

HOUSE OF COMMONS

minutes of evidence
taken before

TREASURY COMMITTEE

Banking Crisis

Monday 3 November 2008

RT HON MR ALISTAIR DARLING, MP, MR MERVYN KING and LORD TURNER OF
ECCHINSWELL

Evidence heard in Public Questions 1 - 132

Oral Evidence

Taken before the Treasury Committee
on Monday 3 November 2008

Members present

John McFall, in the Chair

Nick Ainger

Mr Graham Brady

Mr Colin Breed

Jim Cousins

Mr Michael Fallon

Ms Sally Keeble

Mr Andrew Love

John Thurso

Mr Mark Todd

Witnesses: Rt Hon Mr Alistair Darling, MP, Chancellor of the Exchequer; Mr Mervyn King, Governor of the Bank of England; and Lord Turner of Ecchinswell, a Member of the House of Lords, Chairman of the Financial Services Authority, gave evidence.

Q1 Chairman: Chancellor, welcome to you and your colleagues to this inquiry into the banking crisis. Could you introduce yourselves formally for the shorthand writer, please.

Mr Darling: I am the Chancellor and with me I have the Governor and the Chairman of the FSA.

Q2 Chairman: First of all, I would like to welcome you along with your colleagues, because this is, I believe, the first time the tripartite authorities have appeared together to give evidence. We are well aware that it is a hugely busy time for you so we are very grateful that you have taken the time to come along. Today's evidence session is the first in our inquiry into the banking crisis. Next week, on 11 November, we will deal with accounting standards and this will be followed on the 18th by evidence from the nationalised banks. We will be publishing details of these evidence sessions shortly. This is also a groundbreaking evidence session in another way, in that for the first time a departmental Select Committee has invited members of the public to submit questions ahead of the evidence sessions and we are delighted by the public response. You can see the result, Chancellor: 5,000 e-mails to the Committee with questions to all the principals. Some of them will be read out today but all of them have been carefully examined and have contributed to the briefing before us. Many of the e-mails the Committee has received have been about the potential losses suffered by the Isle of Man and Guernsey depositors and Icelandic banks but to ensure that we give sufficient time to cover all topics, we will discuss these issues towards the end of the session. Governor, I am aware that you are currently in purdah; you have the inflation meetings next Wednesday and Thursday and therefore you are unable to answer questions relating to your forthcoming interest rate decision or the forecast but you will be glad to know that the Committee will discuss these with you when you come before us again for the November inflation report. Can I start with you, Chancellor. Ted Whitton has put in a question to and he says, "Where has all the money gone? In any deal somebody wins and somebody loses but this time everybody seems to be a loser."

Mr Darling: That is a very general question and let me deal with it because it perhaps sets the scene for the discussions we have this afternoon. We face at the moment, along with every other country in the world, an extraordinary set of circumstances where the banking system all over the world has been under extraordinary strain since the summer of last year. It culminated, as the Governor said in

his speech two or three weeks ago, with a situation where many banks across the world had effectively stopped lending to each other. Why does that matter? The banking system is absolutely crucial, not just to the world economy, to our own economy, but it matters to individuals and it matters to businesses. We all rely on the banking system to operate effectively. Without it, quite simply, the country would come to a halt. That is why over the last 15 months or so we have had to take a number of steps that in past years we might have thought to be extraordinary, like the nationalisation of Northern Rock at the beginning of this year. You will recall that even within Parliament that was deeply controversial at the time. Indeed, there are some people who still believe it was the wrong thing to do but it was a very controversial thing to do. We were perhaps one of the first countries to have to face up to a particular problem with what was, I think, our fifth biggest mortgage lender at that time. We had a similar problem with Bradford & Bingley in September and, of course, since September, since the collapse of Lehman Brothers in the United States, the problem became acute across most countries in the world. That is why it was necessary for us at the beginning of October to announce that we were going to embark on a major programme to help our banks recapitalise, to build up their strength, so they will be able to continue to lend to each other, to businesses and to people. We put those measures in place, as I announced in the House of Commons on 13 October, and that process has gradually been worked through. As I have said on previous occasions, if you look at the money we have put into the system, the money that we put into Northern Rock is in the course of being repaid. In fact, it is being repaid slightly ahead of the schedule we planned. In terms of the money that the Bank of England has been lending through its special liquidity scheme, that money is lent to the banking system and it is repayable over a three-year period, so we get that money back as well. In relation to the recapitalisation of the banks, of course, the Government gets shares in return for that recapitalisation in respect of RBS, HBOS and Lloyds, because the other banks have chosen to raise money on their own account on the private markets, and therefore the Government gets shares which eventually, when we get out of the shareholdings, can be sold. So yes, there is an upfront cost. Yes, the Government has had to intervene - and so has every other government in every large economy in the world - but the reason we are doing it is because it is necessary to maintain the financial system because, as I say, we all depend on it. That is a very long answer to the question but it is a perfectly fair question that people can ask. I do not know either the Governor or the Chairman of the FSA would like to add anything. I am sure they would agree with what I have said.

Q3 Nick Ainger: We have 180 questions, Chancellor. We do not want you to be here until 10 o'clock tonight. We are going to direct them at one person and ask for a short answer. Lord Turner,

from Gavin Elliot, "Is the £37 billion bailout of the banks not an admission that regulation has failed totally?"

Lord Turner of Ecchinswell: I think, to be honest, it is an admission that at the level of the whole world there was a failure to see enormous risks developing in our financial system. I think in retrospect - and hindsight is a very useful thing to have - it is clear that the world for many years was on a boom of credit extension which turned out to be unsustainable. There are major questions that raises also about the capital adequacy regimes which we and Europe and America and the whole of the world have applied to banks and whether we need to change those in future so that they prevent that sort of boom of credit occurring. I think therefore what I would entirely accept is that there are major questions to be asked about the whole structure of how the world has done financial regulation, in particular in its capital adequacy regimes, its oversight of liquidity, and fundamental things like that.

Q4 Chairman: Governor, when the problems in the banking sector were reported on the television news in the past people spoke about "peering into the abyss". What would really have happened if the banks had not been bailed out at the taxpayer's expense? Has the taxpayer not been taken for a monkey?

Mr King: No, the taxpayer has not; as the Chancellor said, this is an investment in the banking system which in the end I believe will pay off. It was necessary to recapitalise the banking system so that it could continue lending to the real economy, which is vital to all our economic prosperity. When the banking system fails to do that as a result of a complete collapse of confidence in the worldwide banking system that we saw, not just in the UK but around the world, it was necessary to take drastic action and that action, based on the experience of previous episodes we have seen, was one of recapitalisation. I think that was exactly the right thing to do. This was not done in the interests of the banks; this was done to protect the rest of the economy from the banks.

Q5 Chairman: You were talking about moral hazard, Governor, and you told this Committee you had warned the banks about it. It does seem in that sense, your warning about it, nothing was done and the taxpayer really has been taken for a mug.

Mr King: No, the taxpayer has not. The taxpayer is putting money up front, as the Chancellor said. That does not mean to say that it will not get money down the road which will more than justify the original sums put up.

Q6 Chairman: I hope that satisfies Mr Peter McKay who put in that question. Chancellor, from the questions we have received, it is clear that the Government has some explaining to do for the public. Denis Sayers was certainly not alone in asking "Where are you going to borrow the money from to fund the banking bailout and what will be the consequences of such a level of government borrowing?"

Mr Darling: The answer to that is that the Government borrows that money from the markets in the normal way. I will set out the consequences of that together with the wider consequences that the Government is having to deal with as the economy slows down and tax receipts slowdown at the time of the Pre-Budget Report and of course again at the Budget next year.

Q7 Mr Fallon: I will have later questions about Iceland but an awful lot of people have e-mailed us asking who was really responsible for letting all this happen. We seemed to have this impression of "see no blame, hear no blame and take no blame." Chancellor, if I can begin with you, Sean Walsh asked us about your responsibility. If you take credit for the boom, why will you not accept some responsibility for the bust? These were British banks - Northern Rock, Bradford & Bingley, Lloyds, the Scottish banks - over-lending to British borrowers and doing so under the control of the three of you.

Mr Darling: I think, firstly, all of us have to accept responsibility for the regulatory regime we have. We all have to accept responsibility for, in my case, the wider conduct of economic affairs in this country. I will always do that. In relation to the regulatory system generally, the problem I see is this: that in the past governments have tended to concentrate on the regulatory system within their own country. As you know, we made major reforms to the regulatory system ten years ago, essentially ending a self-regulatory system and bringing the regulatory bodies together. What has happened here, as Lord Turner has pointed out, the problems that have built up over the last few years and became acute by last summer, summer of 2007, is that whilst individual regulators focused on what was going on within their own areas of responsibility, and there are clearly lessons to be learned there as well, as the FSA acknowledged earlier this year, where the system is deficient is in spotting problems that are building up not in one country but in several countries. In this case it

happened to be primarily within the United States but it is a problem, which is why for some years we have been arguing for far greater co-operation between the regulators. That is why we helped set up the Forum for Financial Stability ten years ago. Undoubtedly there are lessons to be learned. Nobody can look at the present system and say that there are not lessons to be learned from it. There are, and particularly in relation to making sure that regulators are focused on what is going on not just in their own country but what problems might be building up elsewhere as well.

Q8 Mr Fallon: But Mr Walsh actually says, "Government should have been well aware of the multi-national nature of banking transactions." You and Mr Brown were in overall charge of all this. Why do you not accept responsibility and say sorry?

Mr Darling: I have said to you that I accept responsibility for everything that I am responsible for but in relation to what has been happening in the banking system overall, I think there are several levels of responsibility. Yes, in our national regulators; undoubtedly we needed to toughen up what was happening internationally. There is another area which we overlook at our peril and that is the responsibility of boards of banks, who are supposed to be the first line of defence in relation to their own institution. Yes, we have to look at what governments are responsible for. We also have to ask ourselves how we ensure that in future banks actually know what they are doing, not just at a senior level but at middle management and so on. The difficulty we have had over the last few years is that a situation was allowed to build up where money flooded into the system, interest rates were low, people were looking for better returns, and they lighted on the securitised market. Then of course, when that went wrong, when people started to default in America in 2007, the consequences for the rest of the world were catastrophic in terms of the health of the banking system. So yes, of course there are lessons to be learned on our part, there are lessons to be learned in every single country in the world, but crucially, it is important that we make sure that we have a far better surveillance, far better monitoring of the problems that are building up. We have been concentrating on America; we do need to understand that, as the world becomes smaller, in the sense that we are getting rapid growth in India and China and so on, we need to make sure that we keep a close eye on what is happening right across the world.

