, the LIBOR rate was demonstrating that banks were very reluctant to lend to each other, and there were times in September '07 and October '08 when banks were so unwilling to lend to each other that LIBOR became almost non-existent. It was impossible to think—

Q71 Mr McFadden: What I am driving at is that there is a difference between saying, "This measure is faulty" when banks are not lending to each other, because it is based on indications, and a policy desire to bring the interest rate of LIBOR down. Those are two different things. The first is, "Let's try and get a measure of what is really happening in the market," and the second is a policy desire among central banks. What was your understanding?

Sir Mervyn King: The height of LIBOR was a measure of the sickness of the patient. After '07, initially as we went through the end of '07 and the beginning of '08 LIBOR came down, which seemed to be a reflection that banks were having fewer funding problems, that it was easier for banks to get funding and hence that it would be easier for them to lend. Then, as market sentiment deteriorated in the spring, LIBOR rates shot up again. There were several episodes of this, which to my mind—I said so at the time—illustrated that the issue was not liquidity; it was an underlying concern about the capital position of banks. Really, the problem was solved only after the recapitalisation of the banks here and in the United States and Europe, which brought the whole thing back down under control. Right through this period, LIBOR was used just like a thermometer—"What is it telling us about the health of the banking system?"

Q72 Mr McFadden: I want to read a little bit from the Fed's website—documents that they published on Friday—because what we are trying to get to the heart of here is: what were these concerns? Were they reliability or were they misreporting for some reason? The Fed says, “As market strains intensified in early 2008, to better understand the nature and extent of the potential problems with LIBOR, analysts in the Markets Group” —that is, the markets group of the Fed—“gathered additional and more in-depth information…on April 11, an analyst from the Markets Group queried a Barclays employee in detail…The Barclays employee explained that Barclays was underreporting its rate to avoid the stigma associated with being an outlier with respect to its LIBOR submissions, relative to other participating banks.”

The Fed goes on to say that “analysts in the Markets Group reported on the questions…in their…briefing note. The briefing note cited reports from contacts at LIBOR submitting banks”—plural—“that banks were underreporting borrowing rates to avoid signalling weakness…this report was circulated to senior officials at the New York Fed, the Federal Reserve Board of Governors, other Federal Reserve Banks, and U.S. Department of Treasury” and so on.

From that, it looks like the Fed had picked up that Barclays were engaged in under-reporting their rates. Why did that not set more of a red flag warning going in the UK?

Sir Mervyn King: That was never shared with us; we never saw that. I don’t think there is any reason why it should have been shared with us, to be honest. If they had had regulatory concerns, they would have shared them with the regulator. The Federal Reserve Bank of New York has overlapping relationships with two bodies in the UK—the Bank on policy questions and the FSA on regulation.

Q73 Mr McFadden: But it says here, “New York Fed officials also met with representatives from the British Bankers Association to express their concerns and establish in greater depth the flaws in the LIBOR-setting process. The New York Fed analysis culminated in a set of recommendations to reform LIBOR, which was finalized in late May. On June 1…Mr. Geithner emailed…the Governor of the Bank”.

What it says here is that the Fed were worried, the Fed found out from Barclays that there was under-reporting, the Fed discussed this with the British Bankers Association and then e-mailed you. It seems odd.

Sir Mervyn King: It is not clear. I don’t know whether the Federal Reserve said to the BBA that they were concerned about misreporting and falsifying submissions. That certainly was not what they said to us and they did not pass any of that information to us.

Q74 Mr McFadden: The words used here are, “met with representatives from the British Bankers Association to express their concerns and establish in greater depth the flaws in the LIBOR-setting process.”

Sir Mervyn King: And we had expressed our concerns to the BBA about their need to be more active in reforming the process that was being used. We had no evidence of any wrongdoing. We were concerned that everyone in the market had doubts about LIBOR because of the dysfunctional nature of markets.

The BBA themselves had concerns; they were fairly active in approaching the reporting banks. They reiterated the rules of the game and issued the consultation. Paul Tucker had a number of meetings with Angela Knight where we put pressure on the BBA to take seriously the need to improve the system—and it was.

Q75 Mr McFadden: Let me ask about that part. Tim Geithner, in his document, on which you took advice from your officials when you were in Frankfurt, sets out several things. I will not read the detail, but the headlines are: "Strengthen governance and establish a credible reporting procedure"; "Increase the size and broaden the composition of the USD panel"; "Add a second USD LIBOR fixing for the U.S. market"—this was because the rates were bouncing around during the trading boom, with the time difference and so on—"Specify transaction size"; "Only report the LIBOR maturities for which there is a net benefit"; and "Eliminate incentive to misreport."

The detail of that last one is essentially about making the banks from which the average is drawn a more random collection from the basket of reporting banks. How many of those six recommendations did the BBA take up in their 2008 review?

Sir Mervyn King: All those were in the consultation document which they used to talk to all the other players in the market about. In the end, some of them dropped out because the players in the market felt that they were not practical. The one example that I remember in particular is the second fixing because of the legal difficulty of knowing to which fixing a contract would refer.

But in the end, when they announced their reform, some of those proposals were in. At no stage after that did the New York Fed—or, indeed, any other central bank or player—express any concern about the final outcome. The BBA went to great lengths to ensure that their consultation—this is what we pressed them to do—was a global consultation, and it was taken very seriously.

Q76 Mr McFadden: But, to end on this, don't you think there is an impression here, both in this initial story of what the Fed has put up on its website about its actions throughout April and May 2008 and in the subsequent investigation that we discussed in last night's session with you, Lord Turner, that the American authorities, all the way along, have been more worried, hungrier for this story and more active in pursuing it than has been the case in the UK?

Sir Mervyn King: There is a very good reason in the case of the New York Fed: it is a regulator; we are not. The New York Fed is a regulatory body and the Bank of England was not, so the interest in and the approach to these things will be very different. The New York Fed could have chosen to share that information with us, but it chose not to. I think that was perfectly reasonable. All we could have done with it was pass it on to somebody else, so why would it send it to us in the first place?

Q77 Mr McFadden: But you are the Bank of England, Governor. This looks a bit like acting as a post box to the BBA. It looks like a very passive response to this list of concerns.

Sir Mervyn King: Not at all. As I have said, we solicited that e-mail from it. We were asked for advice on how the New York Fed should interact with the BBA, so the New York Fed clearly realised straight up that its role was to interact with the BBA, not with us. The BBA was the body with the power to change this and to set it. The New York Fed asked us for advice about how best to interact with the BBA. I then said—I filed a note—that the BBA's response to that point was wholly inadequate, so I asked Paul and others in the Bank to make sure that the BBA realised that we thought it should be a lot more proactive, and it was. There was a lot of contact then between the BBA and the New York Fed, and we were very supportive of that. We made sure that the New York Fed's line was very much in line with our own views. We worked together on that to put in similar thoughts to the consultation. But we were not a regulator.

Q78 Andrea Leadsom: Good morning, Governor. Have you got to the bottom of how an individual derivatives trader might use LIBOR manipulation to the benefit of their trading book?

Sir Mervyn King: No. Again, it took three years for the regulators to find out that it was being done. In some ways, I think there is some similarity, if you will forgive the analogy, with the betting scandals in cricket, where no one saw it, because the games were not being fixed; it was just that, if there were three no balls in the 17th over, somebody else had made a bet on it. I was very struck and surprised, when reading these three reports, to discover that changing LIBOR by one basis point was the kind of rigging that people were interested in. You would never have noticed that from market activity. We were worried about tens of basis points.

Q79 Andrea Leadsom: Now that we know it was done, have you got to the bottom of how it was done? In other words, have you at the Bank of England assessed how one trader could manipulate LIBOR to the benefit of their book, and what they stood to make from that; or have you assessed that they would have had to collude with other banks? To what extent have your investigations looked into that?

Sir Mervyn King: We are not an investigative body—that is the regulator's job. We have only seen these accusations—or reports, rather—of the three regulatory bodies for two weeks. It clearly raises concerns, and I think that the regulatory bodies will want to think carefully about the monitoring of individual transactions.

As I have said, my conclusion is that a system that is based on self-reporting, where submissions of the rate that people think they can borrow at are based on their own judgment, is one that can clearly be manipulated by collusion between the submitters and people trading in almost any other instrument that depends on LIBOR.

Q80 Andrea Leadsom: Forgive me, Governor, but if you have not assessed how it was done, how do you know that other markets have not been manipulated as well?

Sir Mervyn King: I do not. It is only two weeks since these reports landed on our desks.

Q81 Andrea Leadsom: But you have known about the potential for a considerable amount of time.

Sir Mervyn King: No, I haven't—not at all. The first we knew about fraud in this connection and that aspect of it was, indeed, two weeks ago when the reports were published.

Q82 Andrea Leadsom: What steps are you now taking to see whether other markets have been manipulated in a similar way?

Sir Mervyn King: We are not responsible for the regulation of markets. That has to be for the FSA and its compliance area—the Martin Wheatley area. One of the great benefits of the division of regulation between prudential supervision and enforcement and compliance is that the people working at enforcement and compliance will have a soul focus on this kind of issue.

Q83 Andrea Leadsom: Going back to the Chairman's earlier points, you do not see it as your role to find out what benefit was gained by certain people gaming the system, so you do not really know to what extent the culture at the top was encouraging that, and yet you did think it appropriate to, effectively, ensure that Bob Diamond was forced to resign. What evidence do you have if you have not done any assessment of what type of gaming was taking place?

Sir Mervyn King: I do not think the reports that came out two weeks ago suggested that Mr Diamond had any personal knowledge of that fraud, and that was not the basis on which the concerns that regulators had about the culture in Barclays were based. This had been something that had built up over many, many months about sailing too close to the wind, and the culture that had been built up in the institution which led that to be an acceptable form of behaviour. It was not an accusation about Mr Diamond being involved in the fraud. It is very important to be clear on that.

Q84 Andrea Leadsom: Okay. Lord Turner, to what extent was Jerry del Missier's appointment passed through the FSA one week before the judgments came out?

