HOUSE OF COMMONS

TREASURY COMMITTEE

BANKING CRISIS

Tuesday 13 January 2009

PROFESSOR WILLEM BUITER, PROFESSOR CHARLES GOODHART

and DR JON DANIELSSON

MR WILL HUTTON, MR RICHARD LAMBERT and MR JON MOULTON

Oral Evidence

Taken before the Treasury Committee

on Tuesday 13 January 2009

Members present

John McFall, in the Chair

Nick Ainger

Mr Graham Brady

Jim Cousins

Mr Stephen Crabb

Mr Michael Fallon

Ms Sally Keeble

Mr Andrew Love

Mr Mark Todd

Sir Peter Viggers

Witnesses: Professor Willem Buiter, Professor of European Political Economy, Professor Charles Goodhart, Professor Emeritus of Banking and Finance, and Dr Jon Danielsson, Financial Markets Group, London School of Economics, gave evidence.

Q1 Chairman: Good morning and welcome to this our first evidence session of the Banking Crisis Inquiry. Dr Danielsson and Professor Goodhart, can you introduce yourselves formally for the shorthand writer, please.

Dr Danielsson: Jon Danielsson, London School of Economics.

Professor Goodhart: Professor Charles Goodhart, although I am actually retired now so I am not sure I can properly call myself Professor.

Q2 Chairman: We take the wise men out of retirement! You are very welcome to this session and we are interested in the banking crisis inquiry in the sense of how did we get into this situation and how do we see our way through this and what will the future regulatory environment be like. Maybe I could start with a general question: what is the finance sector for, Professor Goodhart?

Professor Goodhart: It is to seek to allocate savings to their most efficient and best possible use. I would say it is a mechanism of allocating funds in the best possible way.

Q3 Chairman: Has it succeeded?

Professor Goodhart: It has certainly succeeded a lot better than trying to do it by official diktat as in the Communist countries, who failed because their mechanisms for allocating capital and for ensuring that capital was used efficiently completely collapsed.

Q4 Chairman: Let us just look at the past few years, has it succeeded?

Professor Goodhart: The extension of credit was allowed to go too far too fast and the basis on which credit was extended, particularly in the mortgage sector, in many countries, in the UK as well as in the USA, was inefficiently done.

Q5 Chairman: Is it not to do largely with the underpricing of risk and the lack of due diligence?

Professor Goodhart: Certainly the underpricing of risk and with hindsight, in many cases, there was a lack of due diligence, but to a large extent I think it was a failure to predict the decline in housing prices and the subsequent decline in the economy, so it was a predictive failure, in which I might say that virtually every government and virtually all economists shared.

Q6 Chairman: So massive fallibility then?

Professor Goodhart: Yes and we are not able to forecast the future and the future turned out very different from what people had expected.

Q7 Chairman: Dr Danielsson, maybe you could add to that and take in the question of what is the role of the banking sector within the overall financial sector and how has that performed?

Dr Danielsson: The role of the banking sector is to allocate funds from those who have savings and those who have assets to those needing the money. We have cases where we have no real banking sector and those countries do suffer greatly because there is no way to transmit funds from those who have them to those who need them, so the financial system does provide a very useful and needed service in allocating funds, and if we did not have this system we would sorely miss it. This system has a tendency to over-extend itself. We tend to give too much credit and we tend to get into a bubble situation and the occasional crisis, but, in my view, that is almost an inevitable part of having the system, and if we did not have this type of banking system we would miss it.

Chairman: I will come back to those questions when Professor Buiter comes. Mark Todd?

Q8 Mr Todd: I notice that Professor Goodhart said that there had been an under-pricing of risk and, Dr Danielsson, you have written of the complexity of calculating risk in financial products. There are a lot of highly paid people who do exactly that job. Do you have any advice as to how we can get this right or is it a completely vain hope?

Dr Danielsson: There is one thing that people in the financial system perhaps have not learned from the economists. The economists learned 30 or 40 years ago that you cannot think about the economy as an engineering system whereby you can just create a whole bunch of equations trying to describe how the economy works. That type of thinking was prevalent up until the 1970s and that might exist even today somewhere deep in the bowels of some central banks, but, by and large, we have realised that we need to take into account expectations, and we need to take into account that people are intelligent and people react to rules. By contrast, the financial system is still treated, when you think about models and risk, as if it were an engineering system and treated as if you can take prices in the markets, you can run them through a model and you can get the risk, not realising that people are intelligent and people react to risk, so, in my view, the financial system changed with this observation. If you try to create a rule that will change the dynamics of the system. That process complicates the modelling and therefore if you try to model risk in the financial system as if you were trying to model the risk of nature you will inevitably fail because people react to it. Just to summarise, when you need the risk models the most, they are the least reliable.

Q9 Mr Todd: That is a rather glum picture which suggests that some people have been highly paid for relatively little value in this process. Is that fair?

Dr Danielsson: It depends a little bit on how you look at it because I think those institutions who will survive this crisis the best are the institutions with the best management. To my mind this crisis has shown that it is management of risk that is important.

Q10 Mr Todd: A lot of that sounds down to gut understanding of human beings.

Dr Danielsson: Absolutely correct.

Q11 Mr Todd: And not complicated formulae.

Dr Danielsson: I think trying to take what is a very complicated process and put it into a computer model and try to get an outcome is something that has, by and large, failed. We need to be careful because these models do have a useful purpose within the management process, but taking them to the regulatory side I think has been a failure.

Q12 Mr Todd: One of the gut human instincts would probably have been that liquidity - access to relative easily accessible assets - would be a critical part of the security of any system and yet that has been an area which has been relatively neglected in the control systems we have used. Is that something that we are going to have to devote a great deal more effort to? That is not specifically to you, Dr Danielsson, but do go on.

Dr Danielsson: There is a tendency in all modelling to model what you see and not model what you should be modelling, in other words, you focus on the observable. Liquidity is one of these things that everybody seems to know what it is but nobody has been able to properly define it. We can talk about it conceptually but trying to model liquidity in a statistical decision-making model has been until now impossible, and therefore, as a consequence, even if everybody realised that liquidity was important, because you could not model it and you could not put it into a decision-making process, it was not part of the models, so it sort of got brushed under the table and now all of these proposals on liquidity do not focus on modelling, they focus on management.

Q13 Mr Todd: In other words, it is back to human beings and understanding what seems like a rational approach to access to cash essentially?

Dr Danielsson: I could not agree more.

Professor Goodhart: Going back to the Chairman's opening position, I think that the lack of concern with liquidity that had been shown previously, particularly by regulators, was out of a belief that the wholesale markets, where most banks went to get their marginal funding, were very efficient and would work and would be open under all circumstances as long as the banks had sufficient capital, and it was that belief that wholesale markets will always work efficiently, subject to the banks abiding by the capital requirements, which was shown not to succeed from August 2007 onwards, and those wholesale markets are still not working properly. The banks' search for liquidity has consistently shifted from holding liquid assets to the belief that they could obtain additional funding by going to these wholesale markets. It was the failure of these wholesale markets that brought concern about liquidity back to the centre of the stage.

Q14 Mr Todd: So what should a regulatory system for liquidity look like?

Professor Goodhart: Well, there very nearly was such a system introduced in fact in the 1980s. At the same time as the Basle Committee was introducing an accord on capital they were searching for an accord on liquidity, but that search ran into difficulties, and effectively got dropped in the 1980s, it became too difficult for them to proceed, and the process went on then continuously whereby the banks turned for their additional funding, their liquidity, to the wholesale markets and more and more got rid of their lower yielding but highly liquid public sector debt, to the point where the British banks entered the crisis in 2007 holding a really minimal amount of highly liquid British government debt.

Q15 Mr Todd: Fine, so you are suggesting in terms of a regulatory environment for the future?

Professor Goodhart: We would need to go back to look at an appropriate regime for liquidity.

Q16 Mr Todd: And Basle II - back to the drawing board?

Professor Goodhart: Basle II has got a lot of good features. I think it is the best system that I know for trying to ensure the adequacy and the constraint on risk-taking of the individual system. Where it fell down completely was in looking at the systemic risk, the macro credentials, compared to the micro credential risk. It is not that Basle II is wrong or bad; it is just totally and completely insufficient in that it did not look appropriately at the systemic issues. To take a particular and very obvious example, for an individual institution which is running into difficulties with insufficient capital, the obvious thing for it to do is to cut back its total size by reducing its loans and refusing to make additional loans, but if everybody does that, as is very obvious now, the system and the economy runs into extraordinary difficulties, so what is sensible and prudent for the individual bank and individual institution frequently makes no sense at all for the system as a whole, and it is systemic issues that Basle II did not deal with.

Q17 Mr Todd: Just one last point, if we tighten controls on liquidity, is not one of the inevitable consequences that we will actually slow the recovery from the current credit crunch because we will have a more conservative set of instruments which will require banks to hold more assets in readily convertible forms?

Professor Goodhart: That is actually a generalised problem in the sense that at a time of crisis the tendency of the regulators is to tighten up on everything, but the more that you tighten up, whether it is on capital, liquidity or anything else, the less easy it is for the banks to undertake expansion because you are tightening the controls, and I think that is of greater concern on the capital side than it is on the liquidity side because at the moment there are no real liquidity constraints. The FSA did introduce a 9% requirement very recently, but apart from the FSA's recent measures the constraints have been on the capital side, and the desire has been to raise capital ratios up to 12%, and now everyone is saying, "We did not really mean 12. 12 is fully what we would like to have but under pressure we would be perfectly happy for you to go down." Indeed, one of the issues here is that what you want in your regulation generally is counter-cyclical so that they really tighten and prevent the banks going crazy during these asset price booms and bubbles and then when everything gets difficult in the bust and everyone is incredibly cautious anyhow then the regulations get eased.

Q18 Chairman: Professor Buiter, welcome to the Committee.

Professor Buiter: My apologies for being late.

Q19 Chairman: We are grateful that you are here and, as you know, this is the first evidence session of the banking crisis inquiry. I asked your fellow panellists before you came in: what is a financial sector for and what is the role of the banking sector within the financial sector?

Professor Buiter: The banking sector intermediates between savers and investors and it allocates financial portfolios and allows the trading of risk. It is an essential part of the transmission mechanism for monetary policy and indeed also to an extent for fiscal policy, and when it malfunctions the real economy suffers grievously, as you see. It depends how you define banks. I am talking here about highly leveraged institutions that are very much more liquid on the liability side than they are on the asset side. Deposit-taking and making loans would be the classical bank example, but generally I think anything that is highly leveraged and uses a lot of borrowed money compared to its own resources and that funds itself short and liquid (normally) and invests long and illiquid is a bank. My description means that there is no such thing as a safe bank, of course. The only reason that banks, which are institutions that have big signs on them "please state your run on me", survive is because of the nature of what they do and if they have an implicit or explicit guarantee at the very least of funding provided from the ultimate source of liquidity, which is the central bank, should the liquidity of that funding suddenly dry up. No bank can be safe unless it has a market maker of last resort and a lender of last resort standing by. That said, also on the liquidity issue I think we have to be very careful that we do not end up in a world where banks and other financial institutions are required to always hold the liquidity required to cope with the worst contingency. Liquidity is to a large extent a public good. It is a property of assets that can disappear when trust and confidence disappear. Certain assets are almost always liquid. Government assets tend to have that property, although if you go to Zimbabwe even public assets, public money is not liquid any more. It means that although banks and private institutions could provide for their own liquidity by holding large amounts of treasury bills, I think it would be highly inefficient to do so because they would not be able to engage in their socially useful function of borrowing short and lending illiquid, rather than lending liquid, which they would be doing, or investing liquid if they invested in treasury securities. Sure, they will need some but banks should not be required to hold more inherently liquid assets than is necessary for the ordinary conduct of business during ordinary markets. For the rest the central bank has to be on stand-by. The Bank of England was not and part of the problems that we are seeing is because of that. They now are better attuned to the job and they should therefore let the public good of liquidity be to a large extent publicly provided in an emergency rather than force us to provide it privately always.