Chairman: We are coming on to questions about boards of directors later, Chancellor.

Q9 Nick Ainger: Chancellor, we had a question here from Mr David King asking whether the Government quantified the whole extent of toxic assets to which the banks were exposed before

offering the £50 billion bailout package to them. Did you actually go into that sort of detail with the banks that have been in receipt of the recapitalisation money?

Mr Darling: What we did is we asked the Financial Services Authority, which is the regulator of these banks, to calculate how much additional capital would be required in relation to each bank, and whilst I understand you are passing on e-mails to me, I hope you will allow where it is appropriate us to contribute together because it might explain how the FSA did this. Of course it took into account the exposure which we were aware that banks had to deal with. Otherwise it would not been possible for us to have reached a calculation as to how much each institution was actually able to increase their capital by. That was absolutely necessary.

Lord Turner of Ecchinswell: Could I expand on that? I think it would be useful to explain the role of the FSA in reaching those judgements as to how much capital was required. We had reached a point of view at the tripartite level all together that a very significant recapitalisation of the banking system and of specific banks was required to restore confidence. We had got to a situation, which was mentioned earlier, the seizure of the money markets, when non-bank institutions, whether they be corporates or pension funds or insurance companies, were increasingly unwilling to lend to the banking system at anything other than overnight, and this was becoming extremely critical. Of course, once non-banks are only willing to lend to banks overnight, banks can only lend to themselves overnight; the inter-bank becomes overnight. This was the whole seizure of the inter-bank market. It was obvious in discussions that something radical had to be done to restore confidence, and that confidence has, as you know, three elements to it: Bank of England liquidity support, guarantees to certain categories of funding, and recapitalisation. The scale of the recapitalisation we then worked out by running extreme stress tests - and we deliberately used fairly extreme stress tests - on the assets of the bank, looking separately at their UK mortgage assets, the ordinary mortgages which were on balance sheet; at their ordinary corporate lending assets on balance sheet; and at the assets in their treasury and capital markets activities, which might include some of the ones which people tend to call toxic, though there is no precise definition of what we mean by "toxic", but it certainly includes several where the present market value of those is very much below the original value. There was a process of developing a set of stress tests which defined what we believed was required in terms of recapitalisation to take them to a level where people could absolutely clearly and without doubt have confidence in them. The net effect of that is that we have taken them to a level of capital which is well beyond what the classic international rules of capital adequacy defined, as indeed have other countries in similar recapitalisation programmes, and

at some stage - but it needs to be done in an internationally coordinated fashion - we are going to have to explain what a long-term capital regime will be, accepting that what we have done at the moment was entirely appropriate and required for the specific circumstances that we faced.

Q10 Nick Ainger: But so far we have not had a return to the trust and confidence that existed 12 months ago, despite up to £500 billion worth of support to the banking system in this country. Is not the key problem that banks do not trust each other because they still believe that there are undeclared toxic assets or liabilities for their fellow high street bank partners and that is why we have not returned to lending? Is not the way forward to actually publish or insist that every institution publishes what its exposure is? While it may cause a short-term problem, it is only the long-term solution.

Lord Turner of Ecchinswell: That is a matter for the public accounts of those companies, and they are subject to accounting standards which, on the whole, require them to use fair value approaches rather than accrual, historic cost approaches in relation to that. I think some people have raised issues as to whether that process should have gone further but on the whole I think there has been fair openness in terms of the accounting. So I do not entirely accept that the slow pace at which the money markets are returning to normal can be put down to a continued uncertainty about that accounting treatment. I think it is simply the case that when you have had what was really an extraordinary, extreme collapse of confidence - and the Governor has described it, I think, as the biggest collapse of confidence in the money markets which had occurred since 1914 - it simply takes time for people slowly to return to confidence. I will just reiterate one thing, that one of the crucial elements of the confidence here is not the banks in each other; it is non-bank financial institutions and corporates in the banks. It is when they are willing to start depositing with the banking system at three months or one year rather than at short-term tenors that we will see a return of the money markets to their normal function.

Q11 Nick Ainger: Chancellor, Mr Neill has raised the issue of the guarantees which are in place following the bailout of various banks. He asks what guarantees are in place to ensure that the taxpayer receives any profits and/or our money back before being paid out to the shareholders and the boards of directors?

Mr Darling: What we have done in relation to the eight major banks and building societies is, in return for them raising their capital - remember, this is quite an important distinction. Most of them

are doing so through the markets, in other words under their own steam. RBS, HBOS and Lloyds TSB are using the recapitalisation fund, so they are treated slightly differently from the other banks. In return for that, what the Government is doing is guaranteeing inter-bank lending and it is doing so for a fee. In other words, if we guarantee it, we charge a fee, so that the taxpayer would be rewarded for that, if you like. In relation to those banks where we have used public funds to recapitalise them, we are saying there that additional conditions will attach in respect of lending to small and medium-sized companies and also in relation to the mortgage market. There are also restrictions on payment of dividends. Basically, what we are saying there is that we have taken, as you know, preference shares, which come with an additional payment, as well as ordinary shares. The reason we have done that is to make sure that we did not end up in a situation where the public recapitalised these banks only to see the money go out the other side without actually fulfilling the function we wanted. So there are conditions and, as I said when I made my statement in the House on 13 October, those conditions do mean that where there are guarantees, there is a fee for it, and of course, in relation to shareholdings that we take, when we come to sell them in due course, and of course when we get dividends, and that becomes possible, the public will get a return there as well.

Q12 Nick Ainger: You know from Treasury Questions that there is serious concern from small businesses, from homeowners, that the very banks which we have bailed out do not appear at the moment to be honouring that commitment for getting money back and supporting credit availability at the same level as last year, not pursuing people to repossession and so on. Should you not publish the agreements you have reached with these individual institutions so that their customers can actually check whether they are complying with the agreements?

Mr Darling: There are a couple of things here. I am about to write to you, Mr McFall, in your capacity as Chairman of this Committee, setting out the details of the holding company that the Government is setting up today to manage the shareholdings in RBS, HBOS and Lloyds TSB, and probably also Northern Rock and Bradford & Bingley, or that part which the Government still maintains. That letter will set out the objectives of this company, which are to ensure, as I said in the House at the time, that these companies are managed in a commercial way and at arm's length from the Government. They will also of course, being the shareholder in these banks, and a substantial shareholder in relation to both RBS and, assuming the merger between Lloyds and Bank of Scotland goes ahead, although a minority shareholder, still a substantial one, make sure that those conditions are put in place. In addition to that, although the wider body of banks, those who raised their money on the markets, are not subject to the detailed agreements which I was referring to, we

do want to ensure that we encourage them to do as much lending to small business as possible and, of course, to lend into the mortgage market. You are probably aware that Lord Mandelson, the Secretary of State for Business and Enterprise, and I met the banks last week and we agreed that we would need to meet on a regular basis to make sure that we did everything possible to make sure that funding is being made available. What I have said in the House of Commons both on 13 October and last week at Treasury Questions is that yes, of course the availability of money must be maintained and it must be at competitive rates, but that does not mean that every person who wants a loan will necessarily get a loan on the terms they want. Pretty much on a cross-party basis people did say that what we cannot do, having done all this, is to then go back into the very irresponsible lending that so many of us have been critical of. It does not mean that automatically there will not be any difficulties but what I am very anxious to do, and we will be putting in place arrangements, and I agree with you that we should publish agreements that we have, so that people know exactly what is possible and they will know the terms and conditions on which we do it.

Q13 Mr Brady: Chancellor, Eric Daniels, the Chief Executive of Lloyds TSB, has been quoted as saying that the bank faces "very, very few restrictions" as a consequence of accepting the capital injection from the public. In that context, would you respond, please, to Joan Neddington's question, who says that she understands the importance of bailing banks out but, "as a taxpayer, I object to my taxes funding bonuses. What is the Government going to do to stop this?"

Mr Darling: In relation to Lloyds TSB, on the assumption that they take up the shares that they have indicated they will from the bank reconstruction fund, they will be affected by the same restrictions as HBOS and RBS, the conditions that I was referring to in relation to lending, in relation to the payment of bonuses and in relation to remuneration of their boards. Anyone who uses the bank reconstruction fund is treated the same way and, as I said in reply to Mr Ainger, I will arrange for those agreements to be published once they are concluded.

Q14 Mr Brady: So are you saying that bonuses will not be paid next year?

Mr Darling: We do not actually expect many bonuses to be paid at all from the banking system next year but what we have said is that there will be restrictions whilst those preference shares are there. I am not sure if you are referring to the prospectus which Lloyds TSB published today but no doubt you will want to have a look at that. It anticipates being in a position to try and redeem the preference shares rather earlier than anticipated and, once they are redeemed, as part of the agreement we struck, a different set of restrictions would then apply.

The Committee suspended from 4.33 pm to 4.44 pm for a division in the House

Q15 Mr Brady: Would you accept, Chancellor, that in relation to bonuses, in relation to dividends and preference shares, there is a sense which has grown up that the deal which was put on the table at the time of the recapitalisation is not exactly the same as the deal that is on the table now?

Mr Darling: No, it has not changed at all.

Q16 Mr Brady: So you think for Barclays, or any of the banks that did not access the scheme at the time, they have made that decision on precisely the same terms as Lloyds TSB, RBS and the others?

Mr Darling: I assume they have. The position is that we said, "You need to recapitalise and there are two ways you can do it. One is you can do it through the markets in the normal way," which Barclays have chosen to do, "or you can get capital through the bank recapitalisation scheme and the conditions are different if you do that." The banks themselves, and, indeed, Barclays' position has not changed either because on the weekend these discussions took place you will recall that when I made the announcement on the 13th I indicated that Barclays was proposing to make its own arrangements.

Q17 Mr Brady: Are you not concerned, Chancellor, that what you have created is a very uneven, inconsistent situation where different banks are regulated in different ways, have different competition rules applying to them than others, and it is not really a level playing field?

Mr Darling: No. This has been reflected in some of the e-mails you have been getting. If we had said, "We are willing to recapitalise you and there are no strings attached," I think quite understandably you would have been saying "How come you have allowed such a situation to arise?" I do not think it is unreasonable if you take a bank where we might have over 60% of its shares or in another case over 40% of its shares that we should not say there are restrictions. If you take, for example, the restrictions on the bonus payments being made to the board, I do not think it is unreasonable to say, "Look, you have got into a situation where you need exceptional recapitalisation, we are helping you but you have to accept that there are some restrictions on what you can otherwise do." Also, in relation to mortgage lending or lending to the small business sector, it is not unreasonable if you put very substantial sums of public money into the banks concerned that you do not get something in return for that.