Lord Turner: It is important to realise that there was no formal approval process required for Mr del Missier, because the nature of the job that he was moving from to did not involve a change in status in terms of what he had already been approved for. I know that this is an issue to which Andrew Bailey gave consideration. It was not something that he and I discussed in detail. I trust Andrew's judgment and I left it to him. We did not have a discussion about it. Therefore, in a sense, it would have been best if you had asked Andrew yesterday about it. But his point of view I know, because he talked to me this morning and said, "If this question comes up, here's what I did." I know he did talk with Bob Diamond about it and say, "Look, do you want to do this, given what is about to happen on LIBOR, given that, although there is no case being found against Mr del Missier, there may be a lot of public comment?" But Andrew did not believe that it was sufficiently clear what had to happen there that he should stop it occurring at that stage, though I think he had doubts about it. But the crucial thing is, because he was not changing the definition of the role that he was doing, it did not involve a change of status. If he had been going to a chief executive role, it would have been a different position in our hierarchy of significant influence functions, and therefore there would have had to have been a formal approval process. But there did not need to be a formal approval process in this case.

Q85 Andrea Leadsom: Okay. Had there been a formal approval process, would he have been approved?

Lord Turner: I don't know the answer to that.

Q86 Andrea Leadsom: But in hindsight, you can see that it is rather astonishing that not only was he appointed one week before the report came out that clearly implicated him, but also the comments he made about wanting to create a bank with the most honourable and amazing controls and internal procedures and so on—a quote that looks rather like a joke now.

Lord Turner: Those comments that he made to you, are you talking about?

Q87 Andrea Leadsom: There is a public quote in the media from Jerry del Missier about how he wants Barclays to be famous for its fabulous controls. Do you accept that the FSA was asleep in terms of allowing his appointment to be made one week before that report came out?

Lord Turner: No. I don't think it was asleep, because I know that Andrew consciously thought about it, had a conversation with Bob Diamond about it, and believed that there was no disadvantage in that going ahead.

Q88 Andrea Leadsom: Governor, in terms of Marcus Agius and the senior non-executive director, Mr Rake, why do they then escape? Is it just because Bob Diamond is more culpable? Is that a subjective judgment? You describe Bob Diamond as having been the one at the helm, but, astonishingly, two other people who could be seen to have been at the helm, and indeed, Marcus Agius, who could have been fairly criticised for failing to provide any sort of check and balance on Bob Diamond, who, as the FSA and the Bank have said, was certainly gaming the system. Why is it that Marcus Agius and Mr Rake seem to escape unscathed?

Sir Mervyn King: I do not want to personalise this. Indeed, when I met them both, I tried very carefully to use the phrase that the regulators had concerns about the executive management. The point I made to Mr Agius was that, honourable though his resignation was on that Sunday, no one believed that the culture in the institution was set by the chairman but by the chief executive. It is the culture that matters. What matters now is that Mr Diamond has gone, and now Barclays, which is a great bank, has to look forward and create a new bank with a new culture and take it forward. I think Mr Agius has made it clear that he will perform the task of ensuring that we get through this difficult period and will then leave. I think he has taken a very honourable position. In the heat of the moment, he thought that, given the pressure on the bank, the honourable thing to do was to resign. Both Lord Turner and I felt that there was one more duty that he had to perform, which he should perform for Barclays, which was to see it through the next stage. I think that that is what, very honourably, he is doing.

Q89 Andrea Leadsom: But bearing in mind that all of these decisions are to a certain extent arbitrary—they are certainly challengeable—do you not think that this argues again for the proposal that this Committee put forward, which is that the Court of Directors should have very clear powers to review the decisions that the Bank of England has taken, and to properly scrutinise the internal processes that come up with these potentially arbitrary decisions?

Sir Mervyn King: Yes, and I am sure they will.

Q90 Andrea Leadsom: Okay. Thank you. Well, that is very interesting. Do you think, Governor, that the BBA has done a good job?

Sir Mervyn King: I think they had to be nudged to get into the right direction, but, once they had been nudged in May 2008, they did work very hard to make a success of the consultation. I think the real challenge in all this—and it is something that is not to do with the failure of any person in a bank or institution—is that we have a $500 trillion market in derivatives based on the illusion that there will always be a benchmark interest rate against which the contracts can be fixed. For the vast majority of time, it is easy to find that interest rate. Before 2007, what was the interest rate at which banks will lend to each other in a three-month unsecured market? The answer was basically the same number for all banks.

91 Andrea Leadsom: Yes. I am very familiar with how it works.

Sir Mervyn King: There was no worry about credit risk for banks. Occasionally, there will be, and that has now been going on for five years. The big question is whether it make sense for people to think of basing contracts on an interest rate when you know—this is not to do with dishonesty or incompetence—that there will be times when liquidity dries up and there will be no reference interest rate to benchmark the contracts on.

Q92 Andrea Leadsom: Yes, but it is broader than that. It is more than five years—it is actually seven years—that there has been fraud as well as LIBOR fixing and a difficult interbank market, so do you not think that over a seven-year period the BBA, which is responsible for managing and monitoring this fixing, should take responsibility for their failure to do that?

Sir Mervyn King: I think it is harsh. In terms of the fraud—things like the one-basis-point changes that people were aiming at—I do not believe that the BBA could possibly be held responsible for monitoring whether the quotation was one basis point too high or too low.

Q93 Andrea Leadsom: So should the FSA be held responsible for failing to regulate the bank's internal procedures? Clearly, this was being shouted out across a dealing room. It is not as if it was one basis point and nobody knew about it.

Sir Mervyn King: Some people clearly knew and many others did not. We can try to put in place mechanisms to detect it, or the regulatory authority can do it, but I go back to what I said earlier. It took three years of detailed investigation by the three bodies—Department of Justice, CFTC and FSA—to get to the bottom of it, and, in the end, the evidence that proved conclusive was e-mail traffic in which the people who committed the fraud revealed themselves through e-mails.

If you put in place a system whereby every e-mail is monitored every week for signs of fraud, people will not do it through e-mail. They will find some other way of talking to each other. These things are extraordinarily difficult. I do not want to blame anybody. It is worth trying to ask ourselves the question: how can we improve this for the future?

Q94 Andrea Leadsom: But that is slightly extraordinary, because the whole point about running a bank is that you do not monitor every e-mail every day, but you create a culture where people will report things that have gone wrong, and there should be a procedure by which that finds its way to the top. What you are saying is that you do not want to blame anyone, which suggests that that is just a nonsense, so why bother with the regulator?

Sir Mervyn King: You asked me about BBA and the regulator. I do not think it was their responsibility. You are absolutely right that in each bank the responsibility of the executive management is to create a culture that encourages upward reporting of things that are thought to be somewhat dubious. I think that most organisations try to do that. That does not mean to say that there will not sometimes be things that go wrong.

On the concern about Barclays—I have no idea what the remaining investigations into the other banks will show; I am not party to that at all—what I do know is that we had reports on Barclays. It did show a culture in which over many, many months—you can see that in the letter of Lord Turner—they had been sailing too close to the wind across a very wide variety of areas. This was not so much the straw that broke the camel's back as perhaps a bale that was too much for the camel's back. It all adds up to a picture of the culture at Barclays that made regulating the bank extraordinarily difficult.

I remember very clearly that to be a regulator before 2007 was to have no support from anybody—dare I say it, even in Parliament. The consensus was, "Anything the regulator did was to impede the working of our efficient and dynamic financial services industry."

Everyone said that; I am not trying to pin it on any individual. The regulators had a very tough job.

It is easier now to come up and try to change the culture, but when we had this evidence about Barclays, it seemed appropriate to ensure that the board of Barclays really appreciated that the regulatory style had changed and that regulators had lost confidence in the executive management. That was a message that they deserved to hear. It was important that we get that message to them. What they did with that message was up to them. They would then be accountable. If they had done nothing after hearing the messages, then a few weeks or months down the road, if other material had become available, they would have been culpable for their failure to act. But it was their decision, and it had to be seen as their decision, which is why I do not accept that what happened was, in any sense, the arbitrary use of power. It was the exercise of judgment and the conveying of information that was important to the board to them.

Q95 Andrea Leadsom: Thank you. I have one quick question for Mr Fisher. Are you happy with the Bank's preparations for unwinding QE at some future point? Do you think that enough work has been done? Do you think that we are treading into unknown territory without a proper exit plan?

Paul Fisher: We have done a considerable amount of preparation for QE exit. We cannot do any more until we know the circumstances of the time. The preparations we did went back to 2010, when we had discussions with the Debt Management Office about a range of options we would have for exiting QE. We came up with some plans. Those plans depend in part on how quickly we need to unwind QE, so we cannot be definitive about it.

We have done about as much—we need to think about it again, because it was a couple of years since we drew up the initial plans. It does not look like we are going to exit any time soon, so we have further time to plan. We need to take into account the fact that the QE programme is now much bigger than it was when we did the previous planning, and look at the state of the market. We are confident that we have thought through a lot of the issues.

Chair: We are going to come back to that subject later on this morning, if we get the chance.

Q96 John Mann: Governor, a light-touch regulation was not a consensus. It was a majority view, and there were a number of dissenters, both political and academic at the time. I am surprised that you did not read the academic studies in 2007 and 2008. Did you read *The Wall Street Journal* on 29 May 2008?

Sir Mervyn King: Yes.

Q97 John Mann: That was presented to you on that day?

Sir Mervyn King: Yes.

Q98 John Mann: Lord Turner said a few minutes ago that he realised it would be "a very big public issue", and he realised it a few weeks ago. Despite that, Lord Turner and the FSA failed to give Parliament a crucial letter from him to Barclays that was obviously relevant to the inquiries and hearings of this Committee. You similarly failed to provide a series of documents that have now come into the public domain that are of significance to all the hearings of this Committee and Parliament on the matter. What is your excuse for not providing Parliament with these documents?

Sir Mervyn King: You wrote to us, Mr Mann, and put in an FOI request. We have answered your FOI request, and you received the data yesterday. We put yours to the top of the list to get it top priority. As you know, you can't just turn these things around in a matter of a few hours, or even a few days.