Q20 Chairman: In this banking crisis inquiry we are looking at how we arrived at this situation, how we get ourselves through the present situation, and what the regulatory environment will look like in the future. On the first point of how did we get into this situation, could you give us your views?

Professor Buiter: In many ways it is a classic credit and asset boom; excessive lending and excessive leverage which became more and more risky. That is how credit booms and credit busts happen. It took some new forms and it was regionally more widespread. We had securitisation problems in the US which of course were not restricted to the subprime market, but became an issue there, but there were country-specific financial excesses in most countries in the North Atlantic area. British households had debt equal to 70% of disposable income abd that had very little to do with US subprime debt, and there was general regulatory failure because of the growing belief that self-regulation and, if intervention was required, the so-called principles-based light-touch regulation would be sufficient. I think that is and was an illusion. Financial markets are very useful but inherently fragile and dangerous institutions, and the notion that it could be self-regulating was always ludicrous. Even Mr Greenspan recognises that now, somewhat belatedly. There was a general lowering of regulatory standards. The fact that finance - and I am talking here about the finance of border-crossing financial institutions of which there may be 60 to 80 institutions that matter globally - the fact that the domain of the market and the range over which these institutions roam is global and regulation is national means that, whatever you do, these firms and financial innovation will be running rings around the regulators. The logic of a global market is to have a global regulator. You cannot have that, I recognise that, but that has implications that you will always be in an environment where regulatory arbitrage will undercut regulatory effectiveness, not just because of innovation within a nation but competition between nations. Regulatory standards were used to attract financial business.

Q21 Chairman: So from what you are saying it seems as if there was a misplaced faith in that market mechanism in the past few years?

Professor Buiter: Yes, in the self-regulating sense.

Q22 Chairman: How does the current crisis then compare to that, say, of Japan in the mid-1990s and the Wall Street Crash of 1929? Are there any comparisons?

Professor Buiter: In many ways they are very similar. The Japanese boom was of course much bigger than anything we have seen and the bust has been much, much bigger than anything I hope will see. Their stock market came down 90%, was it?

Professor Goodhart: Nikkei was at 38,000 at its height; it is now at about 8,400.

Professor Buiter: So that is a healthy decline! A massive asset boom and bubble and a massive bust, and in Japan of course that was followed by spectacular policy incompetence. There was no serious attempt to address the toxic asset issue for seven years. The recapitalisations that took place really were late and inadequate and the banks were allowed to go on making zombie loans to zombie institutions rather than trying to clear the debt. I hope that Japan provides an example at least as regards the policy response on how not to do things. They did certain things right. Keeping the zero interest policy and engaging in quantitative easing is clearly something that will have to be emulated here, as is the case already in the United States, but their reluctance to clear or to ring-fence the toxic assets, to recapitalise the banks, and the willingness to let the overhang of bad assets become a tax on new lending to potential profitable enterprises are all warnings of what we should avoid, and we have done so far. The US in the 1920s was again just a big bubble that burst and a very perverse monetary policy response where monetary policy actually tightened.

Professor Goodhart: And in all three cases the real economy had behaved very well in the years up to that. The 1920s were years of low inflation and steady growth in the US. The 1980s in Japan was a golden era. The period between 1992 and 2007 was probably the best years of economic developments that the world has ever seen and this had led people to believe that risks generally had declined, that we would not see future problems, so everyone poured into asset markets because risk had gone, and of course risk had not gone.

Q23 Chairman: It was a great moderation.

Professor Buiter: There were also great moderations in the 1920s and in Japan as well.

Q24 Mr Crabb: Professor Buiter, you describe the general regulatory failure: do you think that the international architecture for financial regulation now needs to change given the current crisis?

Professor Buiter: It needs to but it will be extremely difficult. In any regulatory regime that one can think of one will have the US doing its own thing because they are not going to be agreeable to being bound by international agreements and certainly not regulated by a foreign entity. I think the best we can hope for is that we come to a single European regulator for the European Union for border-crossing institutions. That would take care of 27 dimensions of regulatory arbitrage - not enough, but it is a lot easier to reach agreement between a single EU regulator for border-crossing financial institutions and the Americans and the Japanese and maybe the Chinese and the Indians. At the moment I think there are just too many unco-ordinated, mutually undercutting regulatory regimes.

Q25 Mr Crabb: Professor Goodhart, would you share that view?

Professor Goodhart: I do not think a single European regulator is feasible at the moment, even if it is desirable. As everyone has seen, when a crisis comes you need to recapitalise the banks. Recapitalisation is enormously expensive, so you need to have a regulator that has access to funds via a ministry of finance or treasury. There is not a federal ministry of finance or treasury who could provide such funds. Without such European funding, without a European fiscal competence in that respect, effectively the exercise of trying to ensure that their banking systems remain viable has unfortunately got to remain within the nation state. I fear that under these circumstances with a global system and national regulators what is actually going to be needed is to have rather more power to the national regulator rather than less, so that the national regulator can see the development of asset price bubbles and credit bubbles in their own economy and take the appropriate steps to prevent that making their own country's financial system become at risk.

Q26 Mr Crabb: Do you think that the current crisis reveals a failure on the part of the IMF in terms of sending out warning signals?

Professor Goodhart: No, they did send out warnings. This idea that there were no warning signals from central banks, there were loads of warning signals, particularly from the BIS. This stuff about early warning signals is actually pure nonsense. It is not that there were not enough early warning signals. Everybody forecast that the situation was getting dangerous because risk was being underpriced; the problem was not the lack of early warnings. The problem was the lack of both instruments and willingness to do anything about it.

Q27 Mr Crabb: So how should we improve those instruments to ensure that sovereign states take heed of the warnings?

Professor Goodhart: That is very difficult because in a boom everyone loves it and the idea that you are going to have a regulator saying, "I am sorry, we are not going to have 100% or 125% loan to value ratios; Northern Rock, you are not allowed to behave that way, you are not allowed to do subprime mortgages based on nothing except the expectation that housing prices will go on rising, you are not allowed to do that," runs counter to the wishes of the lenders, the borrowers, and virtually every politician at the time during the boom, so what you are asking regulators to do is effectively to take the punch bowl away when the party is going, and that is not a popular activity.

Professor Buiter: The regulators were not terribly keen, to be honest. During a big asset boom/credit boom there is universal capture of the regulators and the political process by the financial sector. You can see that because who argues with success? People who take home £50 million a year must be doing something right. It is very hard to interrupt that spiral until it is done by brute force through an implosion of the bubble. There is no willingness among the regulators or among the political classes to interfere with an asset boom or a credit boom. I have never seen that.

Professor Goodhart: The subprime market was regarded as a triumph in 2004-2006. It was providing access to home ownership for the disadvantaged class in America. This was regarded as one of the great triumphs of finance.

Professor Buiter: Finance as social engineering - it was.

Q28 Sir Peter Viggers: The crisis is of course worldwide. Was the UK economy in better or worse shape to cope with the problems a couple of years ago?

Professor Buiter: Compared to?

Q29 Sir Peter Viggers: Compared with other countries?

Professor Buiter: Probably in the worst shape maybe after the US. It has the largest financial sector relative to size of economy of the major industrial countries. Only much smaller countries have balance sheets with 400-450% of GDP for their banking sector. It had this long-standing boom which had resulted in this very highly leveraged housing sector. The corporate non-financial sector is actually in quite good shape but between the banking sector and its inherent fragility and the over-leveraged households, and I think also the stretched public finances, the pro-cyclical fiscal behaviour of the second part of the Labour administration made the boom larger than it would have been and also made it more difficult of course to respond effectively with counter-cyclical measures once this becomes necessary as it is now. Britain of all the larger countries was probably the most vulnerable; it was not Iceland but it was not as it should have been.

Q30 Sir Peter Viggers: Professor Buiter, you made a passing reference to ring-fencing toxic assets which sparked my thinking that the nearest analogue to the present situation is of Lloyd's of London in the 1990s where scrupulous efforts were made to identify and isolate toxic assets. Is this something which is being done sufficiently? Is it important and what messages are there here?

Professor Buiter: In the US also it is the one part of the Government's arsenal that has not really been used yet. The TARP was set up to buy up toxic assets. In fact it has not been used for that. The only successful example of toxic asset ring-fencing inside an institution in this case is in the Citigroup deal where £200 billion or £300 billion-worth of dodgy assets is insured now by the Treasury so that if their value falls below a certain level they go in, so that is a way of providing financial support for that. I think that one wants these assets either off the books or ring-fenced on the books in the way that they can be dealt with, their true value, or lack of it, is, revealed, that the remaining uncertainty is taken away and then that the state, if it is the only one who can carry that load, can take them on its books and try to make in the long run as much money out of them as they can. They may have to be held to maturity.

Q31 Sir Peter Viggers: The question of the future of securitisation, the model of 'originate-to-distribute', which has been a very important part of our system and of course the boom, to what extent will the system self-regulate? To what extent will people who have had their fingers burnt withdraw from this field? And to what extent will further regulation be needed?

Professor Buiter: For three years they will withdraw. That is the half-life of memory in the financial markets. There is nothing wrong with securitisation. It is a wonderful invention to make the illiquid liquid and the non-tradable tradable. The problem is that when you commoditise relationships, which effectively you do and make them tradable, you tend to destroy the incentive for gathering information or weaken the value of the information from the original borrower. What information is gathered is no longer traded with the instruments when they get bundled with 7,000 other instruments. Some of the CDOs apparently if you were to read all the documentation that ought to go with it it ran into four million pages which even the very well-paid lawyer would not have time to deal with. The lesson is very simple: we can have securitisation; we will have it again; it is an important source of finance, but we need to force the originator to hold onto a sizable chunk of the first loss or equity tranche of the securitised commodities. That keeps the incentive for gathering the information and monitoring the relationship intact.