Q18 Mr Brady: I want to come back later in relation to the Icelandic banks but finally for the moment, I am glad you mentioned the e-mailers because the Chairman has just told me the same thing. Still on the theme of consistency of treatment, Susan and Jean have e-mailed us wanting to know why it is that they, as people who are losing out very badly from the situation with Equitable Life, are not being treated in the same way as people who have lost their savings potentially through banks or building societies.

Mr Darling: As I think I have said on a number of occasions, we will make a statement on how we deal with Equitable Life following the Ombudsman's findings shortly. That is a different problem to the problem we are dealing with just now. Equitable Life is not a bank. It has problems which, as you know, go back for 15 or 20 years. There was an inquiry by Lord Penrose six or seven years ago. There then followed a four-year inquiry by the Ombudsman. I will be looking at both and, as I said, I will be publishing our conclusions shortly.

Q19 Mr Brady: I am sure you would accept that it feels the same if you are in the position of having lost your pension savings as if you have lost your life savings in a bank.

Mr Darling: Absolutely. I understand the position of anyone who has entered into an arrangement and the arrangement turns out to be different to what they thought they were entering into. Like, I suspect, every one of us around this table who are Members of Parliament, I have many constituents who are affected by what happened at Equitable Life. As you know, the situation at Equitable Life, Lord Penrose found that the company, as he put it, was substantially the author of its own misfortunes. The Ombudsman has also pointed to a number of failures which she has identified. I need to respond to both. I understand perfectly well the point that Susan and Jean are putting, and I hope that we can respond to Susan and Jean and indeed many others shortly.

Mr Brady: I hope so too.

Q20 Chairman: Chancellor, John has read your Financial Stability Report - that is me - the one you produced in October, which is excellent. I note that in 2002 lending and consumer deposits were in balance but in 2008 lending exceeded deposits by over £700 billion. How did we get so much out of kilter? What is the future now in terms of lending and deposits?

Mr King: The banking system borrowed more through wholesale funding in order to expand its lending and it believed that it was profitable to do so, that it could finance the cost of borrowing by

earning suitably adequate returns on the lending that it was taking. That strategy seemed to be quite profitable until August 2007, when the risks involved in borrowing very short term to lend what perhaps was thought to be short term through securitised instruments but turned out to be lending long term when the securitised mortgage market closed, that turned out to be rather risky. As for the future, the banks will need to regenerate new sources of funding. The level of savings will be there. Indeed, one would expect that in the next year or two the domestic economy will be saving more as a fraction of GDP than it has in recent years. I have no doubt that the savings pool is there and one of the aims of the guaranteed borrowing programme is to give banks a start in terms of obtaining guaranteed borrowing to start funding lending to the real economy by looking to those sections of the non-bank financial economy and the non-financial sector from which it was not obtaining funds before.

Q21 Chairman: Lord Turner, in retrospect that seems a no-brainer, getting out of kilter so much as £700 billion. What is going to happen in the future? Do you think it will be more in the balance?

Lord Turner of Ecchinswell: I think it is exactly the sort of issue that needs to be looked at with far greater attention in future by regulators, by central banks, by governments throughout the world, to do this sort of macro analysis. If I pick up the question earlier of admitting errors where they occurred, I think the FSA has admitted two errors. It has admitted errors in relation to----

Q22 Chairman: I do not want to go into the past of the FSA. I just want to look into the future.

Lord Turner of Ecchinswell: What is going to happen? I think there is going to be some sort of process of rebalancing because let us be clear that part of that money, that imbalance, part was coming from wholesale borrowing within the UK, part was the flipside of the current account deficit, and some of it was effectively coming from purchases by, for instance, American money market funds of retail mortgage-backed securities from the UK. The fundamental problem that went wrong there was not actually a problem of bad assets. It is probably the case that large numbers of these retail mortgage-backed securities will pay off on time, as it says on the paper. The fundamental reason was that the underlying investors, American money market funds, were doing maturity transformation; they were investing in long-term assets with short-term liabilities, and they are no longer willing to do that.

Q23 John Thurso: I have an excellent question here from Leighton Jones, who says "I question whether it is necessary for HBOS and Lloyds TSB to be merged. Each company will have its own injection of government capital and by keeping them as separate entities we will avoid the need for

an artificial calculation of the value of HBOS shares in terms of Lloyds shares, and we will retain the competitive element in mortgage and banking facilities that HBOS has always provided." Governor, could I ask you, bearing in mind Mr Jones's question, what are the pressing matters of financial stability that have meant that Lord Mandelson has overridden the obvious competitive disadvantages in pushing this through?

Mr King: I do not wish to speak for Lord Mandelson. It is a question you can put to him.

Q24 John Thurso: Presumably you advised him.

Mr King: From our point of view, I think what we saw at the time when the merger was engaged was that HBOS was suffering from a very rapidly falling share price and clearly a loss of confidence which was undermining its ability to continue as an individual entity. I think the only alternative to the merger would have been a full-scale nationalisation and I think that would have had quite dramatic repercussions for the UK banking sector. That merger, I think, was a very important step and it is still there as a commercial transaction. It is not for me; it is for the market and the regulators to decide where it goes from there but our advice which we gave at the time was that, in the interests of UK financial stability, the merger was a desirable outcome.

Q25 John Thurso: Would you have given the same advice if you had known that a few weeks later you would be taking a share in all the other banks?

Mr King: I think it is impossible to say because in the circumstances where we gave the advice the loss of confidence in HBOS was there, and only something pretty radical would have stopped it. I think that is a hypothetical question that it is very hard to answer. There is no doubt that when we made that recommendation we were very conscious of the difficulty facing HBOS, the merger was the right way forward, and now that it is there on the table you cannot undo it. It is a merger there, it is going to be a commercial transaction, and we will see what happens.

Q26 John Thurso: What a lot of people are asking is, the deal for a merger was obviously the right thing at a point when HBOS was the only institution in trouble. That was the perception. What we have arrived at is a situation where the whole system was in trouble and needed to be rescued, a wholly different situation, and therefore why is nobody revisiting the merger given it has some pretty nasty side-effects in the reduction of competition?

Mr King: There is a commercial transaction on the table and the two parties have to make up their minds about that.

Q27 John Thurso: Let me ask you then, Chancellor, this started obviously as something that came out of Downing Street in terms of a solution to a problem, and a good one, but there is now a completely different problem, a completely different solution. Why has this now become a commercial decision that does not need any intervention?

Mr Darling: The initial move in relation to this came from the two companies themselves, as is fairly well documented and was made public at the time. HBOS and Lloyds TSB started to talk to each other. Why was that? Obviously, Lloyds saw an advantage for them, but HBOS, you may recall, earlier this summer had to engage in a rights issue. It was not without its problems and HBOS reached the situation where it needed to find some way to get through things and it came to the view that the best thing to do would be to enter into a deal with Lloyds TSB. The competition authorities would have been engaged at that point because of the combined strength of that bank. I made it clear at the time that I was prepared to say that the competition issue could be trumped by the issue in relation to financial stability. That was a decision that Lord Mandelson took on Friday. He did so under advice from the Bank of England, the FSA and the Treasury.

Q28 John Thurso: Can you explain to me why it should remain necessary today?

Mr Darling: I would say two things to you. One is that it is up to the shareholders in Lloyds and HBOS as to whether or not they want to vote for this merger. If they do not do so, we will have to proceed on the basis that we have Lloyds TSB on the one hand, HBOS on the other, both will have to go back to the FSA and we will have to recalculate the capital requirements and proceed accordingly. However, you should look at what the OFT report says about HBOS because it makes it clear that the most likely outcome without the merger would not be a strong, independent HBOS continuing to exist and exerting the same competitive pressures as it was in the past, because it recognizes that HBOS has a number of problems. Remember, it was very heavily dependent on the wholesale markets, the markets we have been talking about, markets that have dried up. The idea that HBOS was a perfectly happy, functioning bank and there was nothing wrong with it, and then along came Lloyds TSB and put in a bid for it is not quite right. Look at what the OFT report says. When we looked at it, the authorities, the Bank of England, the FSA and ourselves, it was our view that the financial stability argument was still a strong one. At the end of the day, it is up to the

shareholders, and indeed, it is open to anybody else to come along and put in a bid for HBOS. The only thing I would have to say to you is that so far no other bid has been put in place, and the problem we had was, if we had not intervened, if we had not allowed the Lloyds bid to have gone forward, HBOS would have been in an extraordinarily difficult situation. Again, HBOS of course has benefited very substantially from the recapitalisation coming through the Government's recapitalisation fund. Why is that? Because, frankly, it needed the money. You should look at the OFT report because it did make the point that if this does not go ahead, it does not mean that HBOS is out of the woods. Far from it; it still has very substantial problems we need to resolve.

Q29 John Thurso: Because we are under a time constraint, can I ask for a couple of quick answers to a couple of quick questions? One, is it correct what was said by a Minister in the House of Lords that the funding for HBOS was contingent on the deal going ahead and if the deal did not go ahead, there would be no funding for HBOS?

Mr Darling: No, I am not aware of anyone saying that. It could not possibly be the case because HBOS does need capital, and the amount of capital it needs was fixed on the assumption that the merger would go ahead. If that merger does not go ahead, it will have to go back to the FSA.

Q30 John Thurso: It is available but it has to be renegotiated.

Mr Darling: Of course, and I have said that on a number of occasions.

Q31 John Thurso: Second question: over the weekend there was much speculation about a rival bid and there was a gentleman's name mentioned. If that materialises, will you give it a level playing field?

Mr Darling: Yes. Legally, there is nothing to stop any third party coming along and putting in a bid. If they want to talk to the Government about it, they can do so but as of now, or at least, as of when I set off to come to this Committee meeting, there is no other bid on the table.

Q32 John Thurso: A question for Lord Turner: if - and we must assume it will happen - stability returns to the banking system and in a couple of years you discover you have a problem of competition with this giant bank, what will you do about it?

Lord Turner of Ecchinswell: We are of course not the direct competition authority. It is the OFT which is responsible for competition. We will all jointly have to look at that situation at that stage. I

think it is not clear that we are heading towards a banking system so concentrated that there cannot be reasonable competition. We have quite a few players still, including big building societies like Nationwide, and of course Abbey Santander. That is an issue which will have to be looked at at the time but it is certainly not a direct issue, or certainly not in the sole competence of the FSA because it is a competition issue rather than a prudential or conduct of business regulation issue.