Q99 John Mann: I was referring to the stuff that has come from America.

Sir Mervyn King: When we realised that the Federal Reserve had put it out, we published material—

Q100 John Mann: My question is: why didn't you provide that? It is obviously relevant to our inquiry.

Sir Mervyn King: Mr Mann, it is very difficult to anticipate all the questions that you are going to ask. When you ask for material, we supply it. The Chairman asked earlier on if we would provide relevant material, and we will.

Q101 John Mann: I get the message. Like Lord Turner yesterday, we should have asked for information we didn't know existed that was pertinent to our inquiry. I am pleased, because there are other FOIs with you or on their way to you. I am sure that they will get suitable priority.

Sir Mervyn King: I think you may take your place in the queue on the other ones, Mr Mann.

Q102 John Mann: I am sure that it is the same information, so we will be happy to share it around. Does Mr Tucker act and has Mr Tucker always acted with your full authority when he has done things in relation to LIBOR?

Sir Mervyn King: He has always acted by talking to me about what the policy and the approach was. Clearly, I do not monitor every phone call or everything that he does. I trust him to go out and do the job that I ask him to do.

Q103 John Mann: So there are no occasions when he has acted without your authority?

Sir Mervyn King: No; not that I am aware of, and I see no reason to suppose that there would be.

Q104 John Mann: Neither would anyone else, I am sure.

Mr Tucker, the e-mail that has just been released, of 28 May, to Bob Diamond from yourself, headed LIBOR: "Bob Have spoken to hsbc and rbs, stuart and johnny"—presumably Stuart Gulliver and Johnny Cameron—"Sense similar across all three of you." What is the "similar" that was sensed?

Paul Tucker: Senior participation in the BBA's review. This reflected a conversation with the Governor. As the Governor has already said, we wanted to give the BBA the message that they should not just do their normal annual review of LIBOR; they should do a much broader, global consultation on LIBOR and its governance. We conveyed that to the BBA.

In parallel, we decided to say to the banks that this broader review should not be conducted at the level of the normal committee, which is kind of desk level, but should be more senior. I called roughly the number twos, the number threes in each of the big sterling banks to say that—and I reported back to the Governor that I had done that.

Q105 John Mann: Indeed, you said, "I encouraged contact amongst mark dearlove peer group." Yesterday, Mr del Missier said that he had been instructed by Bob Diamond and he had passed on the message to Mark Dearlove, and Mark Dearlove had not questioned anything in relation to it. I note that, in fact, with your e-mail of 22 October, you were not actually trying to contact Bob Diamond at all; you were trying to contact Mark Dearlove. The reason you contacted Bob Diamond is, "I think mark d is away."

Paul Tucker: No. I wanted to speak to somebody at the top of the firm. I simply noted that Mark Dearlove was away. I wanted to speak to either Bob Diamond or John Varley.

Q106 John Mann: You put: "Sorry to bother you but I think mark d is away."

Paul Tucker: Yes.

Q107 John Mann: So you wanted to speak to Mark Dearlove.

Paul Tucker: No. I wanted to speak to Diamond or Varley, for exactly the reasons that I conveyed to you last week.

Q108 John Mann: You put here: "Sorry to bother you but I think mark d is away." How often did you discuss, in 2007-08, LIBOR with Mark Dearlove?

Paul Tucker: Mark Dearlove would come to meetings in the Bank, where we would discuss money market conditions. The team would talk to him about what was going on. But this was a call which I wanted to have with Bob Diamond or John Varley, and I was not bothered which one I had it with.

Q109 John Mann: Well, the e-mail is quite clear. Going back to your e-mail of 28 May: "I encouraged contact amongst mark dearlove peer group." It is the fact, isn't it, that it is now emerging that you were discussing LIBOR with this level of people on a regular basis?

Paul Tucker: No, no. In May, we wanted—the Bank wanted—the banks generally to participate in this review at a more senior level. Therefore, we decided to call each of the big sterling banks, at number two or number three level. We wanted that to be understood at the treasurer level that they needed to participate there or thereabouts.

Q110 John Mann: I do not dispute that for a moment. That is not the answer to my question. My question is: were you not discussing LIBOR on a regular basis with Mark Dearlove?

Paul Tucker: Funding conditions, yes—money market conditions—and, as I said last week, LIBOR was used as a portmanteau term, occasionally, for all of that, as it has been this morning.

John Mann: We see *The Wall Street Journal* stating on 29 May that "Banks routinely misstated borrowing costs" to the BBA "to avoid the perception they faced difficulty raising funds during the crisis". Governor, having read that, you then had correspondence with the

President of the Federal Reserve Bank. You are aware of the allegations out there of what is going on.

Sir Mervyn King: Would you like to carry on with the article? The same article points out there is no evidence of any specific wrongdoing and, indeed, that the allegations could well be explained by volatility in markets.

Q111 John Mann: The analysis indicates a series of banks reporting significantly lower borrowing costs for LIBOR than other market measures suggest they should. It also correlates with previous information that was in the public domain and with the money markets meeting of November. Isn't it the case that what you were concerned with was the position of the banks in raising funds, not the fiddling of the LIBOR reported rates?

Sir Mervyn King: What we were concerned with in May 2008 was to ensure that there was going to be a proper review of the LIBOR process, to make sure that everyone involved in it—it was a private sector market, private sector instrument, they weren't regulated. The idea was to try to make sure that the stakeholders in the LIBOR market were satisfied with the way it was working.

That's why it was important to ensure there was a global consultation, involving all the major players in private markets and the New York Fed, and that the BBA had to take that seriously. Angela Knight picked that up with some enthusiasm and she had a lot of direct contact with the New York Fed. At the end of the process no one came back to us and said, "We are not satisfied with the outcome."

Chair: John, we are going to move on in a moment. We'll have one more question and take one answer. Then we'll move on.

Q112 John Mann: Then it will be a long question. In reply to the question asked by Mrs Leadsom, you used the same definition of fraud as Bob Diamond: that it was, in my term, "a few rogue traders" and that the low-balling of LIBOR was not fraud. That is not the view in the US, is it? A US Federal Reserve employee said in the last day or so that US confidence in the London market as a whole has been severely shaken, partly because "the slow reaction time of the UK authorities. They had to be continually prodded by us." The employee also said that it might be too idiosyncratic to allow US mega-trading there, as in London.

Despite the fact that there are serious commentators in the US questioning the viability of parts of the London market, you appear to be still in denial that it was known that LIBOR rigging was going on—the low-balling—when it was patently obvious to everyone that it was known. Why are you still in denial over that? Wouldn't it help the situation if the Bank of England, along with the FSA, recognised that low-balling had failed to be spotted because you had other priorities because of the economic crisis? That honesty might give us some credibility in going forward and dealing with this crisis.

Sir Mervyn King: "No" is the short answer. The slightly longer answer is that there is a world of difference between people saying they do not know how to submit when they are doing LIBOR submissions because the market is dysfunctional. No one knew what to make of the quotes that had been submitted. That was something I discussed with this Committee in November 2008. There is a world of difference between that situation and deliberate misrepresentation of the submissions with a view to a financial gain, either private or institutional.

I did not say that fraud was restricted just to the rogue traders. It was also true that there was deliberate misrepresentation by Barclays in the submissions. On that, we had no evidence of wrongdoing. None was supplied to us. The evidence you cite—there were plenty of academic articles that looked in it and said that they could not see in the data any evidence of manipulation. I say again, if you go back to the inquiries that the regulators made, it took them three years to work out and find the evidence of wrongdoing. If it was so obvious and all in the newspapers and everyone was talking about it, one might ask why everybody did not say, "This is wrong." The reason was that it wasn't wrongdoing. It was a market that was dysfunctional and was not operating in any effective way.

Chair: We are going to move on. Otherwise, we will be on this subject till lunch time—maybe tea time.

Q113 Mark Garnier: Paul Fisher: the funding for lending scheme—a completely fresh subject and a big smile of relief from the panel. The institutions that are eligible to participate in this FLS are banks and building societies that are participants in the Bank's sterling monetary framework, and have signed up to the discount window. How many institutions are currently eligible?

Paul Fisher: We don't publish a number or a list, but it is getting on for 100 now, and it is changing all the time as we are getting more banks signed up. We changed our policy in 2010 to allow smaller banks and building societies in, and it has roughly doubled in that period.

Q114 Mark Garnier: Okay; 100 is quite a lot.

Paul Fisher: It is not there yet, but it is getting on towards it.

Q115 Mark Garnier: Fantastic; and you have seen lots of organisations coming forward with enthusiasm for this scheme.

Paul Fisher: We have had a lot of contact since we announced the details, yes.

Q116 Mark Garnier: And what sort of size, in aggregate, would their total balance sheets be worth?

Paul Fisher: The banks, individually, would be quite small. The largest banks are well over £1 trillion and smallest ones might be a few billion, I guess. I have not looked at the very smallest one to see what size they are, but this could be a very small building society or bank.

Q117 Mark Garnier: The smallest bank I have come across has got a £50 million balance sheet. Would they be included in that?

Paul Fisher: They have to meet our minimum credit standards and we would have to look very closely at a small institution to make sure that it was going to remain solvent and viable over the period in which we were going to be dealing with it, but subject to that, yes.

Q118 Mark Garnier: The fee structure penalises banks if they don't lend. How did you set about establishing the size of this penalty?

Paul Fisher: We used our economics area to do some substantial analysis of different scenarios—different fee structures we could apply. I think we are very conscious here that the major banks—the big six lenders who account for most of the lending—are all in quite different strategic positions. Some are quite constrained on their balance sheets; a couple of them have got state aid rulings that mean they have to dispose of certain assets—so some of them would naturally be shrinking, and others would be naturally expanding.

We tried to devise a price schedule that could apply to everybody, that gives incentives to both the deleveraging banks and the expanding banks to do what we wanted them to do, which was to lend more in their core portfolios.