Dr Danielsson: Securitisation is something that we would sorely miss if we did not have it. It does provide quite a useful function. In addition to what Willem said, there are a couple of things about securitisation that went wrong in the crisis. Most of these instruments are what are called over-the-counter. They are bilateral agreements between one bank and one client. Therefore there is no way to figure out what exactly is an appropriate market price for these instruments and when there is a problem there is no way to add up all the exposures of the entities. I would think in the future the focus on regulation will be to make all these instruments transparent and liquid and traded on an exchange. If we had taken many of the CDOs and the subprime assets and CDSs, if all of this stuff was traded on an exchange like the London Stock Exchange or some other exchange, then you would have a couple of benefits. Number one, you could immediately figure out what exactly is the exposure of an individual institution. Somebody buying the stuff could figure out what is the appropriate market price, and in trouble, especially like the Lehman Brothers, when they went under they had a few hundred billion dollars worth of CDSs and the problem is nobody really knew what was the net exposure of Lehman's. After they defaulted you could finally sit down and do the calculation. They figured out that the net exposure of Lehman was $6 billion, a lot smaller than anybody suspected. If these instruments had been traded on an exchange, that would have been known prior to the default of Lehman's so they might still be alive. In the future we need to keep those instruments, they are useful, but they do need to be traded on an exchange so that they are transparent, we understand the risk, and any buyers get an appropriate price and can dispose of them if need be.

Chairman: Thank you very much. We are hoping to finish for 11 o'clock. The answers are fascinating but if you could make them a little bit shorter, thank you. Jim?

Q32 Jim Cousins: I am a little confused by what we are being told. Professor Goodhart and Professor Buiter, are you telling us that those in charge of the financial system did not see the problem or that they did not warn people effectively enough about it or just that they did not have the guts to stop the party?

Professor Goodhart: Basically the last. The BIS and the Bank of England and most other central banks knew that risk was underpriced and they were worried before the event that there would be some kind of severe reversal. They did not know where it was going to come from, they did not know the exact trigger, but they were aware that there were problems, but I do not think that they were prepared to take the tough actions and they did not really have the instruments to do so. They were not able to turn round to the banks and building societies and say, "You shouldn't make loans at such high loan-to-value ratios," for example.

Professor Buiter: I do not think that regulators saw what was coming. There were general warnings. Indeed, the risk rate had become ridiculously low and things were unsustainable but nobody foresaw the complete freezing up of all wholesale markets that mattered and nobody anticipated that the world's leading banks would be socialised or living under a government umbrella by the end of 2008, so I think the magnitude of what was going wrong was not seen by anybody, at least nobody that went on the record. There were warnings and they were not heeded. They were not heeded basically because people feel that they cannot argue with billions.

Q33 Jim Cousins: Does that not leave a serious issue of the quality of leadership right at the top of this? Was it wise for political leaders to have an embedded view that the trade cycle had been abolished? Was it a failure of leadership at the Bank of England that there was this obsession with moral hazard? If you are right in saying that people had indeed identified the problem, then is it not sensible to look to what the leaders said for an explanation?

Professor Buiter: I would agree with that except for the bit about moral hazard. I think there has been far too little attention paid to moral hazard. I think that would be a description of part of the reason we are in this mess and even in the resolution of the crisis we seem to often go out of our way, when there are options available to put out a fire in a number of ways, to go for the way that maximises moral hazard instead of minimising it, so I would not fault the Bank at all for warning about moral hazard; I think it is what kills honest finance and so it is very serious. Yes, I think the political classes were part of a wider climate of opinion that believed in the great moderation. The end of boom and bust is not a word for the great moderation. It is the country-specific version of that. Economists in my profession believed it as well.

Professor Goodhart: And economic leadership in 2005 and 2006 was being congratulated for having achieved the best results that the world had ever seen, and that is in a sense part of the problem. It was a belief that we had overcome the economic and financial problems of the world and it led to hubris, particularly within the financial sector. If there is no risk, just pile on the leverage, add to the balance sheet, buy whatever asset you can, and take home the kind of millions that Willem was talking about as a bonus.

Q34 Jim Cousins: Dr Danielsson, I believe in one of your earlier writings you actually used the term 'hubris'. You have just made a case for ending the over-the-counter trading system and putting everything through properly regulated exchanges. You have made that case now. That case has been on the table for a number of years. Why did it not happen?

Dr Danielsson: There are a few reasons why. Number one, one thing that happened with risk is that for an individual bank complexity is profitable. The more complicated you make your products the more money you make. This is a difficult problem because the individual making things complicated over the counter is not at the top of the bank, it is in the middle of the bank. This is the 'quant guys', the 35-year-old, whatever he is; he creates instruments. His boss has no understanding of what he has is doing, the regulator has no understanding of what he is doing. All they know is that he is making money from some black box.

Q35 Jim Cousins: Yes, but Dr Danielsson, that is fine, we have heard that a number of times; we believe it. The issue is you have just raised the strong policy point about ending over-the-counter trading and putting it through regulated exchanges. That is not a new point. What I am asking you, Dr Danielsson, is why did that not happen?

Dr Danielsson: The reason is because these complex products were so profitable that the banks lobbied very strenuously against making anything over-the-counter and because the products were so complicated the banks had all the cards. They could make the case to the regulators in a way that the regulators did not understand what they were being told. By making things complicated you look as if you know the answer to the problem and it is very difficult for anybody to argue against it. Because over-the-counter products are ten times more profitable than traded products, the banks like them. For the banks complexity is profitable. That is where the lobbying was the regulator was in a very difficult position to resist.

Q36 Jim Cousins: Dr Danielsson, you have said that the regulator was in a difficult position. Where is your evidence for a regulator, or anyone in our regulatory system, this great triad of institutions, wanting to end the system of over-the-counter trading and to put it through properly regulated exchanges but they were frustrated by the money men? Where is your evidence for that?

Dr Danielsson: There have been a number of studies and statements by policymakers that they would like to see those instruments being traded. One thing that was a great worry prior to this was the fact that the clearing system was seizing up, so a number of central banks had made a very strong case in favour of reducing the number of over-the-counter products and making them cleared very quickly.

Q37 Jim Cousins: Including our own?

Dr Danielsson: I do not know if the Bank of England has done so but I know a number of central banks have made that case. This has been discussed very widely in policy circles for a number of years.

Professor Goodhart: The Federal Reserve Bank of New York has traditionally taken the lead in trying to bring about improvements in these derivative markets (because they are primarily derivative markets) and there is a group called the CRNG which is a group to try and improve the functioning of derivative markets at the moment which is trying to move rapidly towards a central clearing house for instruments such as CDSs.

Q38 Ms Keeble: I wanted to ask a bit more about the instruments and levers that you have referred to, in particular, Professor Goodhart, when you gave evidence to the Committee on ten years after the MPC you said that you thought there should be other levers other than just interest rates although you were not specific as to whether it should be applied by the MPC, the Bank or the FSA. I wonder whether you are still of that view that the MPC in particular requires different levers and, if so, what?

Professor Goodhart: No, not the MPC. The MPC is a committee which has a remit from the Chancellor of the Exchequer, and therefore indirectly from Parliament, to achieve a specific object which is price stability as measured by a specific inflation target. The interest rate is, under normal circumstance, the instrument which the MPC uses for that purpose. When you come to look at financial stability, you are looking at a field in which there has got to be much more co-ordination between the central bank, the FSA and indeed the Treasury because if anything goes wrong ultimately it goes back to the taxpayer, so you are not looking at the MPC because it is a different remit, it is financial stability, and one is looking much more at the financial stability committees and instruments that might be used by them. My own preference is for a division between the instruments that look at the condition of the individual institution and maybe the individual market, which will be the responsibility of the FSA, and instruments which would be able to have an effect on the system as a whole, which I would like to see wielded by the Bank of England, specifically not by the MPC but by a separate financial stability committee.

Q39 Ms Keeble: At present there is obviously rather the counter-position in that there are historically low interest rate but much to public anger they are not being passed on. What instruments or what pressures or what levers could be used to get those low interest rates being passed on?

Professor Goodhart: There is an issue about whether lending at the moment by the banks is going to be sufficiently profitable for them to want to undertake it. Remember that there is a margin now between the official interest rate and the rates that banks can borrow from each other in the inter-bank market and the wholesale markets and, moreover, when you are thinking of lending there is a much greater concern about fear of default, so the default risk is much higher, so that the interest rates that the banks will want to charge in order to ensure that their lending is profitable are relatively high compared to the Bank of England's official rate at this moment. If you want banks to go on lending, you have got to enable them to charge a rate at which that lending will be reasonably profitable. There is a continuous tension between the desire not to let the banks get away with anything and making sure that taxpayers' moneys are going to be recovered and at the same time to enable the banks to have sufficient profitability in lending to make them want to expand it.

Q40 Ms Keeble: So is there something further the Government could do either to do with the risk or the profitability?

Professor Goodhart: There are lots of things that the Government can do and some things that the Government ought to do. For one thing in order to keep the system sufficiently liquid and monetary growth sufficiently high, the Government ought to be under-funding the deficit. The one single thing that I would like to see from them in a sense to get us out of the present problem would be very simple: we sack the Debt Management Office and just not issue gilts for quite a long time so that the huge deficit simply comes into the system in the form of increases in liquidity and increases in the money supply. I am very keen to see that. When the banks are having difficulty in lending to the private sector there needs to be a much greater expansion of bank lending to the public sector. That has not yet really started. It needs to be done. Another issue which goes back to the toxic assets, it is not just the toxic assets, the problem is that many of the better mortgage-backed assets, the stuff that was triple A, are now being traded, insofar as they are traded at all, at prices which are far below the expected cash flow and expected ultimate repayment, because people do repay their mortgages as often as they possibly can. Under those circumstances what is probably needed is continued guaranteeing not of the worst assets but on the relatively good assets, which are now trading at vastly under-valued rates, and cannot easily be sold. If you could get the triple A stuff which is mortgage-backed being properly traded and at a reasonable price you would find that you would unlock and unblock quite of lot of what is going on in the banking system.

Q41 Ms Keeble: Professor Buiter, I will ask both my next questions at once which are about risk, and perhaps if Dr Danielsson wants to come in on that that would be helpful, but in terms of assessment of risk which you have written and spoken about quite a lot, from the earlier discussion it seemed to be that there was a view that that should be down to due diligence by investors. To what extent do you think the credit ratings agencies have been culpable in what they have done and that they should be further regulated? As a second question, when you were talking about Japan, you said almost in passing that you thought that quantitative easing was inevitable here. I wonder if you could just expand on that comment.

Professor Buiter: The credit ratings agencies of course and those who used them are culpable. The credit rating agencies got into a line of business that they did not understand. They were reasonable at rating sovereign and large corporates and not at rating complex structures, but they did it anyway and they were hopelessly conflicting. Part of the solution is to take away their quasi official regulatory role, take them out of the Basle II accords, make them single product firms that just do ratings, no other financial products and services and pay them partly in the securities they are rating and force them to hang on to them. As regards what I would call quantitative and qualitative easing especially, which is the central bank on behalf of the Government really taking significant credit risk and illiquid assets on its portfolio, part of the solution is to get the spreads between the banks' funding cost and the official policy rate (which is not the banks' funding cost) down. That should be a continuation of what is already happening - the rapid expansion of the balance sheet of the Bank of England. I would not want to put government securities on it in the way that Charles apparently does because I think rates on long-dated government securities are already very low. That is not where the problem is. I would have to bank aggressively, purchase as an agent for the government really, based on the right default risk associated with that, private securities of the kind that have the most pay-off - mortgages, mortgage-backed securities, even corporate loans, commercial paper, those kinds of things.