Q33 John Thurso: Turning to a different subject, Chancellor, if I may, it is regarding compensation for the shareholders in Bradford & Bingley. I have a constituent's interest in that one of the ministers of the Church has managed to put his entire life savings into Bradford & Bingley shares. There are a lot of questions. Archie Garden has asked a question, and Luke Goh, and a number of others, and what they basically say is the Chief Executive said the bank was fine on 25 September. Four days later the Government nationalised it. Given what has now happened to everybody else, is that not very unfair on those small shareholders or those shareholders?

Mr Darling: Everyone feels very sorry for people, particularly small shareholders in Northern Rock and Bradford & Bingley. The position is that the shareholders in Bradford & Bingley would be entitled to participate in whatever assets that company has left once its other obligations have been paid off. To be realistic, the prospects are not great when you look at the position it is in but the problem with Bradford & Bingley, again, there were two problems. It was very exposed to the buy-to-let market. It also had a problem with the self-certification of mortgages. As with so many other institutions, we did everything we could to help it but it reached a stage in September when the FSA concluded that it no longer met its obligations and it therefore could not be allowed to carry on taking money in.

Q34 John Thurso: Do they have any recourse to the executives one, two, three days before telling them everything was absolutely fine and to leave their money in?

Mr Darling: I would be hesitant about giving anybody legal advice as to whether they have a remedy or not there. My recollection is there is quite a lot of case law on this but I think before anyone took any action, they would be well advised to take proper legal advice.

Q35 Chairman: We have had a few questions from Archie Garden and Luke Goh. Lord Turner, Richard Pym on 25 September stated, "The changes we have announced today focus the business as a strong savings bank, reduce the size of our lending activities, and increase our capacity in arrears collection. We are now strongly capitalised, undertaking a complex transition with regrettable job

losses, but we are planning to put the problems of the past behind us and have a business which is fit for purpose going forward." Was that misleading?

Lord Turner of Ecchinswell: I think the thing you have to realise about any bank is that there is a distinction between its solvency on an ongoing basis and its liquidity position. You get a situation with a bank where if there is a loss of confidence in it, that in itself becomes a self-fulfilling process by which people are then rational to have loss of confidence in the bank. That, bluntly, is one of the central points to realise about a bank, that because it does maturity transformation, because its liabilities are shorter than its assets----

Q36 Chairman: Lord Turner, there is a simple point here. If you have money in Bradford & Bingley and the Chief Executive stands up four days before and says "We are a strong company. We are going forward" and then it is Armageddon four days later----

Lord Turner of Ecchinswell: I think the pace at which things were moving in those two weeks after the Lehman's bankruptcy is almost impossible to exaggerate. All of us realised that things did literally move day by day in terms of the way that the money markets were operating, and I think that is a context that was unique for those sort of statements.

Q37 Chairman: It was not bad supervision?

Lord Turner of Ecchinswell: No, I do not think it was. I do not believe it was. I have looked at it as best as possible. I think that was on precisely day six of my time. In fact, I think it was day five of my time at the FSA.

Q38 Chairman: You never had time to fashion the FSA in seven days, did you?

Lord Turner of Ecchinswell: I do not think so but my overall impression, I have to say, is that, whereas there were errors which the FSA has owned up to relation to Northern Rock, I think since then in relation to its management of what are incredibly difficult crisis situations to deal with, it has worked very effectively both in itself and with the other tripartite partners.

Chairman: We will come back to that and you can keep us informed on that.

Q39 Mr Breed: Chancellor, Mr Michael Freedman I think speaks for quite a few people when he asks "Why is the Government allowing Northern Rock to aggressively harass mortgage and loan customers with bully-boy tactics to recover debts, threatening repossession and personal bankruptcy against customers who make genuine offers of part repayment?"

Mr Darling: It should not be because it should be sticking to the same code as all other mortgage lenders and that is, firstly, repossession should be a last resort and, secondly, it should explore every other option.

Q40 Mr Breed: So why are they?

Mr Darling: We have talked to Northern Rock about it and are having discussions with a number of people to see how they can improve their procedures. What would be helpful is if you had specific cases with the consent of the people concerned so that I can actually find out what has happened in that individual case. It is necessary to find out what exactly the circumstances are in these cases and I would be happy to look at them. Northern Rock is bound by exactly the same considerations as other people. There is a specific problem with Northern Rock and that is that they have a number of mortgages where they lent at over 100% where it is quite clear that there are more people in that category who are getting into difficulties, but they ought to be behaving in exactly the same way as all other mortgage lenders. If that is not happening, if you let me have the specifics, I will be happy to look at it.

Q41 Mr Breed: I suspect, with 5,000 pieces of paper there, you might be having a few of those.

Mr Darling: What I do need in each case is the authority of the individual for me to investigate what has happened in that particular case. All of us, as Members of Parliament, are familiar with this, that if you really want to find out what is going on, you need to know what happened in that particular case.

Q42 Mr Breed: Thank you. Governor, about a year ago, when we were in this sort format, you and indeed Lord Turner's predecessor said to the Committee that "Northern Rock has a good quality loan book." At that time I rather doubted it, in the sense of the sorts of mortgages they were undertaking, and trying to suggest to us they were below the industry average for defaults has rather proved to be not correct. What sort of real evidence did you have to give us the impression that Northern Rock had a good quality loan book?

Mr King: We were relying on the reports that we received from the regulators. When we looked at the mortgages that we took as collateral, the mortgages that we took as collateral did not in fact have particularly high loan to value ratios, and at that time, as you pointed out, the experience of the performance of the mortgages was certainly no worse than that of other mortgage lenders on average.

Q43 Mr Breed: So you took the word of Lord Turner's predecessor?

Mr King: It was totally reasonable to ask the FSA for information about the quality of the loan book. It was the only basis we had to go on.

Q44 Mr Breed: That sounds very reasonable. Lord Turner, why did the FSA tell the Bank of England that Northern Rock had a good loan book when quite patently they did not?

Lord Turner of Ecchinswell: I think it was the case that Northern Rock did not have the same concentration on either buy-to-let or some of the impaired credit categories of borrowers that, for instance, Bradford & Bingley had. It had on the whole quite a lot of mortgages which would be counted as prime mortgages in the normal definition. Of course, you must remember that at that time not only Northern Rock but across the board the level of arrears was very low in the UK. It has gone up since then and we are worried that it will go up further but as of when they will have made that statement last year, although somebody who was predicting what would have occurred on principle might have said it would turn bad, there was not evidence in the arrears data at that time to suggest major bad debt problems. It is important also to notice what the Governor has just said, I think it was in relation to the thing that was presented to you as security for lending, that actually the loan to value ratios were not particularly high. They were not outliers. I do not think it is the case that Northern Rock has turned out to be a big outlier in quality of mortgages whereas that is true of Bradford & Bingley.

Q45 Mr Breed: But at that time you were aware that they were lending 125% of the valuation on incomes of 5, 6 and sometimes 6 1/2 times income. That did not apparently have any sort of trigger for you to think, and there was no real investigation into the together mortgages which actually concealed much of the potential arrears problem which has now been exposed. So the FSA really did not do enough investigation in order to give the information and advice for the Bank of England that Northern Rock had a good quality loan book.

Lord Turner of Ecchinswell: I think you have got to distinguish between the average and the overall. I believe that Northern Rock's accounts show that the average loan to value on new lending in 2007 was 79%. Now that in and of itself would not immediately tell you that there was a major problem. I think it is true that there was a tale of very high, and in particular above 100%, loan to value ratios. You can under certain circumstances justify that if you have a very, very clear income based underpin for creditworthiness. I mean the creditworthiness of a mortgage is always a combination of the asset cover and the income cover. I will accept entirely that there was a minority of the Northern Rock book which had some particular features but I think, looking at the average figures at that time, whether it was loan to value ratios or whether it was the arrears' experience then being experienced, you would not necessarily have seen Northern Rock as an outlier in terms of quality of mortgages. Where you would have seen it as a very strong outlier was in the nature of its funding sources and its reliance on wholesale markets. That is why at the time the problem was essentially a liquidity problem rather than a solvency problem.

Q46 Mr Breed: But it never occurred to anyone that the fact that someone was doing 125% mortgage deals on 6 times income meant that they might just have a slightly more risky loan book than the average?

Lord Turner of Ecchinswell: I am sure that did occur. What people would have to look at was across the whole of the average loan book. As I say, if you looked at the aggregate average figures for Northern Rock, I do not think it was clear that it was an outlier and, therefore, I think in so far as there was a regulatory failure to focus on key things at that time it was much more to do with a failure to focus on the structure of the funding rather than the particular characteristics of the loan book.

Q47 Mr Breed: Thank you. Chancellor, turning to something quite different, why was it necessary for the Government to use anti-terrorism laws for the purpose of freezing the assets of the Icelandic banks? Were the existing laws relating to insolvency not sufficient to cover this situation?

Mr Darling: No, they were not and actually the legislation we used, although it does cover terrorism also covers the powers that we have to protect the country's general economic interest. Interestingly, when you look back at what happened when the legislation went through Parliament, there was an amendment laid in the House of Lords to try and confine these powers to be used in the case of terrorism and that amendment was voted down. I think it was contemplated at the time that those

powers might be used more widely. Indeed, in my statement, I think on 15 October, when I said that we were using the powers under that Act, I did make it clear that these were general powers which are available to the Government. Can I just say - this is also important - you need to understand why we were doing this. We still have a situation now, five weeks later, where we have stepped in to guarantee the retail depositors in the Landsbanki subsidiary and as of today we still do not have an agreement from the Icelandic government that they will cover us for it so we did need to step in to protect the interested British taxpayers.

Chairman: We do not want to do that just now.

Q48 Mr Breed: Effectively that was the ends justifying the means.

Mr Darling: No, no, no.

Q49 Chairman: Chancellor, we want to do the Icelandic one at the end.

Mr Darling: Mr Breed just said something that I do take exception to.

Q50 Chairman: Very quickly.

Mr Darling: It is my job to protect the British taxpayer and I am very happy to stand up and justify that. I could not have a situation where potentially we are exposed to billions of pounds in covering this and there were assets there which I could perfectly legitimately use powers that Parliament has given us to use. The Act may have provisions in it in relation to anti-terrorism but they also go far wider than that.

Q51 Mr Todd: Can we turn back to the FSA's role. The internal audit report on Northern Rock demonstrated the poverty of regulation of that particular institution but also generic failings in the banking regulation sector of the FSA. Mr Hoare and Mr Maloney both asked what is being done to strengthen the FSA's grip on the regulation of the banking sector?