Q119 Mark Garnier: What happens with this whole idea of lending more—because, of course, clearly you can't force a bank to lend to a bad prospect, and clearly you have got the issue where the economic conditions could start spiralling downwards and you could have this ever-decreasing spiral, in which case the banks may be penalised for not lending in conditions which it is just completely irrational to lend into. How would you compensate them for that?

Paul Fisher: Obviously, we want the banks to remain prudent. The risk of any lending they do on the back of the scheme stays with them, so they will have to judge the credit risk of the borrowers to whom they are lending; but what we are trying to do, if anything, is to try get a more virtuous circle going—the more confidence in the economy, the more growth we get, the better credit prospect a lot of these businesses will be.

Where we have been over the last year is that we have seen lending, for example, to mortgages—as in our explanatory paper: the rates on that have been going up at a time when we have kept interest rates very low. We have been trying to loosen monetary conditions through QE, and some of those lending rates have actually been going up. Credit growth over the last three years has been pretty static, at best. So we are trying to get more growth into credit, but it will be up to the banks. We can't judge the individual credit-worthiness of a business, so the banks themselves have got to do that.

Q120 Mark Garnier: And if there is no demand? There could just simply be no demand for credit.

Paul Fisher: Well, the demand depends on the price and conditions on which the credit is offered.

Q121 Mark Garnier: Which comes very neatly to this £800 million windfall, according to *The Daily Telegraph.* Why do you think the banks are going to pass that on?

Paul Fisher: I did try to warn in the press briefings that you can do those numbers, but they aren't a sensible way of thinking about the way the scheme works. Bank funding costs in wholesale markets are going up and down all the time, and nobody will stop to say, "Oh, we're going to calculate that as a windfall gain to the banks, because their profits go up and down by that amount." What they will traditionally do is have a target margin for their lending rates over their borrowing rates.

The borrowing rates will be a blend of all the different sources and usually they will slowly adjust their lending rates in relation to how their funding costs are changing. They will make more money by lending more—by picking out more profitable opportunities to lend. What we are trying to do is to put some pressure on them to do that through the pricing of the scheme, the 18-month window—so they haven't got for ever—the transparency of the operations, to put some public pressure on them. We are trying to give them every incentive to get out there and lend in their core portfolios.

Q122 Mark Garnier: But it still comes back to this fundamental point: if the borrowers are not viable borrowers and there isn't the demand from viable borrowers, there is not much you can do, apart from just giving money away.

Paul Fisher: I have spoken to plenty of viable borrowers up and down the country, as I am sure Members have, who are seeking credit and find it hard to get it.

What I hope the scheme will do is turn the tables around. In the recent past, businesses have been frightened, almost, to go to their banks, because they are worried that previous arrangements will be undone and cheaper facilities might get replaced by more expensive ones, and so on. Giving the banks the incentive to go out there and push some lending at people should change the conversation and put some pressure on, and the borrowers should have less fear of going to their banks to demand the cheaper credit.

One way in which the scheme will work will be for existing firms with expensive arrangements to seek out cheaper arrangements with other banks, because that would count as new lending for the other bank.

Paul Tucker: It is worth adding, very briefly and directly related to your point, that some borrowers may not be creditworthy at interest rates that are up here, but if the scheme works successfully to bring down the cost of funding, those companies will become viable borrowers.

Q123 Mark Garnier: Yes. That all sounds very good, but of course banks are always setting the rate of interest they charge on a loan to determine the risk that goes with that loan. You are absolutely right—

Paul Tucker: The cost of their funding plus their assessment of the risk. Part of what has happened is that the cost of bank funding has rocketed largely, I would say, because of the dark cloud from the euro area. What this scheme is doing is saying, "We will help to pull down the marginal cost of bank funding, but in a scheme where you are incentivised to pass it on," bringing more borrowers within the field of those who could afford to borrow at those rate.

Q124 Mark Garnier: What risk does this pose to the balance sheet of the Bank of England or the Treasury, if any?

Paul Fisher: We protect the balance sheet of the Bank by adopting conservative haircuts on the collateral that is passed with us. If any individual loan goes bad, that is at the risk of the bank and it has to take the loan back and post new collateral. If the value of the loans or other collateral is changing over time, we will call for extra margins, so we are always fully protected. Only if a bank actually defaults and we end up holding that collateral, is there a risk, and that is where our haircuts should protect us, in that we should have enough collateral to cover the loan. You can never say there is zero risk, however.

Q125 Mark Garnier: But you would need yet another collapse of the banking system. What are the chances of that happening?

Paul Fisher: The scheme is partly designed to help to prevent that of course, to support the economy.

Q126 Mark Garnier: There are estimates that there is going to be £80 billion worth of extra lending. Is that fair?

Paul Fisher: There is no limit built into the scheme; it is unlimited in that sense. The natural limits will be the amount of collateral they can post, the amount of capital they have got to allocate to the lending and their ability to find profitable businesses to lend to. Those will be the things that cap it. I have not wanted to set a number to act as a hostage to fortune or to limit our ambitions—

Mark Garnier: But can you give you us an idea of the order of magnitude?

Paul Fisher: Five per cent. of lending is £80 billion. If we got lending growth of 5% over the next 18-month period, I would grab that now as an outcome of the scheme. We have had flat credit growth over the past three years, so 5% would represent a considerable improvement. For me, any sustained growth of lending would be much better than where we are now, particularly in a world where our assessment was that lending growth was more likely to fall than to go up.

Q127 Mark Garnier: Do you think that this will change the direction?

Paul Fisher: I hope it will. I hope it will be sufficient, but if other things happen in the world that put a big shock into the banking system and the economy, it may prove not. In which case, simply keeping credit growth maintained in that circumstance would be a good outcome.

Q128 Mark Garnier: But then again, it does come back to the point that if you see lending growth in negative territory, the banks are going be penalised for that under the scheme.

Paul Fisher: They won't be penalised, but they won't get as much benefit if their lending growth goes down.

Q129 Mark Garnier: My final question, if I may, is: are you going to monitor the type of loans that are being given under this scheme by sector, by the type of business—small, medium and large businesses—mortgages and that kind of stuff? Are you going to do an in-depth analysis of where this money is going?

Paul Fisher: Our main objective here is to support the economy as a whole, so the main focus will on the aggregate, and if we can get aggregate credit growth growing at these sorts of rates that would be a very good outcome.

I am sure we were doing what we can to monitor the different categories of business, but the sectoral data is not as good as the aggregate data, and we are not in a position to demand or force the banks to lend to any particular sector of the economy. Allocating credit between sectors is not—

Q130 Mark Garnier: No, but you can always ask them where they are lending it, to get a sense of where it is going.

Paul Fisher: We will be asking them. We will certainly be talking to the banks, finding out what they are doing, using our network of regional agents to talk to businesses at the other end to find out how they are seeing it come through. So it is a variety of intelligence sources we can bring to bear on that, to monitor what is happening.

Q131 Chair: Have there been any calls to increase collateral eligibility in the discount window?

Paul Fisher: We now have the broadest range of collateral eligibility, I think in our central bank history, in terms of our published facilities. Going as far as taking portfolios or individual loans for mortgages or to businesses really gives you a wide collateral set. Any of these banks which is lending in large scale to the UK economy will have a lot of these loans on their balance sheet, which they can parcel up and give us as collateral.

Q132 Chair: Are you receiving calls for more?

Paul Fisher: We have not been particularly lobbied. We have been lobbied about haircuts, and things like that, to which our response is that we are not going to apologise for our risk management. I have not been lobbied recently on the range of collateral.

Q133 Chair: So, being lobbied on haircuts, but not on eligibility? Right.

Okay, we’ve got quite a lot more to do today and I think it might be sensible if we take a five-minute break.

Sitting suspended.

On resuming—

Sir Mervyn King: I was hoping to be substituted at half time.

Chair: You will notice that we are playing no right-wing and no inside-right either.

Q134 John Thurso: Governor, can I come to you first? I want to ask you about forbearance, which was a completely novel concept to me until I read a very interesting article put out by Robert Peston on 27 June. Since then, I have tried to find out exactly what it means for us. Could you tell me to what extent forbearance being shown by UK banks is affecting their underlying creditworthiness and how much is that a problem that we should be directing our attention to?

Sir Mervyn King: Let me make an introductory comment and then perhaps Don Kohn might want to come in on this, because we have talked about these issues in our financial stability report. I suggest that you subscribe to a—I am sure that they will send you a free subscription, so you do not have to rely entirely on Mr Peston for enlightenment.

Q135 John Thurso: I think I heard the words but perhaps did not grasp entirely the import, and that is what I am really after.

Sir Mervyn King: There is good forbearance and bad forbearance. When the economy is in a downturn, it can be sensible sometimes for banks to say, “Well, look, given the difficult circumstances, we won’t press you to repay the loan on the original schedule. We think you’re a good business in the long run, but you will need longer to repay. We are willing therefore to forbear, almost effectively in essence lending more than would otherwise have been the case, to see a good business through bad times.” That is good forbearance.

Bad forbearance is where banks see that they have made losses, for example, on commercial property, which is where our biggest concern would be, and are reluctant to acknowledge those losses. They do not want to put those losses on to their balance sheet and into their profit and loss account because that would hit their capital. So they do not recognise the losses by not demanding repayment of the loans and not forcing repayment. That can be bad forbearance if it leads the bank to give an impression of profitability or of its capital position being stronger than is in fact the case.

What we wanted to do was to find out how much of these two different kinds of forbearance there was. We asked the FSA to inquire into this because it seemed important to us that the banks knew more about it, and we did explore that. For the FSA inquiry, you could ask Lord Turner, and for the FPC’s view on forbearance, you could ask Don Kohn.

Q136 John Thurso: I will come to the FPC view in a moment. What I often hear about from my constituents are relatively sound businesses where there is a small drop in EBITDA and therefore a breach of a covenant. They typically have relatively modest loans—£300,000, £400,000, £500,000 or whatever it might be—and find themselves with absolutely zero tolerance from the banks.

Yet I read this article and look at forbearance as being a major problem for stability. To what extent is it that there would appear to be one rule for the small companies on the high street that get hammered, because they are not that important, and another rule for big systemic operations that need to have forbearance to pretend that they can keep going?