Q42 Nick Ainger: This is a question initially directed at Professor Goodhart and Dr Danielsson. Your colleague sitting next to you has written: "Banks that don't lend to the non-financial enterprise sector and to households are completely and utterly useless, like tits on a bull. If they won't lend spontaneously, it is the job of the government to make them lend." Do you agree with that? Should the Government now be directing banks to lend?

Professor Goodhart: Banks are profit maximising entities and they will lend when they can see that there is a sufficient return from doing so. The problem at the moment is that they do not see that there is a sufficient return from such lending. I think this is partly because they are too scared and I think that government guarantees, because they are so scared, would actually help. I think that directing banks to lend would simply be a retrograde step. If the Government wants loans to be made at rates which the banks do not think are viable, then the Government should make them itself.

Dr Danielsson: Just to add a little bit to that. I think we should keep in mind that the banks today are being prudent under current regulations. Under the system we have today in a recession, they are supposed to lend less, they are supposed to withdraw from risky activities and preserve their capital. That is exactly what they are doing. On the one hand the banks are doing exactly what they are supposed to do. The policy response has been interesting. On the one hand we want them to lend more and on the other hand we want them to lend less. On a slightly longer term scale we do need to find a way to adjust the regulatory mechanism so that in a downturn banks become a little bit less prudent and in an upturn they become more prudent. That is a longer term issue. I would otherwise agree very much with Charles that the banks are profit-maximising and, if anything, experience has taught us that just about the worst entity for allocating credit in the economy is the government. We would rather have the banks do it as a profit-maximising entity rather than government, as a general rule.

Q43 Nick Ainger: The investments that have been made by the Government in banks, some commentators have said that again there is this contradiction that in order to protect the taxpayer and possibly to send a reminder to banks that the 12% interest rate on the preference shares that is actually preventing the banks from lending. Would you want to comment on that?

Professor Goodhart: Lots of other countries followed the measures and steps that were taken by the Prime Minister on 8 October, but none of the other countries imposed anything like as severe a penalty rate on their banks as we did. I think that it was too high, it was counterproductive and, as you say, there was an inconsistency between, on the one hand, wanting to ensure that the taxpayer does not lose, if anything gains, from the funding provided to the banks, and on the other hand a wish that the banks expand lending. If you are going to impose or put funding with banks on terms which are disadvantageous to the banks, the banks will do everything they can to get rid of it as quickly as they can, and that usually means not expanding their balance sheet.

Dr Danielsson: I could not agree more, I have nothing to add to that.

Professor Buiter: There is nothing wrong with making the banks pay a very high price for government support because, after all, they have failed. You have to discourage the kind of behaviour that brought this about and a financial penalty is the best way of doing that. As a consequence banks stop lending simply because they want to get rid of the government or those that are not yet subject to this arrangement want to prevent falling into the clutches of the government. That situation can only be remedied either by making the capitalisations by the government mandatory and not giving banks discretion as to when to get rid of it, or to complement it by forcing lending in the aggregate. I would not micro-ration lending but I would assign the banks totals of lending that they should use or lose. So they would still lend to the most profitable activities but what they did not lend under the target would be taxed away. I think that is an implication of trying to create the right incentives for future behaviour once this crisis is out of the way. We did not have to start from here, but given where we are the worst thing you can do is say, "Okay, do what the Americans did, first talk tough, like AIG, and then allow them to pay off an expensive credit line with a cheap one". That basically tells people you can do this again because they will be able to get away with it, there will be no penalties. You have to impose penalties when you can and now is the time that you can prevent damage to the real economy by forced lending in the aggregate.

Professor Goodhart: I think under-funding the deficit would be far less damaging to the economy than my colleague's proposals of requiring the banks to achieve some forced minimum amount of lending to the private sector.

Q44 Nick Ainger: I assume you do not agree with him about the nationalisation of banks either?

Professor Goodhart: I think that "nationalisation" is an unfortunate word. In the Swedish bank crisis the banks were taken over completely by the government with the intention of reselling them. I think that may well have to happen in some other countries, not necessarily excluding the UK. Government temporary ownership of the banks is not necessarily something to be refused or avoided, but the idea that the Government should go on owning the banks indefinitely would be a very bad thing.

Q45 Mr Brady: Professor Buiter, you spoke about the importance of dealing with toxic assets, but how should we do that? What model should be followed?

Professor Buiter: I would create a facility like the one that was created for the safety and loan toxic asst, admittedly a lot easier because it is all property, but create a state agency that buys the stuff and either sells it later or sits on it until the assets mature.

Q46 Mr Brady: Buys it at what price?

Professor Buiter: At this point, since we have recapitalised banks anyway, at any price that the banks are willing to part with it. I would price it quite aggressively at more than they can get in the market but less than the best estimate of the present value of future cash flow at a reasonable interest rate. A lot of these things are very difficult to value and in that case just give the banks a take it or leave it offer. They should not be allowed to carry stuff on their books that is effectively not valued or valuable. If that is the situation they are in there should be just one entity that without liquidity constraints can hang onto things that cannot be valued and watch the cash flows come in, or not, over the life of the instrument.

Q47 Mr Brady: Do the other two witnesses agree that the toxic assets have to be dealt with? Is that fundamental?

Dr Danielsson: A lot of these toxic assets are low priced not because they are toxic but because there is no liquidity in the market. Some of them, of course, are highly toxic. I saw a calculation which said that some of the CDOs are based on a calculation of 90% of US mortgages defaulting, which makes no sense. The problem is that there is no liquidity in the market to buy them. If you were able to somehow do a "bad bank, good bank" model, split the toxic assets up, put them into a bank for the government to hold them until maturity, I am sure for a lot of these assets the government would not be losing that much money. The problem is with valuation as you have correctly identified. If Charles' scenario of the government completely nationalising the banks happens then that problem is solved because you can just split them up. Trying to identify the toxic assets prior to this is very difficult because the banks will have an incentive to sell the most toxic to the government and there is no proper market mechanism for doing that. Trying to get toxic assets out of the banks prior to nationalisation is a very difficult, if not impossible task and after Charles' nationalisation it becomes trivial.

Professor Goodhart: I think the better approach is to go for guarantees of the better quality mortgage backed assets first. You can certainly do an exercise of trying to have a "bad bank, good bank" model, it was done in Switzerland very recently with UBS, but I think guarantees of the better mortgage backed assets initially would be an easier and simpler exercise.

Q48 Mr Brady: You would do that initially, but you may still have to do the ---

Professor Buiter: Is this for new issues or existing?

Professor Goodhart: I think it would be for existing, yes.

Q49 Mr Brady: Can I move on to something completely different. Was the Government's approach to the Icelandic banks the correct one?

Dr Danielsson: I guess I should take that up being from that poor little country. The problem with the Icelandic banks crystallised the question that was put earlier about international co-ordination of the national regulations. What we have at the moment is a system where we have international regulations and international rules but domestic enforcement. We have not really had any proper cross-border blow-up of a bank, except that one, and this should send a warning signal that it is not viable to have a system where you have global regulations and national supervision, national enforcement. Within the European Union, if we are going to have the banking rules as we had them, we do need to have national supervision. As to that particular case, the reason why these banks came to this country was because they could not borrow elsewhere, they could not borrow from other banks. That should have sent warning signals both to the FSA and to its Icelandic counterparts. As they were increasingly getting money from this country and elsewhere, increasingly investing it into risky assets, on one level you might say they were gambling for resurrection, but the FSA should have become increasingly worried about that. However, I suspect it might have been a way to bring those banks under the UK regulatory umbrella and it may be that the price for doing so was too high, I do not know. As to the specific response of the UK authorities to this, I think in many ways they did exactly what they had to, they had to protect their own interests, but there was one big mistake there and the mistake was when they decided to take over the assets of the bank by using anti-terrorism laws. There are three big problems with that. First of all, in my mind it undermines the fight against terrorism to use such a big weapon against such a small non-terrorist target and the next time the Government wants to use anti-terrorism laws people will point to that mistake and say, "Maybe there is something wrong with what you are doing".

Q50 Mr Brady: Because we are short of time I just want to cover one other issue. Given the guarantees and the compensation that has been given to investors in Northern Rock, Bradford & Bingley, some of the Icelandic banks and so on, how do we get back to the idea of moral hazard in a sensible way? Perhaps I am directing this to Professor Buiter. Is there not a danger that all depositors are going to feel that they are always safe?

Professor Buiter: I think in the future the incentive structure for the banking sector will be horrendous. We are going to be living with the consequences of what we have done for years. Ireland is an extreme example where the entire balance sheet was guaranteed. Here, everybody's deposit guarantees have gone up to ridiculous levels where the protection of widows and orphans is no longer an issue. Also, of course, from the financial stability point of view you do not need deposit insurance, you need lender of last resort. They are alternatives and you do not need them both. These are very bad incentives for sensible management and sensible risk-taking in the future and we just have to try and get out of it as soon as possible. International co-operation is essential. The worst was prevented in the case of the EU the weekend after Ireland did its "everything is guaranteed as long as it is Irish" because every European country started raising its deposit limits, some unlimited. Fortunately, there was enough dismay at what was done in Ireland, especially here in Britain where Alistair Darling and Gordon Brown made very strong representations that this was ludicrous and distorted the competitive level playing field, that there was some limitation of the damage, but that was all it was. We are going to have to get back to international agreements on ensured amounts otherwise moral hazard will be king.

Q51 Mr Fallon: Professor Goodhart, coming back to the terms of the bank bailout, apart from the 12% rate on the coupon, were there any other terms which you disagreed with?

Professor Goodhart: I think the restriction on dividends was entirely understandable given the shortage of funds. The guarantees were sensible. It was really the cost of the money that I think was too high, otherwise it was extremely well-done. The British initiative at that time was correct and it was followed round the world, and rightly so.

Professor Buiter: One trick that was missed was that the top management and the boards of all the institutions should have been told to go because the British banks had failed and they had to go to the public trough. The fact that it only happened to a few people continues the moral hazard in the future. The fact that the incumbents stayed by and large is strange.

Professor Goodhart: I have to differ from my colleague on that. After all, the appointment of the top CEO and people on the board is a subject for the shareholders. One of the concerns that I think a lot of us have is that shareholders' rights were trampled on all over the place. Under crisis conditions I think that is right, but for the Government to step in and say, "We are going to get rid of X, Y and Z" when they were not the owners would have been a step too far. You have to have proper governance and proper governance is, after all, a matter for Government. I do not think that Government should take steps to remove management when that is the job of the shareholders. I rather agree with Willem that management has failed and the shareholders should have taken steps to get rid of many, if not all, of the CEOs and the chief managers of their banks, but it is for them under these circumstances and not for the Government.

Q52 Mr Fallon: The Government shareholding is now to be managed through UKFI. How can UKFI protect the taxpayers' interests but operate at arm's length, yet still want to get involved in issues such as the level of lending or the remuneration of senior executives?

Professor Goodhart: That is one of the problems. As we have been indicating at several stages, there are really quite deep inconsistencies within the Government's approach to the banking sector. It is trying to achieve a whole series of objectives simultaneously and not all of these can be done at exactly the same time.