Lord Turner of Ecchinswell: Since the internal audit report was produced, and it was, of course, the FSA which was most instrumental in pointing out its own faults, and those faults include inadequate resources devoted to some potentially high impact firms, too rapid turnover of some of the key staff

and a failure in some classic protest things to document and make clear what had occurred and to stick to procedures, a very major programme has been put in place. It was put in place earlier this year called the Supervisory Enhancement Programme. This entails the additional 218 people in focused relationship management supervision. By relationship management we mean supervision of those larger institutions where we have dedicated professional people to them. That is 218 extra people, which is on top of about 500, think of it like that.

Q52 Mr Todd: Are they in post now?

Lord Turner of Ecchinswell: 38% of the positions have so far been filled. We are doing that from a combination of external recruitment and internal moves.

Q53 Mr Todd: You must have a fair number of poachers seeking to be gamekeepers at the moment?

Lord Turner of Ecchinswell: I think we could probably say that the environment for recruiting is slightly more favourable than we might have anticipated last year, that is correct. Yes, we are recruiting people. We are making sure we improve the quality of people on average. We have designed a new induction programme for all new supervisors which will be a nine week course in core supervisory skills and we will also be putting our existing supervisors through that process with a defined training and confidence scheme.

Q54 Mr Todd: Okay. I think you have said enough to say it is work in progress but certainly you would not ---

Lord Turner of Ecchinswell: No, we are not there yet. Obviously of its nature when you launch a thing like that it takes time, but by spring next year we would anticipate that we have completed that programme.

Q55 Mr Todd: Thomas Huertas in a speech of a few days ago made a number of interesting points about Basel II and the capital adequacy regime. Presumably the FSA and the Chancellor, actually the Governor, all three of you, are presumably seeking to pursue amendments to Basel II to reflect the experience we have had in the last few months and those are likely to focus on cycle, practicality and also the adequacy of capital altogether?

Lord Turner of Ecchinswell: Yes, I think that is absolutely right. I think if you look at Basel II and, indeed, Basel I, what is interesting about it in retrospect is that both of those took steps to improve the sensitivity of different relative measures of risk to the relative risk that was being taken between different banking activities. I think in retrospect there was a surprising failure to ask fundamental questions about how large is the capital buffer which banks need and we are bound out of this to end up with larger capital requirements and the issue of whether those capital requirements should be made counter-cyclical is going to be absolutely clearly on the international agenda.

Q56 Mr Todd: What you presumably do not want is each state inventing its own rules in this area where we will get regulatory arbitrage?

Lord Turner of Ecchinswell: That is exactly what we do not want. I think what we have to accept is that a whole series of different nation states have in response to the crisis taken specific action, necessary action, to increase capital adequacy in order to restore confidence. We now have a system where we have just overridden our existing rule book. We need as rapidly as possible to get to an international agreement about what the future rule book should be but that has to be a more effective rule book than it was in the past.

Q57 Mr Todd: Time line on that because otherwise we will be inventing our own rules in each state with the consequence ---

Mr King: There are three areas where work needs to be done. One is on the level of capital requirements; secondly, on the regulation of liquidity and the amount of capital that needs to be put aside and, thirdly, on the so-called counter-cyclical capital requirements. On the first, that is a question of judgment, there is no obvious inhibition on making that judgment sooner rather than later. The Financial Stability Forum is working on that. The immediate need is not to force banks to have higher capital requirements at present but to have more capital, it is the buffer that matters between the two. On liquidity, we are taking a strong lead, the UK. We, the UK, are taking a lead in the Basel fora to bring back into the Basel process discussion about regulation of liquidity which was never part of the Basel process and should have been. A third on counter-cyclical capital requirements, that will take time I think to get through any international forum. That is not to stop us doing it ourselves. Spain, for example, was a country that decided off its own bat to have what they call dynamic provisioning of capital requirements. Switzerland has taken action off its own bat

to raise the capital requirements. The Basel framework is a minimum set of capital requirements, that is how it avoids regulatory arbitrage. It does not stop any country adding to that.

Q58 Mr Todd: Nigel Beidas has asked about the alphabet soup of tricks that the banking sector got involved in - SIV, CDOs, all of that - and how that was not watched adequately by the FSA.

Lord Turner of Ecchinswell: Let me draw a distinction between that alphabet soup. There was an alphabet soup related to the area of structured credit and derivatives. This is CDOs, ABCP, CDS, CDO2 et cetera, et cetera. I think what is really quite telling in retrospect is to understand that only two years ago people were saying that the proliferation of all that had made the system more safe than it was. Indeed, if you read the April 2006 IMF Global Financial Stability report, that is exactly the story that you will get, that this complicated set of structured credits and derivatives had made possible the diversification and the spreading of risk in a way that would reduce the amplitude of the credit cycle.

Q59 Mr Todd: I think we all know that was indeed argued.

Lord Turner of Ecchinswell: It was wrong. Clearly there should have been more understanding of the dangers in that, but it is very easy to say that with retrospect. I think the bit which was more clearly an area where regulators and authorities across the world should have focused earlier was the other bit of the alphabet which is the SIVs, the off balance sheet because I think we should have recognised that things which are off balance sheet and which essentially had done regulatory arbitrage by escaping capital regimes by going off balance sheet are inherently risky things. I think it is easier to say that was something which ought to have been spotted and things done about their capital adequacy earlier. I think on CDOs and CDS, in retrospect there was a lot written about it which is just bizarre to read today but sometimes the wisdom of crowds is deeply unwise.

Q60 Mr Todd: Yes. The regulation of foreign banks licensed to operate here, again we will return to some of them later in this hearing but the evidence of the last few weeks has led you to reflect what?

Lord Turner of Ecchinswell: I think there is a major reflection required which I am sure we will come back to on the discussion of Iceland about passporting arrangements within the European Union and the EEA. I think there is a real problem of a conflict between a single market approach to

passporting and complete reliance on home country supervisors. I think there are also difficult issues to do with large global integrated finance institutions on the wholesale side, such as Lehman's, where one has to recognise that it is very difficult to take other than a global regulatory approach to those but that when you go into administration there is an entirely national legal approach which cuts across what has been done before. Now, there is probably no way other than to take a global approach but that is where we get to the issues of a greater degree of global co-ordination of regulation through colleges of supervisors and processes like that.

Q61 Mr Todd: Kirk Guest asked about bonuses in the FSA, any in the banking regulatory sector who have earned one?

Lord Turner of Ecchinswell: We do have a bonus system and I am sure we will pay some bonuses this year because I have to say some of them have earned them very well indeed. I think if you simply look at the sheer amount of work, and I think it was pretty good work which was done, relating to the bank recapitalisation scheme and some of the crisis management, we have had people, as indeed have the Bank and the Treasury, working extraordinarily long hours and quite competently. Let me be clear, we will not reward bad work but it is part of our remuneration process to reward good work and we try to have a system which distinguishes that.

Q62 Mr Todd: Of course, a fair number of FSA staff left after the Northern Rock fiasco.

Lord Turner of Ecchinswell: Some did, yes.

Q63 Chairman: In terms of credit derivatives, a lot is over the counter. Are you quite content with the unregulated nature of that or do you think that should be brought into regulation?

Lord Turner of Ecchinswell: Over the counter do not escape prudential regulation in relation to capital adequacy. There is a separate issue as to whether the entire level of capital supporting trading in derivative instruments was adequate, and I think there is an argument it was not. The key issue with over the counter, of course, is that if you do not have a central clearing house and a central counterparty there is a massive accumulation of gross claims of the different counterparties among one another which can make it very difficult to see where risk lies and which can create great complexity if you do have a failure of institution. The FSA has, therefore, been working for some time in particular with the Fed of New York on ideas to put in place a clearing system and a

central counterparty system in relation to credit default swaps in particular, and that is a key priority and is on the agenda of the Financial Stability Forum.

Q64 Chairman: The reason I asked that, Lord Turner, was you gave the impression in your answer to Mark that you are quite content with the present system.

Lord Turner of Ecchinswell: No, no, that was not intended at all. That was absolutely not intended at all. In relation to SIVs, et cetera, we need to bring them in. In relation to CDS there is a major issue about the clearing and counterparty systems that relate to them.

Q65 Ms Keeble: I wanted to ask about the credit rating agencies. I really wanted to ask what the proposals are for the future rather than an analysis of what has happened in the past. We have had a lot of submissions from members of the public, including from one Derek Hunter, talking about the fact that the public have put their faith in what they thought were Triple A ratings either for banks or particular products and then these were not founded. This is for the Chancellor first and then for Lord Turner. What is the intention for better regulation of the credit rating agencies? It is widely recognised that is much needed.

Mr Darling: I agree with you. There are moves both from the European Union and, wider than that, internationally to regulate the credit rating agencies. It is probably fair to say that the whole thing is further down the track in Europe in that there are only 27 countries involved as opposed to potentially some many hundreds, I suppose. The recognition is that they do need to be regulated, they are pretty important. I just come back to a point I made earlier that I have always believed that a board of a bank should rely on a credit rating agency for an assessment but it should not substitute the credit rating agency's judgment for its own, and I rather think that happened on too many occasions. There are other issues like conflict of interest with credit rating agencies, a number of issues that need to be looked at. I agree with you that this is an area where we need to change the way in which we have done things.

Q66 Ms Keeble: This has been asked for for years, certainly since there were the problems with Northern Rock. It is not just about banks relying on the ratings, it is also members of the public. I certainly recall asking these questions in the wake of Northern Rock. I cannot see that there has really been any progress and now people have lost money again and the same cries have gone up. When is it going to happen?

Mr Darling: I think there has been a lot more progress in Europe than there has elsewhere.

Q67 Ms Keeble: But we have had the problems here.

Mr Darling: I know. Given the nature of what we are dealing with, a solution in one particular country, especially when institutions are trading across several, I do not think will be adequate. You need to have a solution to that certainly at a European-wide level, but also much wider than that, internationally. For us to have a solution that is purely directed to the UK would not be enough. The risk is if you did it in one country it would simply result in people going elsewhere and you really do not want that. There has been a lot of progress made in Europe and I think further progress will be made internationally.

Q68 Ms Keeble: In what?

Mr Darling: In relation to the regulation of credit rating agencies.

Q69 Ms Keeble: Yes, but what?

Mr Darling: Agreement that it should happen and, increasingly, agreement as to those areas which ought to be regulated. I know it can be frustratingly slow at times but we do actually need to get other people to come along with us on this.