Sir Mervyn King: It is hard to judge, which is why we asked the FSA to carry out its inquiry.

Q137 John Thurso: Shall I ask that question to Lord Turner?

Lord Turner: Let me first of all make a couple of additional points to those that the Governor has made. In assessing the risks involved in forbearance, as well as in trying to understand how much is good forbearance and bad forbearance, we also need to understand how much banks have provisioned against a forbearance.

It is not the case that if you are forbearing—in other words, giving the borrower greater opportunity to pay back—you are necessarily hiding things on your balance sheet, because you can simultaneously forbear and provision extensively against that. One of the crucial things we look at in a prudential point of view is not just how much forbearance is going on and whether it is sensible forbearance, but also what is the level of provisioning against it. That is the first point.

The second point is that in some sectors, such as the mortgage market, we are concerned to make sure that we have appropriate forbearance policies. Indeed, we have a code of conduct to make sure that firms do not leap into immediate repossessions at the first sign of problems. That is good forbearance practice.

On the specific question that you have asked, yes, I think there probably is a danger that there is a slight bias in the system. I think somebody once said that, “If you owe me £100, that’s your problem, but if you owe me £100 million, that’s my problem.” It is often the case when you have very large concentrated loans that the lender will feel, “If I try and get this back immediately, I won’t get it back—it will crystallise the loss.” So there can be in the operation of forbearance somewhat of a bias in favour of the largest companies.

That is not something we can precisely regulate, and it is true to say that we have, over the last two years, significantly increased our understanding of forbearance practices, some of which are organised with banks at a really quite decentralised level. So when we first ask them for details of precisely what they are doing on forbearance, it takes them some time to give us the data. But we have been increasing our focus on this issue and also discussing it within the FPC, and the consequences.

Q138 John Thurso: I am coming to the financial stability in a minute. Your side of it, as well as looking at the overall picture, is also about looking at the fact that this could be, if banks fail to forbear on reasonable companies, a major drag on potential future growth and recovery.

Lord Turner: That would be more a Financial Policy Committee concern to bring in the global consequences of it. The argument can work either way. There are some people, for instance, who argued that the Japanese banks in the late 1990s, with their tendency to apply large amounts of forbearance, kept on extending new loans to businesses that weren't going to recover, rather than closing that out and relending to new businesses right across that. So in the macro sense, you can argue it either way.

Q139 John Thurso: A very quick answer about this: basically whether banks are forbearing on companies who will recover or are masking bad loans is something that the FSA would be concerned to look at, whereas the extent of that forbearance from a financial stability point of view would be for the FPC.

Lord Turner: We are certainly very concerned. In particular, if there is forbearance with companies that cannot clearly recover, our crucial focus, even if they have done that, is have they provisioned against that to make sure that the balance is protected against any risks?

Q140 John Thurso: Mr Kohn, how important is forbearance for financial stability and for understanding the health of banks?

Donald Kohn: I think it is a very important issue, Mr Thurso, and the FPC's concerns were along two dimensions. One, that the banks themselves had sensible policies in place and were enforced to promote the kind of good forbearance that the Governor was talking about: that there are businesses of whatever size who hit hard times temporarily but are fundamentally sound and can be carried along. Because if they are not—if those businesses are foreclosed upon unnecessarily—that is going to add to the adverse feedback loop of the financial system and the economy. That has financial stability as well as economic stability concerns.

The second concern of the Financial Policy Committee was the one that you raised about accurately representing the capital and profits of the banking organisations. So we asked the FSA to look not only at provisioning and systems for provisioning, for forbearance, but how much provisioning was accompanying that, and whether they thought there was a significant under-provisioning that then posed a threat to the financial system when that became clear to the public or when those loans finally did go bad.

What the FSA came back to us and said was, "There is probably some under-provisioning but it is not large. The banks are taking account of the fact that loans and forbearance have higher risk and we do not believe that any under-provisioning is a threat to financial stability."

Q141 John Thurso: When banks feel that they have sufficient capital strength rebuilt in their balance sheet and a sufficient return of liquidity, how are they going to change their behaviour in respect of forbearance?

Donald Kohn: I think they will more confident about doing the good kinds of forbearance. I don't expect that they would greatly raise the amount of forbearance but I do believe that institutions that are concerned about their viability, because of threats from other sources, are probably less likely to be willing to make loans and to forbear on the loans they have made because they will want to collect and protect their capital. Asking them to raise capital and having them raise capital should promote new lending but also sensible attitudes towards the loans they have outstanding.

Q142 John Thurso: A potential scenario that one could imagine would be that they rebuild their balance sheets, liquidity returns, they are feeling a bit punchy again, so why not clear the decks? Let's get all these mortgages that are a bit worrying and let's deal with them all in a oner, get it over with and carry on. The danger is that we get a sudden slew of impacts in the mortgage market and people who are affected. What you are saying is that you do not think that that will be the case.

Donald Kohn: I do not think that that would be a sensible response to that circumstance. A sensible response for the banks would be to look at their potential profitability and their capital, and if carrying those loans along and getting repaid over a longer time period—a longer maturity—was sensible, they would do that. I do not see why they, all of a sudden, would foreclose on loans that might otherwise be repaid. So I would not expect a sudden surge in foreclosures when capital reached good levels.

Q143 John Thurso: It goes back to a comment Lord Turner made nearly two years ago now about what is the social point of banking. If banks are a part of the fabric of society and are actually a part of the instruments of a generally good and civil society, then they lack responsibility towards people who are basically sound—be they in business or homeowners—whereas possibly a great deal of what we have been seeing over the last two years is that it might be unwise to rely on that.

Donald Kohn: I think that is the banks fulfilling their social and economic role in society by channelling savings into investment and loans where they would do the most good and have the most effect. Hopefully, over time, there is a coincidence of those two things. I agree that we have seen some horrendous behaviour over recent years, in which the desire for short-term profits has overcome the longer-term good that the banks can play in society.

Q144 John Thurso: On the other side of the equation, I suppose it is, to what extent are you concerned about asset encumbrance?

Donald Kohn: Assets and what?

Q145 John Thurso: Asset encumbrance. In other words, the fact that, whereas pre-crash banks could borrow unsecured, they are now very largely having to borrow by putting up assets. One of the factors, for example, if you look at Greek banks, is that they virtually have no assets left, because they have all been pledged. Europe is seeing 20% pledges—I do not know what the figure is in this country, which was really my question.

Donald Kohn: It is about 19% or 20%, I think.

Q146 John Thurso: Which, historically, is very high.

Donald Kohn: Asset encumbrance is something that the Financial Policy Committee is tracking closely; we have had several conversations about that. The degree of encumbrance is itself an indicator of how troubled the underlying system is, because banks go to encumbered borrowing when doubts about their creditworthiness raise the cost of unencumbered borrowing.

We have seen upward pressure on the rates that our banks here in the UK pay—even more upward pressure on the rates that banks on the continent pay—and, as a consequence, they have seen that the less expensive way of borrowing is to encumber their assets. But you are right, the more assets that are encumbered, the less space or room there is to borrow more through pledging assets. So it is a symptom of an underlying problem that we need to monitor very closely.

Paul Tucker: May I add one thing to that? I absolutely agree with what Donald said. What is worth adding is that things would be even worse if the banks were not able to borrow on an encumbered basis, because then they would have been shrinking their balance sheets aggressively. That is the first thing.

Secondly, one needs to make a distinction between the extent to which their borrowing is secured in private markets—through covered bonds and so on—and the extent to which their borrowing is secured from the authorities. That is where the Greek and wider euro area problem is—they cannot even borrow encumbered in the private market, so a lot of it is coming from the central bank.

Q147 John Thurso: But you would agree that the inability to borrow unencumbered is having a drag both on their ability to recover and on the economy as a whole. It is a major drag on future growth.

Paul Tucker: Absolutely. I am in completely the same place as Don about this being a symptom of headwind to growth. It is absolutely why the banks need to continue the progress of strengthening their capital.

Q148 Chair: On that point about the eurozone, Governor, are some of the eurozone banks so encumbered that they are virtually insolvent?

Sir Mervyn King: I do not think it should be for me to say publicly whether banks in other countries are insolvent. I think there is no doubt—

Chair: I take that point. Let me rephrase the question.

Sir Mervyn King: Thank you. That would be helpful.

Q149 Chair: We will come at this from another angle. Do you get a sense that the markets think that some of the eurozone banks are so encumbered that they might be insolvent? I am not talking specifically about Greece; I am talking about the heart of the eurozone.

Sir Mervyn King: I do not think you can talk about the heart of the eurozone; you have to distinguish between the periphery, in a vague sense, and countries more to the north. Markets are clearly concerned.

Q150 Chair: Let's call that the heart, then. If you're not in the penumbra, you're likely to be near the centre of things.

Sir Mervyn King: The romantic part—the sunny part. Markets clearly are concerned. That is why they are not lending. Since the middle of last year, what happened was that the ability of banks as well as sovereigns to borrow overseas to finance their continuing external deficit dried up. That is when there was a serious problem, and they had to turn to other countries in the euro area to finance those external deficits.

I do not think that situation has really improved since then. Therefore, you can certainly see that the degree of market concern is such that markets are very unwilling to finance those banks and sovereigns, whether unencumbered or encumbered.

Q151 Chair: Mr Kohn, do you think that the full weakness of the eurozone banks has been exposed to view?

Donald Kohn: I don't know, Mr Tyrie. There has certainly been an attempt by the European Banking Authority, through the stress test, to expose the vulnerabilities and strengths of the eurozone banks. I do not have specific information to know.

Q152 Chair: Do you have confidence in those stress tests?

Donald Kohn: I think there is room for improvement.

Q153 Chair: Have another go. Do you want to elaborate on that?

Donald Kohn: Clearly, the markets did not have confidence in the stress test. They did not feel that the stresses were sufficiently stressful or accounted for a sufficient adverse shock that they could be confident that the stress test had been passed.