Professor Buiter: I agree with that. It would simplify things if the banks had been completely nationalised, which they could have easily been, because in that case the problems that Charles alludes to, certain things should have been done by the shareholders would have been solved. Different parts of the Government are pursuing different agendas: the FSA says "stop lending" and the Government says "start lending"; the FSA says "whatever you put in your balance sheet make sure it is the Treasury's" and the Government says "Whatever you put in your balance sheet, make it is loans to homeowners and small businesses". You cannot do both, so at the moment they are conflicted.

Q53 Mr Fallon: Professor Goodhart, finally, the Swedish shareholding you referred to still exists. How should a future British Government relinquish control of the bank ownership it now has?

Professor Goodhart: I think in all cases the Swedish Government sold off their shareholdings. Basically what you do is as soon as a crisis is over and normalcy has been returned, after a period of time you auction it off, you sell the bank back to the private sector.

Q54 Mr Fallon: So that is a straightforward privatisation?

Professor Goodhart: Yes, exactly. We have done enough privatisations and the Government should know how to do that sort of thing by now.

Q55 Chairman: A final question for Professor Buiter. You mentioned that bank senior management should go and we are now in a halfway house. Are you of the view that given this halfway house the banks are now back in the driving seat? Given that three years is the half-life memory of those in the financial services industry, do you think we will back to business as usual within tickety-boo?

Professor Buiter: Yes.

Q56 Chairman: That is pretty dismal.

Professor Buiter: That is the way the world has turned since banks were invented.

Chairman: That begs an awful lot of questions for our second evidence session. Thank you very much.

Witnesses: Mr Will Hutton, Executive Vice-Chair, The Work Foundation, Mr Richard Lambert, Director General, CBI, and Mr Jon Moulton, Managing Partner, Alchemy Partners, gave evidence.

Q57 Chairman: Good morning and welcome to the second part of our evidence session. Can you introduce yourselves for the shorthand writer, please?

Mr Moulton: Jon Moulton, Managing Partner of Alchemy Partners, a private equity and distressed debt investing firm.

Mr Lambert: Richard Lambert, Director General of the CBI.

Mr Hutton: Will Hutton, I am an Executive Vice-Chair of The Work Foundation and author of a number of books on this subject.

Q58 Chairman: Thank you very much, and welcome. With our previous panel I mentioned that this banking crisis inquiry is looking at how we got here, how do we see ourselves through this situation and what will the future regulatory environment be like. Jon Moulton, how did we get here?

Mr Moulton: I think that the previous panel said it fairly accurately: a wall of cheap debts, asset inflation much accelerated by securitisation, complex financial products, and a grotesque failure of every regulatory system and governance system in the entire set-up. It was really quite spectacular. That is how we got here. It all collapsed when we started running into the well-known wall of debt of all kinds that could not be repaid, and that is what blew it up.

Q59 Chairman: Richard, what is the financial sector for?

Mr Lambert: The financial sector is to provide the credit and payment systems that keep our economy going.

Q60 Chairman: And the banking sector within that?

Mr Lambert: The banking sector is the key engine of that.

Q61 Chairman: How did the banking sector get in the situation it is in now?

Mr Lambert: I would go with Jon's answer and I would go further back than that and say you would have to start off looking at the enormous capital imbalances that have developed in the world over the last 10 or 15 years with huge deficits in the United States, the UK and other developed economies, enormous surpluses in Asian economies and the attempts to intermediate that in different ways. One analysis I saw made a good comparison suggesting that back in the 1970s when there were huge oil surpluses, they were intermediated to developing economies like Mexico and Poland; this time round the surplus funding was directed to sub-prime borrowers in the United States. I think you have to take the capital balances and imbalances into account when you are thinking of the big picture.

Q62 Chairman: Will, the issue of the City of London: has the City of London's importance to the UK economy been exaggerated and have politicians, regulators and central banks bent their knee to them for too long?

Mr Hutton: You know that is my view.

Q63 Chairman: Oh, is that right?

Mr Hutton: So it will be no surprise to have me confirm it. Yes, that is my view. For example, when Gordon Brown, as Chancellor, set the five famous tests for euro membership it was instructed that one of them was that it should benefit, at least not damage, the interests of the City of London and no other part of the UK economy was singled out. That was very much the mood at the time, that financial services that represented close to 10% of GDP and had grown from 6 or 7% of GDP were at the vanguard of what we were going to sell the world in the 21st century. I always thought that was putting too many of our eggs in one basket and too many sacrifices and distortions were being placed on the rest of the economy to make that play. I would just add a couple of things to what Richard and Jon have both said. I do think this question of global imbalances just did not happen as an accident, that was a direct consequence of the way Asian countries in particular responded to the Asia financial crisis in 1998, a deliberate policy to peg their exchange rates and acquire foreign exchange reserves at an extraordinary rate, and that is the Japanese story and the Chinese story certainly. As much as 40% of the $10 trillion of liquidity that was generated in that decade came from those two sources alone. Jon made the point about regulatory failure, and that is absolutely obvious, but it went beyond that. We actively fanned the flames and I think the abolition of Glass-Steagall in the States in 1998, which was made impossible for US regulators to protect because of the line we took in London, made a fusion of commercial banking and investment banking possible which very much fanned securitisation, the kinds of liquidity that was provided to hedge funds, and private equity became much more possible because of that emergence of universal banking. One must discuss the incentive structures, the fact that people were able to get alpha pay for beta performance, as the Chief Economist of the IMF has said, and the way that performance was computed so that people could walk away with fabulous gains from one year's performance but what happened in years two and three was largely ignored. That incentive structure was very, very important. My big critique of the British Financial system as it has emerged over the last generation is it walked away from its ownership responsibilities and became fixated with and highly focused on transactional relationships. In a way, whether it was the originate and distribute model in banking, whether it was the emergence of the derivative markets and the credit default swap market, all of this was about a highly transactional approach to what must be for effective finance, to add to what Richard said about what the role of finance is in a capitalist economy. Finance at its best is about building relationships with wealth generators, maturing them, supporting them, investing in them, seeing them out of tight corners and supporting them with growth when they need it, being judicious in how they do that. Our financial system always had a bias not to do that and that bias became accentuated in the last decade.

Mr Moulton: The question was how important is the financial system and it is obviously good to have a successful financial system. However, it is very asymmetric, the failure of the financial system wrecks the total economy, and that is why we are here.

Mr Lambert: It is also important to keep it in scale. According to the Pre-Budget Review, the financial system in total represents 7.5% of gross value added, so it is possible to overstate its contribution to the economy.

Q64 Chairman: If it represents 7.5% gross value added, that it could wreck the system means there is something wrong in the system.

Mr Moulton: That is where we are heading now.

Chairman: There is something disproportionate there somewhere.

Q65 Jim Cousins: One of the difficulties that we have all got is that the banking crisis is not over, second wave effects are now developing and one of those, of course, is about hedge funds. Mr Moulton, do you agree with the predictions coming out of the United States that the hedge fund sector is effectively going to collapse?

Mr Moulton: It is collapsing; it is not a question of a prediction. It is contracting very, very rapidly indeed. The availability of leverage to actually keep the hedge fund sector going has been very, very dramatically reduced. The poor performance of many hedge funds has resulted in people pulling money out of it and the financial scandal of Madoff and so on has helped still more. Yes, the hedge fund world will go down by a factor of three or four over an 18 month period, that sort of magnitude.

Q66 Jim Cousins: There is obviously a debate to be had about what the contribution of the hedge fund sector to the problems we have got might have been, but also some regard has got to be paid as to whether the collapse of the hedge fund sector if it continues will compound those problems. Do you think that the collapse of the hedge fund sector and the fact that many of its investors now find themselves trapped inside its funds without any route of escape will cause yet more problems in the real economy?

Mr Moulton: It is causing some level of problems in the real economy. It is not a huge problem. In the context of the banking world, it is one of the symptoms of the real basic thing that I think is wrong with the banks. They got too damned complicated, nobody could manage them and nobody could understand them. Exposures to hedge funds when they were lending in exotic ways against exotic assets leveraged from one end to t'other was clearly part of the reason that the banks collapsed. Those exposures were unmanageable and not understood. That is something that happened right the way across the banking world, not only did they get too adventurous, they got too complicated and became unmanageable.

Q67 Jim Cousins: Do our other two witnesses think that this is a sector which will continue to cause problems as it unwinds and which needs greater regulation?

Mr Lambert: My total preoccupation is with the supply of credit to the British economy and to British business generally and I do not think hedge funds are the first order problem in that respect.

I think the first order problem lies in the regulated sector rather than in the unregulated sector and that is to do with the way that over the last years a funding gap has opened up in our banking system which is now having to be bridged and that is why credit is in short supply and is the issue I think we need to be focusing on, at least that is what I am focusing on.

Q68 Jim Cousins: You do not feel that what has happened in the hedge fund sector and the unwinding of this enormous bank of credit derivatives inside the bank is contributing to the liquidity problems we have?

Mr Lambert: If you take the Crosby Report on house mortgages, what you see there is that over the last seven or eight years there has been an enormous growth in mortgage securities in the UK from close to nothing in 2001 to around £250 billion at the end of last year. Hedge fund investors were part of that, they did contribute to that and they have disappeared, and that is part of the problem, but there were many other investors in those assets who have also disappeared. You need to look more broadly at what is jamming up the wholesale finance markets, not just the hedge fund disappearance.

Mr Moulton: There are tens of billions of assets that have been forcibly sold by hedge funds as they shrink and that is certainly mopping up some liquidity and driving some prices down, but it is not a primary issue compared to the scale of what is going on at the banks.

Mr Hutton: I slightly disagree with Richard and Jon in this respect: you had the hedge funds at their peak at $2 trillion worth of assets and a lot of that was financed by bank borrowing and because of the opaqueness we do not know how much of it was from UK banks. Occasionally you get a glimpse of it. There was a credit line to Bernie Madoff from Royal Bank of Scotland of £300 million which is clearly going to be written off and HBOS were involved as well which will have to be written off and the UK taxpayer will pick that up presumably. Some of the lending to hedge funds, given the scale of the price fall of the assets that the hedge funds own, has to be written down and those write-downs come straight through and because they are uncertain about what proportion of the overall portfolio was genuinely toxic or might actually rebound in value - I was listening to the comments from the earlier three - in the high uncertainty it constrains your lending. In that respect, I do think the hedge funds contributed to the asset price bubble, they were one of the buyers of these securitised assets that Richard mentioned and that market that is now de facto shut needs to be opened in my view, and I strongly support Crosby's recommendations on that. Whether it be the closure of parts of the securitised asset market, whether it be some other potential write-downs that banks are facing, the distress in the hedge fund sector is plainly part of the story. I am interested to hear what others think, but I think it is outrageous in terms of moral hazard that we, the UK taxpayer and British Government, have emerged as guarantors of UK bank retail deposits, a significant proportion of which were lent to hedge funds and are now being written down. The way the remuneration structure of the hedge funds was organised was that an annual increase in the assets under hedge fund management significantly accrued to that hedge fund manager and he or she has now got the money, we have got the loss, and we have got a kind of transfixed financial system. I think in terms of the question of moral hazard you were talking about earlier, plainly we have to think rather like Roosevelt did in the 1930s: if we are going to offer guarantees to bank depositors of the type that we are having to offer, that is the liabilities side of a bank's balance sheet and the asset side of a bank's balance sheet have to be looked at to. If parts of those asset structure are the kind of advances made then frankly with virtually no due diligence to hedge funds, who then took the positions they took and on the scale they took them, you cannot say that it is not part of the problem and that going forward it should be part of the structure that should be left untouched.