Q70 Ms Keeble: There must be some sort of timetable by which there can be agreement and consensus and by which things can happen. We have seen some voluntary codes but that does not actually improve the situation. When the credit rating agencies came here it was glaringly obvious that all of the issues that were raised about lack of competition, conflict of interest, an over-mechanistic approach were completely justified. Since then we have seen further disasters and, again, people saying, "These had a good rating, we relied on them, we trusted them and they lost money".

Mr Darling: I think the credit rating agencies were just one part of the problem. In relation to Europe, at the last meeting we had of the European Finance Ministers in September we did make substantial progress and I am optimistic that we can get something agreed, if not by the end of this year then certainly by the beginning of next. That is, getting a wider agreement which includes the

United States, for example. I hope that can be done as quickly as possible. However, if you left America out of it that would be rather a glaring hole in things given how important American institutions are.

Q71 Ms Keeble: What form will the regulation take, a voluntary code or European legislation?

Mr Darling: No. What is proposed in Europe is legislation. Personally, I would prefer something stronger than voluntary regulation otherwise I can see you would not make it stick. This is something that we are discussing.

Q72 Ms Keeble: Who is going to take the lead on that, the Treasury? What is the role of the FSA going to be in it?

Mr Darling: Adair will answer in a moment for the FSA. Certainly in terms of international negotiations it is the Treasury and we act pretty closely with the FSA. For example, one of the things we will be discussing at the meeting of the G20 leaders and finance ministers in Washington in a couple of weeks' time is the need to make far more urgent progress on a whole number of things that I hope will reduce the likelihood of this thing happening again.

Q73 Ms Keeble: I want to come back on a further area later, so I just want a couple of brief answers on this. One is, can we take it that the timetable for the end of this year, the beginning of next year, will see some real progress on better regulation of the credit rating agencies?

Mr Darling: In Europe.

Q74 Ms Keeble: In Europe, okay. The second thing is would you favour seeing an assessment of the bonus payments and remuneration structure of the banks or institutions included as one of the risk factors in an assessment of the creditworthiness or value of the product or bank?

Mr Darling: I am not sure that there is a direct read across between the bonus structure and the creditworthiness of an institution.

Q75 Ms Keeble: It is a risk factor.

Mr Darling: I am not sure that is necessarily the case. What I do think is important, and here Lord Turner may well want to contribute, is one of the things that the FSA is looking at and one of the things I feel very strongly about is that we should avoid a situation where institutions have a bonus

structure that almost drives people into taking the very risks that have brought about the problems that we have got in the first place.

Q76 Ms Keeble: That is one of the reasons why this was suggested.

Mr Darling: I thought you were talking about credit rating agencies still.

Q77 Ms Keeble: When they are doing their assessments of the risk of a product they should take into account the bonus payments and incentives around that. That is one of the issues that have been suggested.

Mr Darling: I would prefer to deal with that problem through the individual regulator. Do you want to add to that?

Lord Turner of Ecchinswell: First of all, could I just say something on credit rating agencies. It is very important for us to understand their role in what has gone wrong but also the limits to their role. What credit rating agencies did over many years was essentially tried to produce ratings which, if they were successful, were accurate predictors of the likelihood of a single company or single bank bond defaulting. Actually, over the long-term they had not a bad record, but not a perfect record, of that prediction. What happened over the last five years was that first of all they went way beyond that single company or single bank credit rating and they began to credit rate all of these complicated things that we were talking about earlier, like CDOs. It turned out that these things were much more tricky to work out what their default characteristics were, or their value was much more tricky, that they were subject to much more rapid change in ratings than the single company or single bank ratings, and there was also a problem that there were some conflicts of interest in that and there was a process by which people were, as it were, designing these structures to get a particular credit rating agency by understanding what the model was.

Ms Keeble: Can I just interrupt and say one thing. We had the credit rating agencies here and they explained all of this.

Chairman: We have written a report.

Q78 Ms Keeble: They explained all of this and particularly explained how, in fact, they are commissioned by the people who want the product assessed. Those are the people who actually commission and pay them.

Lord Turner of Ecchinswell: Absolutely.

Q79 Ms Keeble: That is where the conflict of interest was.

Lord Turner of Ecchinswell: There was a conflict of interest.

Q80 Ms Keeble: We have had all of that explained.

Lord Turner of Ecchinswell: There was a conflict of interest and there was also a problem of people relying on them to tell them something about the liquidity or the value rather than the default. One should never have assumed that a credit rating told you anything about the market value of the instrument, it was only meant to tell you about the probability of default. I think a lot of what will happen on credit ratings, or what needs to happen, will be driven by the market rather than by regulation. People will simply not rely in future on credit ratings for things that they cannot be relied on for. Sometimes regulation is the way to respond to it and sometimes it is the market response which drives it forward.

Q81 Ms Keeble: Are you saying that you are opposed to regulation?

Lord Turner of Ecchinswell: No, I am not saying I am opposed to regulation but I think 80% or 90% of what will now happen to make us correctly use credit ratings is more likely to come because the market will just realise it used them in an inappropriate fashion and a relatively small amount may come from the regulation. That does not mean that the regulation is not important, it just means it is important for us to understand where the big impact is.

Chairman: Mention has been made of non-executive directors and we have had comments from Harold Walker and Michael Waugh, and Professor Bob Garratt has made comments. I am looking at the Financial Times and Paul Myners, your City minister, has made comments when he says: "The typical bank board resembles a retirement home for the great and the good: there are retired titans of industry, ousted politicians and the occasional member of the voluntary sector. If such a selection - more likely to be found in Debrett's Peerage than the City pages - was ever good enough, it is not now." If you look at RBS and HBOS it seems as if that backs it up. For example, RBS has got Bob Scott as its independent director, formerly group chief executive of CGNU, now of Aviva, Colin Buchan, head of equities at UBS Warburg, Archie Hunter, Scottish Senior Partner at KPMG

on the Institute of Chartered Accountants, Steve Robinson, former private secretary to the Chancellor, a very distinguished Treasury person.

Jim Cousins: Chairman, as the Committee's whip ---

Chairman: We are coming now. Peter Sutherland, Chairman of BP. With that, I will ask you questions in ten minutes when we resume at 5.47.

The Committee suspended from 5.37pm until 5.47pm for a division in the House.

Q82 Chairman: Chancellor, I was mentioning the non-executive directors and I finished on Peter Sutherland, but in HBOS we have got Sir Ron Garrick, former chief exec of Weir's, a distinguished industrialist on 235,000, a director of Shell, and we have got Anthony Hobson on 221,000, chairman of Northern Foods. These are pretty distinguished people. What happened? Were they scrutinising the chief executives or do the chief executives just run amok?

Lord Turner of Ecchinswell: I think I was going to say that. As you read out that list, there were many people on that list who clearly had what one would treat as the relevant experience, professional qualifications, ability to read and think about what accounts mean. It is not the case that the boards of our major banks - it may have been the case 20 years ago - were stuffed with a random bit of the non-relevant great and the good, they have for quite some time had people who would appear to have the relevant technical skills often. There is an issue, I think, about simply the total amount of time that non-execs spend on businesses as complicated as banks and insurance companies. Having been a non-executive of a bank, I realised that to do it professionally you really do have to put a hell of a lot of time into it. In future I think we are going to have to think about how much time effectively even very competent people can give to really go into the detail. The other thing to say is I do go back to the point I made earlier: a lot of very, very clever people in regulators, in central banks, in banks, in the IMF, did not see this thing coming.

Q83 Chairman: That is why we have got an inquiry, because of all these clever people that did not do that. Governor, are you going to stick your nose into individual institutions now on these issues and maybe be a bit sceptical?

Mr King: I would not use that phrase. If I could take up the question you just put about people and spotting it, it is a good question but it is exactly the question that was asked in 1847, 1866, and you could go on.

Q84 Chairman: So we are never going to change anything? Let us pack up and go home.

Mr King: I am rather doubtful if the need for future inquiries will ever disappear because banking does run these risks that every now and then there is a crisis.

Q85 Chairman: You are telling me here, in answer to a question, Governor, that non-execs, we kind of hope for them to do their job, they are just going to turn up every few months.

Mr King: I am not saying that at all.

Q86 Chairman: What are you saying then?

Mr King: What I am saying is that the question you have asked is one that was asked in the past and the fact that there is a crisis is in itself not evidence that the individuals in charge of those institutions necessarily failed.

Q87 Chairman: But Governor, this is 2008, we have put £500 million into the banks, we have got 5,000 emails from people who are angry about these and you are telling us, "Look, things are going to go on as they are without any change".

Mr King: I do not say they will go on as they are.

Q88 Chairman: If that is not the case phrase your answer appropriately.

Mr King: What I am saying to you, Chairman, is ---

Q89 Chairman: Phrase your answer appropriately.

Mr King: What I am saying to you, Chairman, is that you and nobody else has any guarantee or any solution that will lead you to a position ---

Q90 Chairman: But, Governor, you do not think there ever will be. Give us an idea of the way forward.

Mr King: We have.

Q91 Chairman: Tell us, other than, "We will see this again in 20 years' time". Give us some comfort.

Mr King: Exactly. Ever since I came to this Committee first back last September I have spelt out for you exactly the direction in which you should go and I am glad to say you have listened.

Q92 Chairman: Thank you very much.

Mr King: Now we are going to get a resolution framework for dealing with failing banks. Secondly, we need a reform of the deposit insurance system, and I am delighted to say that your Committee has followed that advice and has endorsed it.

Q93 Chairman: Governor, my question ---

Mr King: Can I keep going as to what else we need to do.

Q94 Chairman: Go on.

Mr King: Thirdly, regulation of liquidity. Then it comes to the international arena and I have already explained we will need higher capital requirements, we will need counter-cyclical capital requirements and at the international level we will also need liquidity regulation.

Q95 Chairman: Governor, I understand that and that was in our report. How can we get better, more alert non-exec directors?

Mr King: That is a matter for the companies themselves. If you want to impose that centrally from Government essentially you are saying you want nationalised companies. Private companies have themselves to choose the right people for the job.

Chairman: Governor, I think you are way off the mark there.

Q96 Nick Ainger: Some banks have not had the problem.

Mr King: They have benefitted from having a better class of non-executive directors. They have to make their own choice.

Q97 Mr Breed: Governor, could we have authorised people who, in other words, have to be properly authorised by the Bank of England or the FSA before they are allowed to become a non-executive director?

Mr King: I have no objection to that whatsoever.

Q98 Chairman: Lord Turner, give us a precise answer.