The fact that several banks that were said to have adequate capital after the end of the stress test subsequently got into deep trouble undermined confidence further. It is important that those stress tests are very stressful and backed up by the potential for Government capital, if the private institutions cannot raise capital themselves in response to the stress test, in order to engender market confidence. Clearly, the EBA stress test did not do that.

Q154 Chair: I am getting a signal that you are not going to have full confidence in the stress test. Silence often betokens consent.

Q155 Mr Ruffley: On the subject of forbearance, I will ask one question about LIBOR if I may, Governor, and then move on to liquidity. Both you and Mr Tucker have given persuasive evidence to the effect that first, you were not the banking supervisor—it was the FSA—and, secondly, the alleged misdemeanours took the authorities here three years to uncover. All that said, my question is this. You called the LIBOR market dysfunctional. I think everyone agrees with that, and all the market practitioners thought it was in 2008. That is the time period I have in mind. Who did you, as Governor of the Bank of England, think was going to sort out that dysfunctional market? Did you think that was a matter for the BBA and/or the FSA?

Chair: I will take a couple more questions on LIBOR and all of that, but we have—

Q156 Mr Ruffley: I just wanted to ask one question on that.

As Governor, who did you look to? Clearly, you did not think it was yourself for the reasons you have given, and the FSA was the banking supervisor. You also said it was a private market, which is a point well taken. Who did you want to sort this mess out? It was a mess in autumn 2008, wasn't it?

Sir Mervyn King: It was, but I think there are two dimensions to it. The reason why it was a mess and dysfunctional in October 2008 was because of the underlying macro-economic position and the position of the banking sector. If the banking sector had been in health, we would not have had this dysfunctional LIBOR market. The fact that people lost confidence in banks following the failure of Lehman Brothers meant that no one quite knew which bank was reliable. People did not want to lend unsecured to other banks, as we have been discussing. The LIBOR market just wasn't functioning at all. When I came before the Committee in November 2008, the phrase that we exchanged was "LIBOR is the rate at which banks don't lend to each other." The solution to the problem in the underlying sense was to restore the health of the banking sector.

In terms of the immediate answer, a number of us in the central banking world talked about what was the right long-term reform. I am confident that we shall have to return to that. When I meet my central bank colleagues in September in Basel, as the chairman of that group, I will put on the agenda a discussion of the future arrangements for this sort of benchmark interest rate. The big lesson from this period is that there was nothing anyone could easily have done to produce a benchmark interest rate in a situation where no one wanted to lend to each other.

So what did you do? As I said, at the time my instinct was to move to a situation based on the transactional rate—observed transactions. Of course, if there are no transactions, you cannot use that. There is a massive transitional problem about what happens to the legal status of the $500 trillion of contracts already out there, which were based on the existing LIBOR. I have no simple answer to that, but I think that, over a period of time, we need to get people in those markets to recognise that there cannot always be a reference benchmark rate under all situations of market stress. What people have not really appreciated—I fully accept that we hadn't appreciated this before 2007—is that there could be a period, such as September 2007 or October 2008, and we really haven't had periods as stressful since, when it is simply impossible to use the market reference rate. Those writing legal contracts need to take that into account and to have some other method for creating a reference benchmark rate when the markets do not permit them to do so.

Q157 Mr Ruffley: That is very helpful. Moving on to liquidity. In your 22 June meeting, you observed something we all know: "UK banks' liquid asset holdings were well in excess of current regulatory guidance." The minute of the meeting goes on to state, "in June, the Monetary Policy Committee had discussed the possibility that regulatory liquidity requirements might be increasing the demand for reserves, attenuating the impact on the economy of the MPC's asset purchase programme and the associated increase in the supply of reserves." The minute goes on to state: "The Committee considered whether the FSA's liquidity guidance was acting as a significant constraint at present on banks' willingness to lend."

Are you worried that quantitative easing is being impeded by FSA guidance?

Sir Mervyn King: Certainly some members of the MPC were concerned.

Q158 Mr Ruffley: Is that your concern?

Sir Mervyn King: In essence, no. We have had a number of discussions about this, and what came out of it all was that it is true some banks claimed to be under the impression that if they were to run down their liquid assets below the FSA's liquidity guidance because they had had some liquidity shock and they wanted to use the buffer, they would experience someone turning up from the FSA, saying, "You must immediately build your liquid assets back up to the FSA's liquidity guidance."

If that were the case, holding liquidity to meet the FSA's guidance would not give you a buffer of liquid assets that could actually be used. The FSA has been very clear in speeches by Lord Turner and statements by Andrew Bailey that this is not the view of the FSA. The perception we had from banks was that they felt that perhaps people on the ground had not fully understood the interpretation of the buffer. What we felt was that it was important for the FSA to stress to banks and ensure that they fully understood that if they had a liquidity shock they would be able to run down their liquid asset buffer below the FSA's liquidity guidance for quite a period until it was appropriate, when conditions returned to normal, for them to get back up to the FSA's liquidity guidance. The FSA has been emphasising to banks that that is the position.

Lord Turner: May I add one thing? Where we have got to on liquidity shows the great benefits of the creation of the Financial Policy Committee as a mechanism that brings together this macro look, enabling us to bring together the insights and perspectives of the micro-prudential regulator and the central bank. The other thing that we have said, apart from, as the Governor has stressed, the ability to use your liquid asset buffers in periods of stress and for the duration of stress, is that we will take into account in our liquidity guidance the fact that the Bank has now committed, through the activation of the extended collateral term repo facility, to provide more liquidity insurance. The more that the central bank provides liquidity insurance, the more that an appropriately prudent regulator has to require that banks hold their own insurance. That is a trade-off that you can only make and debate and decide to act on when you have something like the Financial Policy Committee, which is bringing together those different perspectives.

Q159 Mr Ruffley: There was discussion, was there not, about suspending the current FSA guidance. Is it the case that that has been overridden by the introduction of the ECTR?

Sir Mervyn King: No, the ECTR was a measure that the Bank could take—we discussed this with both the MPC and the FPC—to put in place a facility so that if there were to be shocks to liquidity down the road, banks would know that there was an auction system in which they could bid and obtain liquidity. It was not a substitute for changing liquidity guidance.

Q160 Mr Ruffley: The reason I want to press this is that it has been the language of exhortation in the answers that there has been misperception by some banks—they are not understanding what the FSA is telling them and that the ILG ratios were not hard floors. All this exhortation is all very well, but it does not seem to have got us anywhere, if you look at the lending profile. Is it the case, Governor, that you think that the ECTR will change things and make banks more receptive to this steer that they are being given by the FSA?

Sir Mervyn King: I don't think in itself it will change their perceptions. What will matter is that the FSA and Lord Turner have been engaging with banks and will continue to do so to make clear what the liquidity guidance is and to demonstrate that the liquidity guidance will be there to reflect the additional availability of liquidity at the central bank. That will certainly bring about some change. In terms of the banks' ability to lend, we set much more store by the funding for lending scheme, which gives clear financial incentives to expand lending. It is as simple as that. I am not a great believer in exhortation or other such procedures. Give them a clear, straight financial incentive and let them make their own decision.

Q161 Mr Ruffley: There was a consensus that the FSA guidance should consider ways in which it might modify liquidity guidance and in the press conference, Lord Turner, you said that there would be a press release from the FSA, which will say, "We will adjust our bank liquidity guidance in the light of these improved Bank of England facilities, stressing that liquidity asset buffers can be drawn down in the event of liquidity stress." That again sounds to me a bit like exhortation. Can you just explain what the modified guidance is and how you think it will make a difference?

Lord Turner: The guidance is, because it is called individual liquidity guidance, agreed on an individual basis with banks—

Mr Ruffley: Micro-prudential.

Lord Turner: It is micro-prudential; it is not a revealed ratio. Broadly speaking, it is based on a ratio between a numerator, which is the liquid assets—essentially the gilts, T-bills and reserves at the central bank—and a denominator that reflects the pace at which money could leave in a stressed scenario. It will be similar to the intended Basel III liquidity coverage ratio in future.

What we can now do, within either the level of that ratio that we set or in the actual numerator, is make some allowance for the pre-positioned collateral at the Bank of England, because that pre-positioned collateral, particularly through the extended collateral term repo facility, is now available to get hold of liquidity insurance without any stigma. We are still working on the details of precisely how to do this, because it is a very complicated issue and it is very important that we work, as we will, with Paul Fisher, because if you do it in a particular way, you can create some funny unintended consequences in terms of the incentives to use the funding for lending scheme. We are working through the details of that. We will shortly be having a meeting with the banks together and we are now engaging with them individually, but, essentially, we will make allowance within the ratio that we are guiding them that they have to have in normal terms. We will make allowance for the fact that they have now very significant amounts of pre-positioned collateral at the Bank of England, which they could use to get liquidity if they needed it in stress circumstances.

Q162 Mr Ruffley: So you will be having discussions—

Lord Turner: Bank by bank.

Q163 Mr Ruffley: When do you expect that process to finish?

Lord Turner: This will occur over the next few weeks. We are getting on with this process.

Q164 Mr Ruffley: Every bank will know—

Lord Turner: Within a few weeks, we will have sorted this out with them.

Q165 Michael Fallon: Turning now to capital rather than liquidity, one of the other recommendations was that the FSA work with banks to ensure that they build a sufficient cushion of loss-absorbing capital. Have those conversations with the banks now begun?

Lord Turner: We have been in continual discussion with them over the last year on this, because if you look at our recommendations from last June onwards, this has been a repeated recommendation. The most crucial discussions that we had were probably over December and January, when we had a whole series of discussions that resulted, for instance, in a significant reduction in the cash bonuses that the banks were paying out, which therefore enabled them to build capital through a greater degree of retained earnings. There are also cases where, as part of our supervisory dialogue, we pushed or encouraged banks to take measures such as selling businesses and so on that crystallised profit, which built their retained earnings. Obviously, for all of them we have a whole series of capital plans as to how, over time, they will meet the Basel III capital requirements. The process of requiring banks to build in capital is just a continual part of the supervisory process.