Mr Moulton: UK banks were not major funders of hedge funds. US banks, Goldman's, some of the big Germans, UBS, these were the big funders of hedge funds. The losses in Madoff are mostly not loans to Madoff, they are actually loans made to investors who went into Madoff, so if you were a private client on RBS they would lend you money to enable you to go into the Madoff fund. Those are the losses that have taken place. They were a bit rash.

Q69 Sir Peter Viggers: When this Committee looked at the banking model and the originate and distribute concept about 18 months ago, the evidence we were given was that a shift back to the more traditional kind of banking was undesirable and, indeed, the Governor of the Bank of England thought that "the originate and distribute model has real value and I would not want to see it disappear". Having had fingers burnt all round, what is the future of the originate and distribute model and will it self-correct or does it need a different kind of regulation?

Mr Moulton: It will come back when people have forgotten the pain that they have just taken by following that route. It will not come back before. People will want to be going alongside somebody, as was said in the previous panel, to see the bank which is leading syndication of some assets stay in there for the first loss level. That kind of thing is going to be reassuring and needed over the months and years ahead. It will be five years forward before people are stupid enough to go into the "fire and forget" type of financing, which was what it became.

Mr Lambert: I do not completely agree with Mr Moulton on this one.

Mr Moulton: Very few people do!

Mr Lambert: As I recall, what the Governor was suggesting was that the world's capital needs are greater than can be met just off the balance sheets of the world's banks and, therefore, capital markets one way or another are going to have to play some part in supplying the capital requirements, for example, of the developing economies of the world. The lesson we should take from this past experience is that the banks need to have more skin in the game. That is to say that the future model should be such in my judgment that would say the banks had a continuing interest in the risk that they were originating going forward.

Mr Moulton: They have to be part principal, not just agent taking a fee and waving goodbye.

Mr Lambert: Absolutely.

Mr Hutton: I strongly agree with what Jon and Richard have said. I think there is a danger in saying, "My God, originate and distribute has got us into such trouble or securitisation has got us into such trouble, let's go back to boring banking". I regard both originate and distribute and securitisation as interesting and important financial innovations. The trouble was, to use Richard's phrase, the banks did not have enough skin in the game. I think originate and distribute is quite a good way of diversifying risk and quite a good way of building a balance sheet rapidly, but the point is you need an effective credit default swap market to help you manage the risk and you must, as a principal, not walk away from it and the job of domestic and international regulators is to ensure a regulatory structure in which that takes place.

Q70 Sir Peter Viggers: Do you think financial regulators can keep up with innovation in financial fields? What more could they be doing? What more should they be doing?

Mr Moulton: They cannot keep up with innovation, it cannot be done. I strongly feel that if one thing comes out of this it is that we need trustworthy banks otherwise they are going to stay in the national ownership, socialised or whatever, pretty well forever. We need trustworthy banks and that means simple banks, banks that can be regulated, can be managed. That does not say we stop innovation in the financial world, but it has to be done in a different place. It is not an accident that this lot all happened after Glass-Steagall went away and we liberalised banking regulation everywhere. We need to have banks which are simple, manageable, comprehensive, the so-called "narrow bank". That is the one thing we must do if we want to minimise the likelihood of this lot turning up again. It is not easy, it is complicated to even do that, but that concept will survive and would be something the UK could do on its own because in the current environment tighter regulation is a competitive advantage, not a disadvantage, which it was before.

Mr Hutton: I am thinking hard about this and I have not completed where I think we need to get to. Jon is right, but, that said, how do you get to where he wants to get to. I have begun to think that what you have to do is set the parameters of what the business model should be, which is why Glass-Steagall was so intelligent, it was trying to separate, trying to create these trustworthy narrow banks and leave the exotic world of investment banking. That would go on but everyone understood that was an area of higher risk, higher return and the contagion effects to the rest of the national economy through the credit system were limited because you did not involve commercial banks in it. What one needs to do is be very, very clear as regulators about what the spheres of banking activity are and to ride that very, very hard, but within that sphere you cannot expect the regulator to be ahead of the pace of financial innovation. We can try to limit these contagion effects in future, and we must do.

Mr Lambert: What I feel is we should not conclude from all this that regulation is impossible. We need to learn two broad lessons. One is that on the regulatory side there needs to be a clearer and better communicated focus on capital adequacy and on liquidity. Clearly the liquidity side of the equation, as the FSA has recognised after Northern Rock, was underplayed in the regulatory scheme of things. The second equally important message that comes out of all this is that as well as regulation supervision is very important, and that means the supervision exercised by boards of directors, by investors, by others who have an interest in the good performance of the system.

Mr Moulton: Supervision and regulation will only work if it is within the capabilities of the people involved to actually discharge those duties. A large bank with 30 or 40 business lines, huge books of derivatives, is not such an animal.

Chairman: I know a couple of you have got a lunch engagement, so there is an incentive for short answers!

Mr Love: Your lunch is not with us, is it?

Q71 Ms Keeble: I want to ask a bit about risk assessment. What was your view of the due diligence that was applied by the industry before people invested in some of these very complex products?

Mr Moulton: It went from tolerable to notional to virtually non-existent as we got near the end of the boom. That was what happened in most areas. In the leveraged loan market, half the people who were taking pieces of the loan did not even bother to go to look at the due diligence materials. That is fact.

Q72 Ms Keeble: Was that a culpable level of failure of due diligence? Was it that people did not do it when they knew they should or that they were not competent to be able to unravel these bundles?

Mr Moulton: A mixture of both. The trouble was if you wanted to get a leveraged loan you had to take what was on offer, so you grabbed what there was without checking it. It is the one woman on a desert island sort of problem.

Q73 Ms Keeble: One woman.

Mr Moulton: In the case of some of these assets the products are simply incapable of being analysed by the vast majority of people out there. Northern Rock's last capital issue, the off balance sheet, and it is on the website, 11 layers of debt, three currencies, interest rate swaps, currency swaps, 415 pages of prospectus, nobody understood it.

Q74 Ms Keeble: Should there have been some whistle-blowing about the lack of due diligence given that there is supposed to be a requirement that it should be undertaken?

Mr Moulton: There was a lack of whistle-blowing. It was all part of the desire to keep the boom going.

Q75 Ms Keeble: Who should have been blowing the whistle?

Mr Moulton: Probably the most obvious target would, I am afraid, be the FSA.

Q76 Ms Keeble: It seemed that in the absence of due diligence people were relying on credit ratings agencies and I wonder if you, Jon, or others would like to comment on the reliance on those, whether that was misplaced and a misuse of the ratings agencies, and whether the reform, therefore, should be through greater regulation or proper use of ratings agencies?

Mr Lambert: Clearly credit ratings agencies were part of the process of turning, whatever you call it, stone into gold or whatever the right cliché is - alchemy.

Q77 Ms Keeble: That is a bit unfortunate!

Mr Lambert: Sorry, yes! Pure gold.

Q78 Ms Keeble: I thought you might be getting back at him over the one woman on a desert island.

Mr Lambert: For example, Commissioner McCreevy has had some important points to make about the conflicts of interest over trading and the appropriate regulatory response to what has turned out as a result of that, and the fact that credit ratings agencies' judgments became part of the regulatory structures was clearly a mistake.

Mr Hutton: That is all true. There was a competitive dynamic going on in the credit ratings agencies and even the sober and better ones found themselves competed into, what can I say, a more relaxed view of what the risk was. There was also a general view which was held by regulators and market actors themselves that these sophisticated instruments did do the job of reducing risk. The system was careering along, it was creating jobs, it was creating wealth and anyone who wanted to constrain it would have been portrayed as an instrument of the Nanny State. 2005, 2006 and 2007 were very extraordinary years.

Q79 Ms Keeble: Do you think that the credit ratings agencies are capable of reforming themselves or do you think there is a requirement for regulation?

Mr Hutton: I think there is no question they have to be regulated. I have always thought in the financial markets there are one or two fulcrum points, and I think this is true of actuaries in the insurance industry and credit ratings agencies in the capital markets, where there might be a need for a kind of public interest player because what is taking place is so fundamental that you need that as part of the infrastructure of effective markets.

Q80 Ms Keeble: In terms of the legacy of the banking crisis that we have got, all three of you have pointed to the fact that we will end up with a different industry which could have a different ethic, as it were. Would you like to say how that might look and could you say some of the specific measures that might get us there? There has been approximate talk of need for greater transparency and so on, particularly in some of the products, but could you say some specific measures that you think would correct some of the difficulties that we have had?

Mr Hutton: My goodness! I am working on a small paper on this and I would be happy to supply the Committee with that.

Q81 Ms Keeble: That would be helpful.

Mr Hutton: It is building on the sort of things we have all said. There has to be an EU-US agreement on reintroducing Glass-Steagall, a modern version of that. I am sure that is part of the story. I think the whole system of credit insurance and credit default swap is a good financial innovation but I am strongly of the view that there should be better infrastructure to handle counterparty risk, a central clearing house which these derivatives are traded through so you can be certain that the counterparty is creditworthy him or herself and there is a standard contract. A lot of them are weird and wonderful and are not standard. There are a lot of things that can be done. Another thing, and this is the hardest thing because it is true, is that you cannot insulate what is happening in the credit capital markets from the equity markets. Richard has made this point and so has Paul Myners, that institutional shareholders were not exercising proper scrutiny about what banks were doing and they were not looking at remuneration structures. I think you have a longstanding problem in the UK capital market about a highly transactional approach to equity. Ownership of a company is a very, very profound obligation as well as conferring rights to dividends and rights to sell.

Mr Lambert: Transparency, improved supervision and a countercyclical approach to capital adequacy.

Mr Moulton: Transparency for me does not cut it. Nobody in this room can read the accounts of an HSBC or a Barclays and claim that they understand them. There is nobody in the room who could do that.

Q82 Chairman: You showed us AIG's book in May and you were rather perspicacious, and that is why you are back here again!

Mr Moulton: I do not think transparency cuts it. My model of the future is that we want our banks that do the money transfers and hold our deposits, the central part of our financial system, to have simple capital structures, to hold assets that are capable of being understood, which means much shorter sets of accounts, some chance that the boards would understand them, and let them operate like that. For the capital structure, Basle II has proved to be quite fatally flawed. Let us remember that Northern Rock was allowed to reduce its capital on the back of Basle II. We need to come up with some simple rule which is, "You will have 15%, 12% in capital, you will have 10% in liquid assets", and then people will trust them because the models will be transparent, they will be capable of being understood.

Q83 Mr Love: Can I relate my question to your answer and Mr Lambert's answer, and that is about the concern, and I wonder whether you share it, that there is a pro-cyclicality within the system at the moment. How concerned are you about that?