Lord Turner of Ecchinswell: Can I say, I think it is important to make sure that we have appropriate non-execs but in many cases we have. It is appropriate to make sure that they have adequate time and visibility of the issue and a lot of banks are looking far more closely at that in future. But if I had to identify what will decrease the likelihood that our equivalents are here in 10 years' time, it will primarily be precisely the things which the Governor has mentioned. It will be a better system of capital adequacy, a counter-cyclical system of capital adequacy, more robust and effective policies on liquidity. It is those, I think, which are most likely to decrease the likelihood of overall systemic problems in 10 years' time, more likely to do it than operating through the competence of the executives or the non-executives of specific institutions.

Q99 Jim Cousins: Chancellor, a lot of people have contacted the Chairman to ask what is the Government going to do to support the housing market for new home owners and for existing home owners in difficulty.

Mr Darling: There are two elements to it. In relation to existing home owners in difficulty, as I said earlier I think in reply to Mr Breed in relation to Northern Rock it is important that all mortgage lenders, banks and building societies, stick to the protocol that most of them signed up to and that is to ensure they explore every possible alternative to eventually repossession. It is also important to look at different instruments, for example, perhaps sale and people being able to lease the property they are in. There are many alternatives which fall short of repossessing a house. I think that is very, very important. In relation to help for mortgages generally, you will be aware that I asked Sir James

Crosby to report to me on that. I will publish his report and I will let you know my response to it at the time of the Pre-Budget Report.

Q100 Jim Cousins: People are wanting to know that the banks you have nationalised, partly or wholly, are doing what you have told them to do. In the case of Northern Rock you have told them to repay you as fast as they can and they are doing it by shutting down their mortgage book.

Mr Darling: That is a condition.

Q101 Jim Cousins: They are asking you to accept your responsibilities.

Mr Darling: In relation to Northern Rock, as you know, the conditions imposed on it were partly as a result of the European Union's state aid rules.

Q102 Jim Cousins: But it is your business plan they are working to.

Mr Darling: It is my business plan, yes, but I have to operate within the law. As you well know, the European Union under its state aid rules precludes, in crude terms, us running a state owned bank aggressively against other privately owned banks. In relation to the banks that we are taking shareholdings in, I have already earlier in the hearing referred to the agreements that we will enter into in relation to RBS and Lloyds TSB and HBOS which will bear on both lending to small businesses as well as mortgages as well.

Q103 Jim Cousins: A lot of people who have contacted the Chairman feel the Government is hiding here behind a lot of rules of its own making. They are saying what about long-term fixed rates?

Mr Darling: Sorry, which rules?

Q104 Jim Cousins: The rules you have just referred to.

Mr Darling: The state aid rules.

Q105 Jim Cousins: Hiding behind the state aid rules. A lot of people are saying, "What about long-term fixed rate deals? What about help for people to get deposits? What about help for people to

switch from buying to renting or having a combination of renting and buying" They are saying they want this to happen now before they are put out of their homes.

Mr Darling: There are absolutely no rules that prevent most of the things you referred to. The state aid rules, whether you like it or not, are part of the domestic law of this country and we cannot get out of that and we do have to stick to them. That is the reason that Northern Rock is reducing the size of its loan book at the present time. You will recall a few weeks ago the commercial banks were having a real problem seeing money being taken out of them and put into Northern Rock so it was necessary for Northern Rock to ensure that it was not draining the system of funds because that would have been grossly unfair and actually very destabilising for the banking system as a whole. In relation to helping people who are looking for mortgages, I agree with you that availability of mortgage finance whilst maybe not the big problem we have got just now will become a problem when the housing market starts to recover. As I said to you I asked James Crosby to report on that and I will have something more to say on that when I get to the Pre-Budget Report. In relation to other measures, in relation to people who might convert from owning to renting, those are all measures that we are looking at. We are looking at with the banks at the moment to see whether or not we cannot offer people options but there is no rule stopping them, the question is whether or not they stack up commercially both for the individual as well as for the lender.

Q106 Jim Cousins: A lot of people contacted our Chairman are not very comfortable with what he Chancellor is saying but they find Robert Peston even more sinister and frightening.

Mr Darling: I cannot answer for him.

Q107 Jim Cousins: In fact some of them even seem to think that Robert Preston is the Governor of the Bank of England. Now, over Northern Rock, over the Lloyds/HBOS deal where Robert Peston was four hours ahead of the official market information and over the recapitalisation of the banks which Robert Preston announced at 9 o'clock, a lot of people are saying, "This is inside information from the top". They are saying, "Who is looking into this? Who is getting to the bottom of it"? That is one for you, Lord Turner.

Lord Turner of Ecchinswell: Certainly we are very concerned if there are market rumours and information coming out ahead of when it should come out. If there is any possibility that there is market abuse deriving from that we will certainly investigate it.

Q108 Jim Cousins: Are you? Are you investigating it?

Lord Turner of Ecchinswell: I think the answer is there is no sign that there is market abuse. Let us be absolutely clear. There is leakage of information that should not have leaked, the net effect of which is that Robert Peston has effectively been broadcasting that before it is correctly broadcast which should be in an RNS Stock Exchange statement. But we have no reason to believe that something is going on other than broadcast, it is an imperfect broadcast, it is not the perfect form of broadcast to the market simultaneously which we achieve by an RNS but as long as he is not and nobody else is tipping off somebody to take a position before he does this imperfect broadcast it is not an issue of market abuse. It is certainly an issue for each of the individual institutions involved as to who is leaking this, and I wish I knew who it was and I think it is very serious that these leaks are occurring. But unless it is the case that you believe information is being passed to people who are taking positions on it before it is broadcast in whatever the form it is broadcast then you do not have a case of market abuse.

Q109 Jim Cousins: I think there will be concern that you say you are concerned about leaks but you are not actually investigating what powers you have and, secondly, a lot of people who have contacted our Chairman are concerned that we have now a journalist who because of these previous leaks to him is now leading the markets and that everything he says now carries a value and it influences real events. Are you not troubled by that?

Lord Turner of Ecchinswell: We certainly are troubled by that but we can only investigate something where there has been an offence under regulation and law and the fact that somebody has ended up with a status where their opinion is seen as leading events or making other people take a point of view on the basis of that is not in and of itself an offence. Other markets have had this at particular times, particular investment gurus who are perceived as having great insights and whose words swing markets. Though it might be concerning, it is not in itself any category of offence against market rules. We will clearly keep an eye on it, and this is something which we have considered whether there are any cases to pursue and certainly I will take what you have said and look at it further. I think we have to stick to what is an offence under market rules. We are not in ourselves a police person of leaks in general, that is not part of our function.

Q110 Chairman: Just to sum up, are you active on this case or are you passive, in other words you wait for people to come to you?

Lord Turner of Ecchinswell: We would certainly pursue it if we believed that there were any market abuse implications from it.

Q111 Chairman: You are passive?

Lord Turner of Ecchinswell: We are not passive in the sense that we are continually monitoring abnormal movements in prices. That is part of the normal process of looking for market abuse which we do through all the classic algorithmic search engines which are used to look for the way that markets are moving in odd fashions and which result in market abuse cases.

Chairman: Right. We are going to spend 15 minutes on the Icelandic and Guernsey/Isle of Man. Sally, you have a question and a very quick answer.

Q112 Ms Keeble: I want to ask about the bonus payments because an awful lot of people have complained about that in a large number of the emails. Apart from the outrage at the scale of it, the bonus payments have also been very dysfunctional in creating some of the problems. Have you got any proposals to regulate them and to try to limit the bonus payments and the bonus cultures in the City?

Lord Turner of Ecchinswell: We have a responsibility to look at not necessarily the level of bonuses but the structure of how bonuses are paid, what they are paid for and in what they are paid and how it may affect risk taking, that is our responsibility. Certainly we are looking at, and we have sent a letter to the chief executives of all of the banks asking them for information about the way that the structure their bonus payments. We will be incorporating analysis of that within our normal supervisory processes. We have the ability if we want to just tell people that we consider their bonus structures inappropriate and we have the ability if we want to reflect inappropriate bonuses in a higher level of capital requirement. We will certainly consider using all that and it is also an issue under discussion among the international regulatory discussions, for instance within the financial stability forum.

Q113 Mr Fallon: Iceland. Chancellor, did you have a meeting with the head of the Icelandic financial authority in September?

Mr Darling: Amongst others, yes.

Q114 Mr Fallon: That was four weeks before their banks failed.

Mr Darling: If I remember rightly, I think it would have been 2 or 3 September. There was a minister for business who had some responsibility for business banking and he brought with him the equivalent of the head of the Icelandic FSA, someone from the Icelandic Central Bank and a couple of other civil servants.

Q115 Mr Fallon: So you knew four weeks before the banks failed that there were some serious problems there?

Mr Darling: It had been a matter of speculation in the newspapers for several months that there had been concerns about Iceland and, by extension, there had been a lot of comment about the banks. Perhaps it would be helpful if I told you the reason for the meeting. The authorities, the FSA principally, had been keen to ensure that the Icelandic authorities made sure that the subsidiary, the branch of Landsbanki, was made into a subsidiary so that we could regulate it in this country and the minister and his colleagues at that time wanted to assure us that they were on the case and they were looking after matters.

Q116 Mr Fallon: We will come on to Landsbanki. Why did you tell BBC Radio on 8 October: "The Icelandic government, believe it or not, have told me yesterday they have no intention of honouring their obligations here"?

Mr Darling: Because on the previous day I had spoken to the Icelandic Finance Minister and I specifically put to him that the legislation that they had passed over the weekend in Iceland had the effect of looking after Icelandic depositors but cutting off non-Icelandic depositors, including those in the United Kingdom. When I said to him, "Is that what you are doing?", he said that it was and I said, "Is that not in breach of the agreement of the European Economic Area?" and he said he did not think so. I have to say to you, Mr Fallon, even if I was wrong on that, which I was not, five weeks later they are still not treating non-Icelandic depositors and creditors in the same way as they are Icelandic ones. That is why I had to step in and guarantee the retail deposits of those people who put money into the Landsbanki branch. As you know, I also took action in relation to Kaupthing

and Heritable where we did something different, we transferred them to ING. The reason we did this was because with the Icelandic government, for reasons that people might understand because clearly the country is in very difficult economic circumstances, I could not have a situation where they simply cut off British depositors or depositors here in Britain.

Q117 Mr Fallon: But the result was a run on the Kaupthing Singer and Friedlander UK bank which was not previously in trouble which then in turn caused the collapse of KSF Isle of Man.