Q166 Michael Fallon: I understand that, but the recommendation from June was that the committee discussed whether there should be a more explicit signal. Clearly, you were being asked to do something over and above what you were already doing. Isn't that what the minutes say?

Lord Turner: Yes, and we will do that over the next month or so. This is not something that you do on day one.

Q167 Michael Fallon: I understand that, but I just want to be clear on how this works. Is this just part of a general conversation? Are they actually listening to you and doing this?

Lord Turner: Yes. The UK banks have built very significant capital buffers over the past three or four years, and but for those extra capital buffers, we would be having less lending to the real economy now, because there would be greater concerns about their credit-worthiness. Our banks are in a much stronger position than they were three or four years ago, and that reflects a continual process of dialogue with them in which they have increased their capital requirements. Over the last year, that has reflected the guidance of the FPC. The FPC could have come out with a recommendation that said, "We are so worried about lending to the real economy that we want you, the FSA, to stop doing that gradual build-up of capital that you have been engaged with." That was one thing that we debated, but decided not to do.

Q168 Michael Fallon: I am just interested in the implementation, because the Governor has said many times previously that he has been able to preach sermons, but not to require people to listen. I am interested in how this stepped-up recommendation from the June minutes actually translates into action by the banks. At what point will we see the banks actually following through on your recommendation?

Lord Turner: Well, the FPC did not say that we were requiring them to raise external capital, and if they are not required to raise external capital, their ability to lend to build the capital is crucially dependent on retained earnings. Our crucial lever on that is the issues about the level of cash bonuses, which tend, by the way, to occur at the end of the year, when the big cash bonuses are paid out, so that debate will intensify then. Then there are the debates about dividends. We are, however, discussing with some of them one possibility, which is that without issuing new equity they might issue new convertible stocks—what are sometimes called CoCos—which may be another way of building capital resilience.

Q169 Michael Fallon: I don't quite understand how you get them to restrain compensation, other than by releasing a clause or whatever, at this point in the financial year.

Lord Turner: No, we can't do that here. That's what I said. The real debates about cash compensation are, of their nature, debates which are concentrated in November through to January.

Q170 Michael Fallon: Mr Kohn, the record of the last meeting also notes that depressed price-to-book ratios suggested that market participants remained uncertain about bank asset valuations. Looking at it from your rather unique vantage point, do you still feel the market remains uncertain about that?

Donald Kohn: Yes, I do, Mr Fallon.

Q171 Michael Fallon: Do you wonder whether the UK banks could provide greater clarity around their asset valuations?

Donald Kohn: Yes, and that was part of another recommendation: that the FSA work with the banks to enhance the valuation of their assets so that more clarity could be obtained.

Q172 Michael Fallon: But how did they do that in a market where, say, commercial values—commercial property values—are continuing to slide all over the place?

Donald Kohn: I agree that the volatility is a problem, but I think you can try and work with the banks so they're not systematically overvalued, even if they are not exactly accurately valued at any particular point in time, and our expectation is that the FSA will work with them to increase public confidence in these valuations.

Q173 Michael Fallon: Is that something the Fed did at the time in the United States?

Donald Kohn: I think it is something the Fed has engaged in from time to time, but I don't know whether it is working specifically with the banks right now on that.

Q174 Michael Fallon: But you are sure that British banks could, in fact, provide greater clarity than they are providing about their current asset valuations.

Donald Kohn: Well, I infer that from the price-to-book ratios and also from the conversations that I have had with people in the financial sector. It is certainly worth trying, in terms of building confidence in the banks, which is so critical for them obtaining funding and making loans.

Q175 Michael Fallon: Thank you.

Lord Turner, one of the other recommendations was that banks should work to assess, manage and mitigate specific risks that stem from current or potential stresses in the euro area. How do they do that in a non-protectionist way?

Lord Turner: Well, the first thing is to make sure that they have fully understood their exposures. One of the crucial issues that we have been engaging with them on this year is that, to understand one possible aspect of exposure, they have to understand not only their assets, but their liabilities. If, for instance, one was thinking about the possibility, which we still think relatively small although we need banks to think about small tail risks, of countries actually exiting the eurozone, then you have problems which arise not from assets going bad and not being repaid, but from the assets being redenominated into a new currency, as the liabilities may be, too. In an exit from a currency, it turns out that which assets and liabilities might be redenominated is a complicated issue to do with the legal structure—for instance, whether it is a branch or subsidiary of your operation in a particular country, the law under which you had written contracts, and the legal position and domicile of your counterparty. Once you understand that and go through the process of getting all that data available, banks obviously then have some ability over the time to make sure that assets are matched by liabilities, which may, to a greater degree, match that out. We have had a very significant engagement over the last year on that redenomination risk.

We have also, without telling them to reduce exposures, been making sure that they look at their asset exposures and sensibly manage those. You will see, for instance, that the exposure of the UK banks to the sovereign debt of the vulnerable, peripheral eurozone countries has reduced very significantly over the last year. That is a perfectly sensible action by those banks, under the stimulus of our not giving instructions but encouraging them to make sure that they had thought about all those issues.

Finally, having said that, there are some things that they cannot get out of quickly. If you look, for instance, at RBS's exposures to the Irish property market, there is nothing you can do in the short term to get out of that. It simply has to be managed sensibly over time. A rapid exit from that would probably lead to the crystallisation of losses, which would hurt their capital position.

Q176 Michael Fallon: For how many countries have you suggested that they ought better to understand how to redenominate their liabilities? Is it just Greece and Spain, or others as well?

Lord Turner: We have certainly encouraged them to run those scenarios for Greece, Spain, Italy, Portugal and Ireland. I think we consider the chances very low for at least some of those countries on that list, but it is sensible to encourage people to run extreme-risk scenarios.

Q177 Michael Fallon: How do you enforce that kind of recommendation if you want to? You have advised them to do that. Without the macro-prudential tools, which you are going to get, how do you enforce it now?

Lord Turner: It is part of a supervisory dialogue. If we say to them, "This is an issue that we are concerned about. The FPC will want a report back on what we have done. You have to provide us with information." We then look at that information and say, "Look, there appear to be gaps in your information. We would like you to do more", and we have a discussion with them about the actions they are taking. That is a normal part of a supervisory dialogue, which, at any time, often involves things that are not instructions. Some things are rules and laws—"Your liquidity should look like this, and your capital should look like that"—but there is an ongoing supervisory dialogue of that nature.

Paul Tucker: Where the two are linked is that if the micro-supervisors were to be unsatisfied with the things that Lord Turner and you are talking about, the regulators can say, "Well, you need more capital at the top of the company to protect you against those risks." Ultimately, all roads lead back to things where the micro-regulators can say, "Here is something you must do". That is why the macro-prudential tools that we have advised the Government to consider giving to the FPC are directed at those particular micro-prudential tools.

Q178 Michael Fallon: Aside from RBS's inherited problem with Ulster bank, how do you rate their performance in preparing for further stress in the zone?

Lord Turner: We think that they have been making good progress in terms of looking at the issues they face and taking action where they have the flexibility to do so. Obviously, there are some other situations where they have real economy exposures and it is difficult to move quickly. Essentially, where you have a bond portfolio, at a price, you can adjust your exposure relatively quickly. Where you have a significant real economy exposure to, for instance, households, real estate developers, or general corporates, it inevitably takes longer to adjust. However, we certainly believe that they are engaged well with this issue and are taking it seriously.

Q179 Michael Fallon: If we had a sudden sovereign default that happened much more quickly than anybody expected this summer or autumn, would British banks be able to cope?

Lord Turner: If you are talking specifically about a sovereign default, the exposure of the UK banks to the peripheral sovereign debt is really quite small and manageable.

Q180 Stewart Hosie: Governor, can I ask in a little more detail about the macro-prudential tools: leveraging ratios, capital buffers and the sectoral ratios? This all comes from the FPC's statement after the meeting on 16 March.

On leveraging ratios, the statement says:

"It was noted that, for banks and building societies, it would be natural to use the internationally agreed definition of leverage that had been set out in the Basel III standards."

However, the Building Societies Association noted that the single leverage ratio is a crude measure that does not take into consideration differences between business models. They do not believe it is appropriate to apply increases in that single ratio universally as a macro-prudential tool, and they suggested a tiered leverage ratio depending on the risk of the bank's business model. Are you considering a tiered model in relation to leveraging ratios?

Sir Mervyn King: In terms of macro-prudential and changing the degree of leverage from one year to the next because conditions have altered, you would simply be asking firms to reduce their leverage by a certain amount. If they were in different regulatory regimes, which the FSA might have imposed on them, they would not end up, necessarily, with the same leverage ratio but they would all be moving in the same direction. That is the first point. That is a matter between the regulator and the individual set of institutions.

The more general comment I would make is that whenever we propose an idea like this, there is always somebody who comes back and says, "Well, it may be a good idea for other people, but not for us." I am naturally suspicious of that. The great virtue of a simple leverage ratio is that you cannot disguise the exposure of the firm by using complicated capital risk weights that may have looked sensible when they were initially devised but that turn out to be useless now, such as, for example, applying a zero capital risk weight to sovereign debt in southern Europe. That does not make any sense now, but it is where we have ended up. I do think that the great virtue of leverage ratios is that they get around all that, and they were a much better predictor of failures of banks in the crisis than were Basel capital ratios.

Q181 Stewart Hosie: I would not dispute that, but I wonder whether you have any sympathy particularly with building societies. They make the point that it is harder to raise new capital given their principal source of new capital will continue to be retained profits generated from within the business. They are in a slightly different position from banks, which can do different things.

Sir Mervyn King: I have every sympathy for that, and I do think that that is reflected in the basic regulatory regime from which they start. The macro-prudential will be saying, "Look, over the next year or two we think the economy is perhaps expanding too quickly—the financial sector certainly is—and therefore we have got to put some constraint on the rate at which the financial sector is expanding." If we felt that that was in the banks but not in building societies, we could restrict our macro-prudential response to banks. If we felt it was true of house lending in general, it might be more sensible to apply it across the board. That would depend on circumstances. I am not saying they would end up in the same position as other institutions, but macro-prudential policy may well mean that we would all be moving in the same direction.