Mr Moulton: Very. The pro-cyclicality is really varied in Basle II in terms of bank capital structures. It looks back, sees what the risk was historically and projects it into the future. The better things are, the less capital you need; the worse things are, the more capital you need. That is exactly the opposite of what we want. It might be a lot less accurate, a lot less sophisticated, but an arbitrary fixed level of capital would be more reassuring and more appropriate.

Q84 Mr Love: There are some who suggest fair value accounting lies at the heart of the problem here and who would want to tinker with that. Do you agree with that?

Mr Lambert: I think that Jon is right, it is the pro-cyclicality of the current regime that is important. One suggestion I would make for consideration is that the people who drew up Basle II could not have been doing it with the assumption that at some point most of the banks in the developed world would have their governments standing behind them. It seems to me that we find ourselves now in a unique position such that if you could get global agreement for a time that the Basle II protocols could be relaxed that would free up lending on a scale that would be valuable. I think that is something we should be considering.

Q85 Mr Love: Mr Hutton, you were staring at the sky, if I may say so, at that point.

Mr Hutton: This is pro-cyclical, and there is no doubt about it, but the idea that we are going to get international agreement on where we are in the cycle and by what degree banks should actually increase or decrease their capital is, I think, close to utopian. There was a way this was done which was very effective, we just managed the liabilities of banks and it used to be done by a system of special deposits and reserve asset requirements. It was very effective, beautifully operational, it could be done in a very timely way, did not need international agreement, but we deregulated it away because the banks argued it was burdensome because it meant there were periods in the economic cycle when they had to lodge with the Bank of England potential interest bearing assets that they could work hard, they could sweat, at either no interest rate or a penal rate of interest and forewent profits. I wrote a lot about this in the 1990s. The argument was we must promote banking sector efficiency by abolishing reserve asset ratios and regulate the banking system through interest rates because the object of the UK is to promote banking efficiency and the financial services industry. I understand why people talk about capital, it would be a better way of doing it, if possible, but practically I do not think it is possible to do it. The tried and tested way that G7 states used right up until the 1980s and 1990s should be returned to as part of this going back to simple banking.

Q86 Mr Love: You clearly will have some difficulty with what Mr Hutton said, but do you have any sympathy for the Spanish system where you build up what they call loss capital in the good times in order to protect you against the bad times?

Mr Moulton: I think it is actually a better system. I am just picking up one small point. Market to market is a point only because assets are hard to value, hard to understand. If you exclude those assets as far as you can from a bank, that problem vanishes.

Q87 Mr Love: I will not get into that because we had a very interesting discussion in the last session. I think the whole issue of valuation of those assets and protecting the public interest in terms of ensuring the money you put in from the public sector is not lost when the whole thing unravels is particularly important. While I have some sympathy for the toxic asset problem, the Americans have not been able to solve it and I am not sure we will be able to solve it either. I want to go on to the role of the media in all of this. Mr Lambert, I have to say in your speech to the Reform Media Group you sounded a bit like a politician, if I may say so, when you were laying out some of the difficulties that there are with the way the media has handled this. You said during that speech, "publish and be damned", which certainly a lot in the media would agree with. Should that apply when it may well bring into focus the whole future of a bank, a financial institution? When is there a responsibility not to publish and be damned?

Mr Lambert: When there is a degree of uncertainty about the accuracy of the story, I think that is where it ends. What I was trying to say there was over the last 30 years the media has become a player in this world because of everything we know about in terms of 24 hour news and online publication and everything else. It would be impractical to try and put controls on media reporting in a world of blogs and online publication. I also think it would be improper to have a world in which informed insiders had information that was not generally available. I do think that publish and be damned is important. My suggestion in that speech was perhaps the media might spend more time among itself thinking about the way some stories are presented, whether it is speculative stories about "Bank A is in trouble, so now we should be looking at Banks B, C and D", and, secondly, unsourced quotes saying hostile things about banks on the view that banks are different. Unlike a motorcar company, if people lose confidence in a bank that has serious systemic consequences. My suggestion was that the media should be talking among itself more than it is doing about this issue.

Q88 Mr Love: Mr Hutton, let me press you as a noted commentator on these issues. That judgment that Mr Lambert is talking about, that very fine judgment about whether the evidence that you are basing your story on is strong enough to warrant being published in a time of financial crisis, how do you make that judgment? Are we asking too much of our commentators and journalists to be able to make that judgment?

Mr Hutton: Gosh!

Q89 Chairman: We are going on to another session on this so we do not want you as an expert witness on this, just give us your passing comment.

Mr Hutton: Okay, I will give you a 30 second view. Broadly the media do a pretty good job. In the fortnight up to 11/12 October there was a run in the wholesale money markets and I knew, and almost everybody in financial journalism knew, that both HBOS and Royal Bank of Scotland could only get overnight money and increasingly were having to turn to the Bank of England. You could argue, whether it was Robert Peston or the city editors of the quality broadsheets, they were pretty responsible. They could have said, "Get your money out", because if the interbank market seized up, why are you as a retail depositor being patsy. There were a couple of occasions when I thought some of the stuff that was said about Bradford & Bingley was pretty tricky. In the main, I would suggest to the Committee if we had had some better journalism, if the financial journalists had been able to make a better pitch to news editors about the seriousness of what was going on in 2006/07, it might have alerted the national discourse more than it possibly did. I think most financial journalists would say they were really anxious to get stuff on the front page or high up in the business pages, or outside the business pages, and their colleagues were not that sympathetic. I think they behaved pretty well, and could have better behaved better in one or two places maybe, but actually we want more quality journalism, not less.

Q90 Mr Fallon: Returning to Government support for the banking sector, there has been a mix of policies now - banking recapitalisation, the Special Liquidity Scheme and the credit guarantee scheme - is that policy mix right?

Mr Lambert: I think it was certainly right in October; whether it is complete is another question. The banking system was close to the edge of a steep precipice and that combination of decisions pulled it back. We are still in a world where the wholesale markets are frozen. There is a particular reason to be concerned about the larger companies. Obviously SMEs are in one category and the banks are lending to the SMEs. We should be thinking about the refinancing needs of larger companies who need a syndicate to take them through and are now finding that noticeably harder than it was. My strong sense is that it is going to be appropriate for the public sector, the taxpayer, to take on some more credit risk one way or another in the coming weeks and months.

Q91 Mr Fallon: The work underway seems to include extending the loan guarantee scheme, considering buying back the troubled assets or quantitative easing. Which of those three, Jon Moulton, do you think will help unblock these frozen markets?

Mr Moulton: I do not think you can pick one, I think the Government is doomed to do all of them to some measure. I am not necessarily enthusiastic about the likely outcome of state controlled banks giving state guaranteed loans to companies resulting in very optimal allocation of resources in the economy, but those things are going to have to happen because the severity of the crisis is extreme.

Q92 Mr Fallon: But of the three, which would you favour?

Mr Moulton: Quantitative easing will ultimately be the biggest part of that; it has to be.

Mr Hutton: There are a number of things to be said. If you are talking about the structure of the package that was put to the bailout on the 11th and 12th, it was a balance and it was right. I think the 12% dividends were too high and loading the insurance premium on interbank guarantees, that kind of weighted average of credit default swaps in the run-up to the crisis, made certain that insurance premiums were extremely high, which I think was a mistake and I notice the Government has rectified that. What happened on deposit guarantees had to take place. My concern now is to echo what Richard said and I urge the Committee to look at what is happening in the States. There has been a very substantial easing in the US interbank wholesale money markets in the last two or three weeks and there Libor rates have come right off the peak and are beginning to look normal. That has been about the Federal Reserve buying Fanny Mae and Freddie Mac guaranteed asset backed securities in the residential market and securitisation market, and also beyond that where the federal government has stepped in. I think we are going to have to do something similar. I am very concerned that we are still talking about a 20 billion loan guarantee scheme for working capital when actually what we have got to do is try to restore our interbank market to the depth and breadth that it existed pre the crisis.

Q93 Mr Fallon: Jon Moulton, is there not some danger of quantitative easing here, unlike the United States, in that our currency is so much weaker and more exposed?

Mr Moulton: They are not being careful at all about quantitative easing, or much more normally known as printing money, which is essentially what we will be doing. Obviously it will lead to a reduction in confidence in the currency and ultimately it will lead to inflation, and possibly quite severe inflation. The problem at the moment is that we are choking to death and really you have got to deal with the current problem rather reckless of the consequences that will follow. The consequences will be severe. The increase in public borrowing and the increase in printing of money have severe consequences to follow.

Mr Lambert: Again, I do not see things in quite such stark terms, I have to say. For me, the important thing is credit guarantees and it is important to keep clear in one's mind the difference between what one might call expenditure, which is a fiscal loosening and the automatic stabilisers, and what you might call investment, which is owning shares in Northern Rock and the Royal Bank of Scotland. I think one would be seeing credit guarantees under the investment heading rather than the expenditure heading and they should be the first step we should take and then see how things go.

Mr Hutton: There is quite an interesting scheme that the Americans have got going with Citigroup where there is $306 billion worth of loans, some of them to business, some of them to households, and what has happened is there is a guarantee of 10% of the loss in a catastrophic event and some American economists have developed some quite interesting models for how you might offer a guarantee and pick up the catastrophic element as a government if there was a very, very severe recession, but compensated by a bigger upside in the recovery. There are some very, very interesting schemes emerging in the United States about how to do credit guarantees in the way that Richard has been describing.

Q94 Chairman: Jon, I think you said it is unpalatable and you do not like the idea of government lending or nationalising. Is that because there are competing and conflicting interests at the moment?

Mr Moulton: I think it is really bizarre. We have been talking about capital and banks, and if the Government owns the banks who needs any capital? We are really in a world where the floor is moving under our feet, the old views do not matter. It is really odd. Now we move it into a state-owned bank we are bound to have political pressure for where the lending will go and that will be inefficient. Some of it will go to deserving homes, some will go to the wrong places. If we then have state guaranteed loans from state-owned banks, and I am not quite sure what we are achieving really, we are socialising the losses across the entirety of the economy. These things I do not necessarily follow all the way through and I do not think anybody else does, but I am uncomfortable because there are enormous changes and nobody has thought them through.

Mr Lambert: I think we are not in that place. We are not in a place where we have a nationalised banking system. We have every reason to try and avoid it for the reasons that Jon implies. I would also say strongly that what took place in October was such as to give our banks now a strong capital base. The intention, and it was stress-tested by the FSA, was to give the banks a cushion from which they could go through a rough time and they are in that position so it is wrong to assume that the banks need more capital.

Q95 Chairman: In a sense it is not nationalising the banks, it is nationalising the credit lines. I had a Christmas breakfast in my constituency last Friday with 80 businesses and they were all howling. Businesses which have been established 30 or 40 years with their banks have their arrangement fees which have gone through the roof and they have got overdrafts which maybe they are not getting now which was a formality just a while ago. It is a real crisis situation. How do we get that down?

Mr Lambert: That is about credit guarantees, I am absolutely clear about that.

