

HOUSE OF COMMONS  
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ORAL EVIDENCE  
TAKEN BEFORE THE  
PARLIAMENTARY COMMISSION ON BANKING STANDARDS  
**BANKING STANDARDS**

DR ADAM POSEN  
KEN COSTA

Evidence heard in Public

Questions 2692 - 2770

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## Oral Evidence

Taken before the Parliamentary Commission on Banking Standards

on Monday 21 January 2013

Members present:

Mr Andrew Tyrie (Chair)  
The Lord Bishop of Durham  
Mark Garnier  
Baroness Kramer  
Lord Lawson of Blaby  
Mr Andrew Love  
Mr Pat McFadden  
Lord McFall of Alcluith  
John Thurso  
Lord Turnbull

### Examination of Witness

*Witness:* **Dr Adam Posen**, Economist and former Monetary Policy Committee member, examined.

**Mr Andrew Tyrie (Chair):** Dr Posen, welcome. Thank you very much for coming to give evidence. Of course, about half of us will be getting a double dose, because you are coming to see the Treasury Committee tomorrow morning to give evidence on a slightly different, although related, issue.

May I begin by asking you whether it is likely that people are going to learn any lessons from this catastrophe? Do you think that regulators are likely to learn much from this and, on the basis of what you've seen, are they doing the right things—the things that suggest they are learning?

**Dr Posen:** Thank you, Chairman Tyrie; I am very grateful to this distinguished Commission for allowing me the time to speak. I think there are one and a half lessons that have been properly learned, and several that have not. Lesson one, which I think has been properly learned, is that financial institutions should have enough of their own capital, and it should be at stake when there is a problem. All the various proposals, as you are well aware, both within this country and at the international level, start with building up capital for banks, and I think that is the right starting point.

The half a lesson I think they've learned is to be more suspicious—I don't necessarily mean in a cynical way about corruption—about claims of what is a clean asset, what goes into an asset, what is the valuation of an asset. I am saying that's half a lesson because, although I think it's been somewhat learned in spirit, there remains, as is perhaps inherent, a tendency to be too clever by half about this: to always keep looking for technical fixes about the specific definitions of which assets, and the thought that regulators can keep up with that in real time, which I think is a little too ambitious.

A couple of the lessons that have not been learned are, first, that the financial system is critical to our growth but the financial industry is not. That is an important distinction. So, it is very important that the UK have a well-functioning, well-capitalised, well-regulated banking system; it is not critical to the future of the UK that the City be everything it always was. I fear that regulators are still unduly influenced, as they are in other countries, by the desire to have national champion financial institutions and to have financial centres where they are. There are clearly benefits to that, but they tend to be outweighed by the bending over to the threats of some financial institutions that those benefits will go away if you tax them or regulate them too much.

I know you had Andy Haldane, my friend and colleague from the Bank of England, here earlier today. I have no idea what he said—I wasn't paying attention, I'm afraid. He has spoken in the past—and members of this Committee who have been on the Treasury Committee have heard me speak in the past—about the fact that there is some room for what I, not Andy, tend to refer to as big dumb rules: that you go after things in a very non-discretionary way; you limit the right of discretion on the part of regulators. One of the things that I'm concerned about in this country in the way that the FSA is being rolled into the Bank of England is that there's a lot of rhetoric about the real problem being that we had box-checking bureaucrats, and what we need are regulators with lots of discretion to make assessments. To me, that is exactly the wrong way to go. What we need are regulators with very limited discretion, and very clear rules to apply. That would be my initial take.

**The Lord Bishop of Durham:** Dr Posen, if I may I will start with a more general question that comes out of your fascinating article in *Prospect* about a month ago. How do you define the social value of the UK banking system to the country as a whole, picking up slightly from what you've just said?

**Dr Posen:** You are very kind to reference that article; I was trying to make a useful contribution to the debate. I think one has to look at the social value of the banking system, or the financial system, in three ways. Like other utilities, ideally, it is imbued with a public trust in being dependent upon certain services: payment systems, clearing, primary—some sort of safe place to put low-return savings for, say, elderly people or people without much money or financial sophistication.

A second thing that it does, ideally, is allocate capital towards useful ends. I have stressed in my own writings and past speeches in this country the need for this banking system to be more reoriented towards smaller, medium and new businesses. That is less because I felt competent to make an ethical or social argument than an economic one, but I think that someone in your position, or others, could easily make an ethical or moral argument about the need for prospective incumbents and persons entering to have access.

Finally, picking up on something I just said, it is a valuable industry like any other sector or industry in this country. To the degree that it happens to generate what becomes the City of London and happens to be an export and high value-added industry, that's great, but it is no different from a nuclear power industry, an auto industry or Cadbury chocolates, except as a utility. I find it no more deserving of protection or promotion than any other industry.