Q182 Stewart Hosie: I appreciate that, and I will ask about the specifics of house lending later when I get to the sectoral ratios. That has got more of a bearing.

In terms of the counter-cyclical capital buffers, the FPC has said that consistent with Basel III, "national regulators may adjust banks' required capital ratios through a time-varying capital buffer in certain circumstances." I think that is straight from the department of "We know what it means to say." However, the BBA said that the FPC must be willing to determine publicly the point in the cycle at which the buffer can be drawn down, but that it remains to be seen how the market would react to an announcement that banks could draw down the buffer at the appropriate point. What work will the FPC do to prepare markets to accept the use of capital by banks during downturns?

Sir Mervyn King: I think the whole point of the FPC is to have a body that has the authority of the official sector in saying, "We have argued for the last three years that you needed to build up capital buffers, given the state at which the economy and the financial sector were expanding. Now the situation has changed, and in our judgment now it would be appropriate to allow your capital buffers to run down." We would be doing that as a judge of the state of the economy as a whole; we would have no financial interest in saying that to banks. If banks did it themselves, people might accuse them of coming up with an excuse. We will be saying, "No, these are the circumstances in which it would be sensible for banks to use their capital buffer to absorb some of the shocks that have occurred." The fact that we can do that, and I hope by then we will have built up a bit of a track record in explaining this, both on the way up and on the way down, will mean that markets will understand why we are saying it and therefore why it is sensible for banks to follow in that wake.

Q183 Stewart Hosie: Have you market-tested the markets to find out whether they would ever accept banks using their capital like that?

Sir Mervyn King: I think it is impossible in these present circumstances to do that. I believe that they would, because it is a sensible argument. In the long run, if you make a good argument, people understand it and accept it. We are in exceptional times; this is not the moment. Our own recommendation is to build up a temporary buffer. In the end, I believe that the way to persuade people is to have a good argument and most people are willing to listen to a good argument.

Q184 Stewart Hosie: It is interesting, in relation to what was said earlier by Lord Turner, that the pre-positioned capital is there now, so that when auctions come and there is a discount window, when there are various repo facilities used, there will be no stigma attached. It has been signalled now that there will be no stigma. I presume that sort of approach will be taken in relation to banks using their own capital in future.

Paul Tucker: We would effectively be saying, "The big threat has passed and here are the reasons we think that. Now the time has come at which banks can start to release capital." In parallel with what happened with the MPC 15 years ago, I think there would be a healthy public debate about that. People would be focused on it. There would be differences of view across the market and commentators, but it would be asking the right question.

Donald Kohn: I think the starting point for a release of capital is very important. To emphasise what the Governor emphasised, this might follow a build-up during a boom time. The objective would be to end up with enough capital that releasing it in tougher times would still be consistent with maintaining financial stability. That is the explanation that we will be challenged to give: why it is that running down this capital buffer now, even though times are soft, is in itself consistent with financial stability and will promote economic stability. That will be our challenge.

Q185 Stewart Hosie: I suspect that argument will be met with a deal of political support, because it impacts directly on the real economy. However, I take it that as an external member part of your job is to look at what the unintended consequences might be. If you come across some that are not very nice, please tell us.

Donald Kohn: I agree; that's my job, one of my jobs.

Q186 Stewart Hosie: In terms of sectoral requirements, again the Committee agreed that it would advise the Treasury that the statutory FPC should have the powers of direction to vary individual financial institutions' capital requirements etc. Again, that is very sensible if there is over-heating in a sector. However, how easy will it be for banks or others to circumnavigate the desired effects of changing sectoral risk weights? Could that be got round?

Sir Mervyn King: I don't know. It is not obvious that it is easy to get round. People will have to misreport their loans to one type of activity versus another. We would have to ensure that the reporting was sufficiently accurate. Clearly, the more you differentiate the capital instruments, the more difficult it is.

Of course, you could argue that it is already there, because of the different risk weights on different kinds of asset. We already have a system where there are incentives to dress up some kinds of lending in one form rather than another. I think that suggests that you do not try to be too clever about it. You have broad brush differences between the sectors.

I do think, for example, that it is quite difficult to dress up lending for house purchase as lending to small business. I do think that in that area if there is an occasion when the FPC feels that there are particular worries about the rate at which lending for house purchase is expanding, it would be possible and appropriate for the Committee to differentiate between that and other kinds of lending.

It is a very reasonable question to ask: can we be certain? The answer is no, because these are instruments that have not been used for many years. I don't pretend. This is not like setting interest rates or even doing asset purchases in our current monetary policy, which are well tested and understood instruments, albeit with lots of uncertainty there, too. This will be a new initiative and we will see how it works. It is worth the effort to try to make it work but we will be learning as we do it, and there will be a great deal of learning by doing it.

Q187 Stewart Hosie: On that, I agree that this is worth trying. I think it is quasi-monetary policy and I think it has got a lot of merit. But you mentioned mortgages and small business lending, and that is really going to be at the heart of this. The first overheating where you want to make a change will be in mortgages, and the first area where you think there needs to be more will be in small businesses.

How will the FPC, the Bank, the regulators cope with the inevitable scare stories about mortgage rationing or of small business funding rationing? You can see these stories coming a mile away. Even if this is done for exactly the right reasons and is done properly and is successful, those stories will emerge.

Sir Mervyn King: For five years we have had lots of scare stories about all kinds of policies. You get used to them, and you end up just doing what you believe to be the right thing.

Q188 Stewart Hosie: In terms of sectoral ratios, could this also be geographic? If there was overheating in the south-east of England property market, could these rules be flexible or focused enough to deal with a geographic sector, as well as a business sector?

Sir Mervyn King: That is very hard to say. It would depend on the information that was available, and people's judgment about the conditions. Remember that what we are trying to do here is not to have targets for economic growth in different parts of the country; we are concerned with the resilience and stability of the financial system as a whole. That is our objective here—stability of the financial system. If we felt that lending to office building in London was going at too rapid a rate and was threatening the stability of the financial system, that is certainly something we would have to look carefully at.

Lord Turner: The other thing to say is that there may be indirect ways of doing things which might have a regional effect. For instance, it is not impossible that we could vary sectoral risk weights against, for instance, house lending, but in a way which also reflected the loan-to-income ratios of the loans which were being granted.

If one did it in that fashion—so that there was a reference to the loan-to-income ratios—that might, under your circumstances, have a different impact on one region versus another, but as a by-product of that rule, rather than simply saying that we are going to do it in this region and not that.

Q189 Stewart Hosie: I have a final question for all of you. There is a clear danger that this could be not just quasi-monetary policy to avoid systemic difficulties, but also quasi-fiscal policy that the politicians might be dreadfully encouraging you to use, either to reheat or to take the heat out. Are there risks there—that people might want to use these tools—or have you used these tools in a way for which they were not necessarily designed?

Sir Mervyn King: I am absolutely confident that my successors on all these committees will resist whatever blandishments are offered them by you or other politicians. They are a tough lot.

Q190 Chair: Well, that was a helpful reply. Of course, we are going to do a lot more on macro-pru tools in the coming weeks, months and, in fact, years.

Sir Mervyn King: It is very important that there is a really good public consultation.

Q191 Chair: And you are going ahead with further consultation documents through the summer and the autumn, aren’t you?

Sir Mervyn King: In due course, yes.

Q192 Chair: I am not trying to pin you down.

Sir Mervyn King: And I very much hope that this Committee will lead the public discussion and consultation. You are in a good position to do so.

Q193 Chair: Well, we will try to make a contribution.

May I end with a question to Mr Kohn, since you are very much in touch with what is going on across the Atlantic? It is about regulatory arbitrage.

Do you think that the atmosphere that is being created, or has been created—not only over the past few weeks as a consequence of LIBOR, but over the past few years, in fact, with respect to remuneration and many other issues, including a sense of reputational damage to banks—considerably exceeds the damage that has been done in the States? In other words, are we in a more difficult position and one that might affect the attractiveness of London as a place to locate?

Donald Kohn: It is very hard to make such comparisons, Mr Chairman. In both jurisdictions, it is very difficult. Think about the Volcker rule in the United States, which is drawing some adverse industry comment, and the fact that non-banks can be designated as systemically important. There are a lot of things going on, on both sides of the Atlantic, to try to make the system more resilient. This is being resisted, naturally.

There is a risk, I believe, of the activity migrating outside the regulated sector or, at least, to more lightly regulated sectors. If that happens, in some respects that can be fine—if it migrates to sectors where, for example, the firms are relatively small and they can be allowed to fail, and it would not threaten financial stability, that is fine—but if it migrates in such a way that, if a whole series of firms fail at the same time and that threatens financial stability, that is a problem.

I believe the regulatory perimeter is a very important issue on both sides of the Atlantic and one that the Financial Policy Committee has definitely in its sights as something to keep looking at and to make sure that, over here, any such migration does not begin to pose a threat to financial stability in the United Kingdom.

Q194 Chair: What about the Main Street versus Wall Street debate compared to what we have been seeing here? The tension between—

Donald Kohn: Well, there is quite a bit of tension on both sides. Last summer, we had the Occupy Wall Street movement, which spread through the country and was here in the United Kingdom as well. The banks on both sides of the Atlantic need to rebuild public confidence that their pursuit of profits is consistent with and conforms to the public good—that they are allocating capital, using savings safely, not exploiting a particular advantage or exploiting to take advantage of others and that they are doing so in an honest and upright way—as has been raised in the LIBOR thing. There is a long way to go.

Q195 Chair: With respect to what you describe as the perimeter issue and with respect to the reputational issue and the relationship with the real economy, you think that the two financial centres are in broadly similar places. Is that a summary of what you have said?

Donald Kohn: Broadly similar, right. It feels a little tougher over here, perhaps, but there are difficulties on both sides of the Atlantic.

Chair: I am very grateful to you for that contribution, and for the contributions of everybody more widely. It has been a long session and we have ranged widely, and we are very grateful. Thank you.