Mr Hutton: There always was enormous short-termism in the British banking system remember. Your opening question was one of my critiques of the banking system back in the mid-1990s, that it always was a banking system which was prepared to offer you an umbrella when the sun was shining and not when it was raining. There are very high margins on debt, very short-term debt, and the arrangement fee structure is embedded in all of that. Picking up what Jon was saying about simple banks in the future, I would like to see much more medium and long-term lending. One of the ways that one can migrate from the asset structures we have now in British banking to the asset structures that I think would be preferable and better for the real economy would be to use the credit guarantee system that Richard is proposing as a bridge from one banking system to another. It could be a very creative moment for British finance.

Q96 Mr Todd: We are having to throw away a lot of intellectual architecture in this process and Jon hinted at that. We would normally want to consider moral hazard, giving inappropriate messages both to those who had made mistakes in the past and messages to those who may be in these ventures in the future, the protection of the public interest and the requirement to achieve reasonable security for what the public sector does, limiting the role of the state, which Jon has set out. My interpretation of your answer, Jon, is that architecture has to be discarded because reviving the economy and protecting its future is quite clearly the most obvious requirement and that we must put these things into the past at least for the present. Is that right?

Mr Moulton: With extreme pain, yes.

Q97 Mr Todd: I thought it was. The support for the banks, and I think Will mentioned this, the reference to the interest rate on the coupon rate, appeared to place perhaps too high a priority on the perception of the protection of the public interest. Is that the view of all of you, that perhaps that mechanism designed in a hurry may need further reflection?

Mr Moulton: It should be converted into ordinary share ownership without a requirement for a coupon, much larger ownership, it gives more upside to the public in the long-term and takes the pressure off the banks in the short-term.

Mr Lambert: The current structure gives a disincentive for banks to lend as aggressively as we would like them to do.

Mr Hutton: I said it when I first looked at it, I said it and wrote it, and completely agree with Richard and Jon. I do not understand where that 12% came from and I cannot think what they were thinking of when they imposed it on the banks. You have got to think of a kind of Marshall Plan.

Q98 Mr Todd: They were surely influenced by the moral architecture that I just referred to, which is try to get reasonable protection of the public investment that was put in place and secure its early repayment, if possible, and the desire to make a moral message. A lot of my constituents would happily lynch bankers from lampposts.

Mr Moulton: Very popular entertainment!

Q99 Mr Todd: It is a thought! Giving apparently relatively free bailouts to banks and offering them ways of taking large amounts of dodgy assets off their books is about as popular to the ordinary person on the street as offering them cyanide. How do we get this message across that these sorts of painful measures, which are very counterintuitive to many people, are nevertheless necessary?

Mr Hutton: I said we need a Marshall Plan for the banks and Nuremburg Trials for bankers. You cannot be certain of what has taken place, but the lack of activism about trying to bring some of these people to book has made it harder to get the policy mix right because we actually have to have functioning credit institutions in this country and functioning wholesale money markets. That is why we are in this discussion now. That is what we have to sell the British public and tell the British public but, equally, some of the people who are involved in actually creating the crisis should be in the dock, if not literally at least metaphorically.

Mr Lambert: If I may just say something there. I think it is important to understand ---

Q100 Mr Todd: Representing some of them!

Mr Lambert: --- that this is a global crisis. It is important for Will to understand that the banking system in Germany, which he has so admired for so long, is down the plughole as well. It is important to put this in a context that says this is not a matter just for constituents, it is a matter for the whole developed world. You cannot point to a banking system anywhere in the developed world, some of which are very different from ours, which has escaped this shock and that is something that we should hang on to.

Mr Hutton: There are degrees of failure. You are right, but there are degrees and the epicentre of the crisis is New York and London and it radiates out.

Mr Lambert: That is because they are the biggest international capital markets, it would be surprising if it was not the case.

Mr Moulton: It would certainly help the politics to see all bankers as victims.

Mr Todd: That is what I am hinting at.

Q101 Nick Ainger: Some of the points I wanted to raise have been touched on already, but thinking back to the Japanese crisis, and we went over there last year to see what lessons they have learned and so on, a few minutes ago all three of you agreed that one of the ways to try and get the credit markets working again would be for credit guarantees to be brought in. What if they do not work? This has been the problem and certainly this was the problem in Japan. Initially they tried certain things, recapitalisation and so on, but it was not sufficient and they just seemed to be stumbling from one thing to another and nobody got a grip of, "This is where we are now, that is where we have to be and we have to do this, and if that does not work we do that, that and that". If the credit guarantees do not work, what would you suggest?

Mr Hutton: First of all, I think they will work. You get to a point where you try credit guarantees but my own instinct, by the way, is to leapfrog the credit guarantee system and go straight to where the Americans are. What is happening essentially is the Fed is buying tradable credit guaranteed assets, that is what is happening in the States, and that is where we would have to go to and rather than muck about I would go straight there. I would go straight there now, in January 2009. What I fear is going to happen is we are going to have a limited credit guarantee scheme rolled out tomorrow, working capital for enterprises of up to £15 million turnover, good and obviously one welcomes it but in terms of the magnitude of what we are confronting it falls far short. The quicker you get to that solution, and my understanding is that is very hotly debated in the Bank of England and you will have to ask the Bank what their position is, the better. The Bank is reluctant to go as far as the Federal Reserve at the moment.

Mr Lambert: I think the authorities here and in the United States have learned a very great deal from what happened in Japan, which was mainly monetary policy failed and the Bank of Japan made some serious policy errors during that decade, the fiscal policy failed and the banking system was not cleaned up quickly enough. We have learned lessons from that. What we have not discussed at all this morning but I think is relevant when we are thinking what is going to happen to the economy over the next 12 months is the massive monetary easing that has taken place in this country in the last few months, both through the Bank of England and what has happened to sterling. If you throw in a massive monetary stimulus and a fiscal stimulus and take an appropriately bold measure on guaranteeing risk, making sure that it is not done on a free basis, that people have to pay for that extra risk, then I think we should be feeling much more cheerful as the year progresses.

Mr Hutton: I agree with that.

Mr Moulton: I think the main thing is to avoid lots of panic packet actions. 20 billion is not a very large number against the scale of the problems we are talking about. Guarantees are not investments, they are partial losses usually, but they are still going to be required to be done. Personally, I would be happier if the scheme was a lot larger, although it offends many of my basic principles. We are in a bad hole and we have to get out of the bad hole.

Q102 Chairman: Jon Moulton, given that you are in private equity, I had a letter yesterday detailing Rake's progress on the future regarding private equity. Are you disappointed that the Guidelines Monitoring Group's report suggests half of the private equity firms in the UK are complying with the code of conduct rules set out by David Walker?

Mr Moulton: You are in a very substantial minority, one of the very few people to have read any of the information that has been produced.

Q103 Chairman: Is that not a feature of the markets?

Mr Moulton: No. At my own firm we do not comply with the guidelines, we answer any question anybody ever asks us, and we say so freely. We get asked about two questions a year. I do not think it matters a rat's. What has happened in this downturn is that private equity has lost control of a lot of companies, effectively to the debt market. Actually private equity is a much smaller owner of companies in the real world now than it was a year ago so, again, we are becoming just a secondary issue compared to the scale of everything else that is out there.

Q104 Chairman: So Sir Mike could be better sailing or playing golf?

Mr Moulton: I think he would enjoy both a great deal more.

Q105 Chairman: That is affecting you, Richard, because you have got a lot of private equity firms signed up with the CBI. David Walker said that private equity firms that did not comply with the code should be named and shamed. Mike Rake went back on that. Was he right to go back on it?

Mr Lambert: I am afraid I am one of those who has not read every single word of this document here.

Mr Moulton: You can see the popularity of it.

Mr Lambert: It is absolutely top of my pile! My impression was that the very large majority of companies who came into the category set out by Sir David Walker have complied and the ones who have not are much smaller and were not required to. Maybe the net should be made wider. I have talked to colleagues who have read the document and my understanding is it is a good start but there is more to go.

Q106 Chairman: The way you describe it, Jon, it is a bit of a con, is it not?

Mr Moulton: It does not do much. It really does not do much for anybody. People struggle to come up with what they actually want reporting. Somebody has to read it and respond to it for it to be worth producing and there is very little readership.

Q107 Chairman: So what a pig in a poke.

Mr Lambert: No, that cannot be right.

Q108 Chairman: Jon has got that point of view.

Mr Moulton: I am allowed that view!

Q109 Chairman: Let him speak, for God's sake. Now that Jon says it is a pig in a poke, over to you, Richard!

Mr Lambert: If you compare where we are now with where we were 15/18 months ago in our general understanding of what his business is we have come a heck of a long way.

Q110 Chairman: Professor Buiter said to us that the half-life memory of those in the financial markets is three years and the banks are now in control again, given the money that they have, so people are going to be below the radar for a few years and then it is back to business as usual.

Mr Lambert: This is a once in a century event and it is a pile-up which will take years to untangle and the half-life is a lot longer than the Professor was suggesting, I think.

Q111 Chairman: Then it will be back to business as usual, Jon?

Mr Moulton: Longer half-life and if we want to avoid the thing coming back again we need to take action which is quite radical about the structure of the banking industry.

Q112 Chairman: Then back to business as usual, Will?

Mr Hutton: Both things are true curiously. I think a lot of British financiers are lying low waiting for the storm to pass and looking forward to 2010/11 when this monetary easing that is taking place, which is absolutely stunning, will start to see some kind of revival and they are hoping to avoid too much impairment as a result of what is taking place of their freedom of action in the future. In that sense William Buiter is right to say that we are talking three years but the combination of issues from shareholders anxious to protect their investments in future, inquiries like your own and this Committee, and action by the Government, this is a moment in time in which we can really improve the dysfunctionality of British finance, which has been longstanding in my view, that was at the heart of my book, The State We Are In, 12 years ago. That dysfunctionality is one of the reasons why we are in the hole we are in and it should be addressed in some of the ways I have talked about this morning.

Q113 Chairman: As far as our Committee is concerned we have a number of sessions to go. What should we keep our eye on? What should we not be beguiled by?

Mr Moulton: People telling you that we will kill innovation in the banking system which has, of course, proved to be a disease. We should avoid being told it is too complicated to do it; it is perfectly capable of being done and it needs doing.

Mr Lambert: I think, I am afraid, you need to be focusing on the short-term needs and thinking about the longer term problems afterwards. The short-term needs are to do with a funding gap of some scale in the banking system internationally and nationally and how best to address that.

Mr Hutton: I strongly agree with Jon, do not allow anyone from the financial community to tell you that any more regulation is going to stifle innovation and somehow damage the City of London. What a lot of bankers say privately is they badly, badly need some regulation to restore trustworthiness and their credibility and the standing of the City. Whether you will get them to say in public what they say in private is another matter. I strongly agree with Richard that we are in a hole that we need to get out of. I also urge you to think through what you think a competitive British financial system that serves the interests of real business in this country would look like. This is a once in a one hundred year chance to change the motion of British finance. As Winston Churchill said, in Britain finance is too proud, industry too humble, but there is an opportunity to reverse that equation and really get wealth generation going outside just the narrow confines of the Square Mile. It in the interests of all political parties and all businesses to do that.

Chairman: That was tremendous evidence, very helpful to us. There were some unpalatable comments, but I hope your digestive systems are okay for the nice lunch you are going to! Thank you very much.