Mr Darling: That is not right. Adair Turner will talk about this. In the week prior to the FSA determining that Kaupthing could no longer meet its threshold conditions, and remember it is the FSA that decides whether or not an institution can take deposits or not, there had been concern that there was not sufficient money in Kaupthing, that is one of the Icelandic banks, and the authorities understood that the money would be transferred back to Britain, but that never happened. I have seen reports suggesting that somehow the problems that affected Kaupthing were all the fault of the authorities here, but that was not the case. I am afraid you have to look behind this. Iceland, as well documented now, has been having problems for some time. They decided - not us - to introduce legislation at the beginning of October to effectively be able to take over their banks, and I think that was what set in place the chain of events. Remember, it was not in the British Government's interest to provoke any of this because the net effect of this is we have had to guarantee the Landsbanki depositors, we have had to transfer the depositors who were in Kaupthing and in Heritable, which is another subsidiary, to ING, but we have had to make good in the meantime the Financial Services Compensation Scheme. We have had to expose the British taxpayer to help people in this country and I can assure you that I would not have done that if there had been any other way of doing it.

Q118 Mr Fallon: Are you aware that many of the British depositors in the Kaupthing Isle of Man bank were originally depositors, in fact, with the Derbyshire Building Society, who are people working for British companies and British charities abroad who are not allowed to have accounts in UK banks because they are not resident? Are you not responsible for their interests too?

Mr Darling: Well, there are two issues here. There is the specific Derbyshire issue, which I will ask Lord Turner to deal with. In relation to people who put deposits into a jurisdiction which we are not responsible for, which includes the Isle of Man, then I do not think so. The British Government's obligation must be to depositors who have put their deposits into UK banks. For this purpose, the Isle of Man is independent of us; it has got its own regulator.

Q119 Mr Fallon: Just before Lord Turner comes in, you did include the deposits of the Bradford & Bingley Isle of Man branches in the deal on 29 September with Abbey Santander, so you rescued one lot and washed your hands of the other.

Mr Darling: Yes, because it was part of Bradford & Bingley, whereas the Icelandic subsidiary of the Icelandic branch was a subsidiary of an Icelandic company, not a British company.

Q120 Mr Fallon: I just want to be clear. You are washing your hands of the interests of British depositors ---

Mr Darling: No, I am not.

Q121 Mr Fallon: --- who happen to be working for a charity abroad but happened to have all their savings in an Isle of Man bank. You are saying you are not responsible.

Mr Darling: My obligation as the Chancellor of the Exchequer is to people who put their money into this particular UK branch. I say, Mr Fallon, that legally, strictly, what we have said to people is, "You have got to look for your first 16,000 or so to the Icelandic authorities" because that is what the EEA agreement is, and they are disputing that at the moment, as I understand, and we would have stood in the place between 16,000 and 50,000 under the British Financial Services Compensation Scheme. I have gone further than that. I have said I will look after the interests of all retail depositors in a branch in London that I think we are responsible for. If you go to the next stage and say, "Look, you should take over responsibility for something that is done in the Isle of Man or Guernsey or, indeed, by extension, other countries", that is quite a significant step to take. There is a particular Derbyshire point, if you like, and perhaps Lord Turner will deal with that.

Q122 Mr Fallon: Just before he does, the Treasury spokesman said on Guernsey, for example: "The UK Government will represent the Crown Dependencies in its negotiations with Iceland". Why are you washing your hands of British depositors in an Isle of Man bank?

Mr Darling: Because as part of the agreement we have with Guernsey and the Isle of Man and places we negotiate, we are the sovereign state. Mr Fallon, Isle of Man and Guernsey operate a specific regime and for tax reasons and others people choose to go in there, they are regulated by

the Isle of Man authorities. I would have to think long and hard before saying that for the first time the British Government would then go and underwrite savings made in another jurisdiction. It is not something that we would lightly do. That said, one of the things that we have been pressing on Iceland right from the very start is they really have to go and get help from the IMF. One of the things that I have said to them is as far as we are concerned, we would be happy to enter into an agreement with them where we will effectively loan them the money that we are paying out just now, but you would expect, and you would be the first to criticise if we did not do this, that we must have an agreement with Iceland whereby they will pay this money back to us over a period. The Netherlands are willing to do that, we are willing to do that, but it does have to be part of an agreement with the IMF because Iceland really does need to have an accommodation with the IMF such is the nature of its problems at the moment.

Q123 Chairman: Okay. Those questions were from Julian Williams, Dave Hawton, Klaus Eriksen, Simon Lam, and many others came.

Mr Darling: Could we deal with the Derbyshire point?

Chairman: Yes, given it is in Mark's constituency.

Q124 Mr Todd: As a Derbyshire account holder, but not with this particular product, obviously I have had people contact me about this as well so I would welcome an explanation of how people who invested in a Derbyshire offshore product ended up unwittingly, as far as one can tell, as account holders with an Icelandic bank because they were not given an opportunity to say, "Thank you, I'm not going to do that".

Lord Turner of Ecchinswell: We have to be clear that the Derbyshire chose to sell its business of Derbyshire offshore Isle of Man to Kaupthing and then ended up in Kaupthing Isle of Man which, it is important to realise, was not a subsidiary of Kaupthing Singer & Friedlander, it was a direct subsidiary of Kaupthing Iceland. I am sure what the Derbyshire would say is, at least in theory, that did not disadvantage those people because they were being transferred from one Isle of Man registered bank to another. Clearly, however, they ended up in a slightly different situation than they were before, but in legal terms they did not, they would still have been ---

Q125 Mr Todd: The depositors were given no opportunity to move their savings.

Lord Turner of Ecchinswell: They would have had it at the end of the term of the deposits. Let us remember that the transfer was done on 21 November 2007, so those who had deposits which were maturing over the last year could certainly have chosen at the end of that deposit maturity to move their money elsewhere. I would imagine that would actually be a very significant proportion of them. I accept entirely that they may not have understood the implications of what was going on. They should have because I have in front of me here the letter and the letter in no way implies that Kaupthing Isle of Man is a UK bank, it in no way implies that it has a relationship with Kaupthing Singer & Friedlander and it does not in any way imply that it is regulated by the FSA, which it is not, but I think we can accept that it is a sorry situation.

Q126 Mr Todd: It certainly is because they invested essentially through a British building society and may have imagined, wrongly, that they would be protected by building society law.

Lord Turner of Ecchinswell: They invested in an offshore wing, that is the complication.

Q127 Mr Todd: The brand name may well have led them to think that the association was with a building society and covered by the protective envelope of building society law.

Mr Darling: Can I say just a couple of things here. This is a case where, again, we need to look carefully at what we need to do. We have said time and time again that people ought to be aware of what it is they are investing in, and obviously some of these banks that are not registered in this country use names that perhaps do not immediately alert you to the fact they may not just be yet another British bank. Certainly in relation to the Derbyshire experience, that is clearly something the FSA will want to look at. Most people who put their money into a building society tend not to study all the form and everything else. The second thing that concerns me is we have a situation here where, because Iceland is a member of the European Economic Area, the bank was passported into our system. It is not a satisfactory situation where you have got a branch here which actually had more deposits than it had back in Iceland and we were not regulating it. That is not a satisfactory situation.

Chairman: We raised that point in June, Chancellor. We are going to come back to this issue.

Q128 Mr Brady: Time is very short, so one question but it may need a response both from Lord Turner and the Chancellor. First of all, I would like to know what role the FSA had in advising the

Isle of Man Financial Supervision Commission to require the transfer of £550 million to the UK prior to the freezing of assets in the UK. The other part of that question is does this not mean as that transfer took place that really there is an obligation on the United Kingdom Government to return that £550 million to the administrators in the Isle of Man so that they can fulfil their obligations to the depositors there?

Lord Turner of Ecchinswell: It is not the case that we required them to transfer ---

Q129 Mr Brady: I did not say that you required.

Lord Turner of Ecchinswell: Okay, I thought you did.

Q130 Mr Brady: What contact did the FSA have with the FSC in the Isle of Man?

Lord Turner of Ecchinswell: Let us be clear, the Isle of Man Kaupthing chose to place a deposit with Kaupthing Singer & Friedlander UK. When Kaupthing Singer & Friedlander UK, for reasons which we could talk about separately, which was regulated by us, we decided did not meet the threshold conditions, that deposit with Kaupthing Singer & Friedlander became a general creditor like other general creditors and it will get paid out according to the dissolution of Kaupthing Singer & Friedlander. The only relationship we have had with the Isle of Man authorities in this is that we have explained to them our general processes of how we regulate banks, including how we would regulate, for instance, Kaupthing Singer & Friedlander, but we did not give them specific assurances to say, "This is a necessarily safe bank", because that would not be a reasonable thing for us to do. It is not for us to end up saying to somebody, "We can give you an absolute assurance on this". We can describe our general processes of prudential regulation, but at the end of the day it is for, in this case, the managers, the executive and directors of Kaupthing Isle of Man to make a decision about where they want to place that money and in particular whether they want to put it in a very concentrated fashion, because I think that was a feature, that this was a relatively large deposit relative to the size of Kaupthing Isle of Man.

Q131 Mr Brady: Chancellor, do you accept the responsibility on the British Government to return that £550 million to the Isle of Man savers?

Mr Darling: It does not belong to the British Government.

Q132 Mr Brady: Clearly, that is my point.

Mr Darling: The deposits of Kaupthing were transferred to ING and the rest of Kaupthing's assets here will belong to the creditors. That has to be dealt with through due process. I would just add another thing. I think, having looked at what has happened over the last few months, we really do need to have a long hard look at the relationship between this country and the Isle of Man, a tax haven sitting in the Irish Sea leading to perhaps people not being clear as to what the different rights and responsibilities are. We come to the situation where you have sitting there all sorts of tax advantages accruing from being in the Isle of Man and when things go wrong, people then say, "What about the British compensation scheme?" It is important that we take this opportunity, not rushing into it, not a knee-jerk reaction, to have a look at it and, indeed, that is something your own Committee might want to look at as well.

Chairman: Chancellor, we visited the Isle of Man and Jersey and we are going to be reporting on that. On that graphic note, I think we will bring it to a halt. Chancellor, a few weeks ago the Committee visited Japan to look at their crisis and to see what lessons were to be learned. One major lesson was that public support is important but it may be difficult to gain because of the perception that we are just bailing out banks. Secondly, that conditionality applied to public intervention is important in that it helps to secure mainly public support. That was why you were here today, to explain that situation. We are very grateful for the explanations you have given, but we are at the start of this inquiry and we are going on to international regulation and other aspects and we hope near the end to have you back again because it has been a very worthwhile exercise. We are grateful to all of you for taking time out of your very busy schedules. Thank you very much.