**The Lord Bishop of Durham:** Picking up on that, it is interesting how little research there has been on this. You hinted this in your *Prospect* article: overall since 1945, or shall we say since the reopening of the euro markets in the early '60s, has the banking sector, including what happened since 2008, been a net contributor to national wealth or not?

**Dr Posen:** I'm going to duck that question because, as a researcher, I don't have the right numbers to hand. It is legitimate to ask that question and there is a way of approaching it. One way is to try to calculate what have been the costs of the various bail-outs and disruptions to the economy coming out of that and putting that against the returns on capital and the services—putting some sort of number, which you can do, on the direct services provided, including all the world's best trading markets, for example. Then, of course, you can throw in what have been the tax revenues. The trick with all this, as always in economics, as I believe you are aware, is what is your baseline? Every country needs a banking system and they have greater or lesser degrees of spin-off additional benefits, so is the baseline just in the abstract, is the benefit zero or is it how well did it do at providing a given amount of investment funding at a given amount of instability compared to some other countries' banking systems? I think that is the real question and the answer is that, depending on the time period, probably the UK looked reasonably good, but clearly the last ten years are a lot to make up for.

**The Lord Bishop of Durham:** Thank you. Following on from there, you commented that there have been complaints about the contribution of the UK banking system—particularly in the SME sector and outside the M25—as we have it now. There have been complaints about that for 100 years, and we remember that there was a royal commission in the 1960s on the role of the City. You seem to give the impression that you feel that those complaints are justified, at least to some extent, rather than merely being whingeing by people who are not doing enough for themselves. What would you see as ways that this Commission could usefully talk about that would begin to address some of those?

**Dr Posen:** You have accurately characterised my views and I hope that, at least, my views accurately characterise the actual situation. One thing that this Committee or its staff could do, or could take from evidence from people like me and others, is put together a somewhat authoritative fact sheet about what benchmarks are for, the cost of capital for access to small and medium enterprise lending, the creation of new business, and the fees charged to small businesses and so on. A lot of that data is available and in fact a lot is provided either by the Bank of England or the European Commission. Compare it to a few other countries and you can get this data for a pretty long time period—certainly back to the '60s—and just say: “Let's stop pretending, we know what the reality is. There is a problem here”. As I think I said in that article, but I certainly said elsewhere, one could look back at the '70s and say that there was a problem with the union structures in the UK, and in the same way, you can say that there may be structural problems in the banking sector. What can you do to address it? I think there are a number of things this Commission is already discussing: efforts to increase the number of new entrants into the banking system, to make the barriers to entry lower; efforts to more thoroughly regulate the fee structure that banks are allowed to charge; and efforts to enable small businesses and new businesses better to make applications to banks on an educational and information providing basis.

There is also the proposal I and many others—including, I think, current Secretary of State Vince Cable and some Labour people—have made for a large investment bank, in the small and medium business sector, that could eventually be privatised, but would certainly be comparable to the SBA in the US, or to Kreditanstalt für Wiederaufbau in Germany. There is also the issue of the securitisation of small and medium business loans. That would be the list I would have in mind to start with.

**The Lord Bishop of Durham:** You mentioned the issue of barriers to entry. I think Mr McFadden will come back in a few minutes to the issue of your comments about breaking

banks up, but to begin to approach that subject, you have talked again about the very concentrated aspects of the UK banking system. Do you believe that the new Financial Services Act and the new financial and banking architecture in this country will make it possible for new entrants to break in?

**Dr Posen:** I think that if implemented properly it certainly could, and the already-present competition laws in this country could be used in that regard. This is perhaps a strange thing for me to say to a Parliamentary Commission, but I think that at this point it is less a matter of legislation than of implementation. Let me be very clear. There are inherently going to be barriers of entry to banking; people are not going to go to Joe's bank the day it is set up. You need a branch network and you need a computer infrastructure and you need some competence and some confidence from people. But the idea is troubling that—let me be very clear that I do not have shares in any of these banks—a Virgin bank or a Tesco bank or the Co-operative buying out a chunk of branches from Lloyds has not successfully expanded in this economy in recent years. Several of the people behind those efforts have raised the issue of various kinds of barriers which I think has to be looked at.

As you rightly said, there is always the possibility that people who lose on a transaction just whinge about it, but I think it is a recurring pattern and it can be looked at. Again, there is a lot of administrative discretion on how these things are implemented. In my view, not as a lawyer but as someone who works on policy, it is fit for this Committee to try to give clarity on the intent of those Acts, even if you do not need to legislate new Acts.

**The Lord Bishop of Durham:** I turn lastly to the question of culture within the banks, which is one of the elements of culture and standards. At a meeting I attended a few weeks ago one of the major commercial banks said to us that they had taken on 2,500 compliance officers and 900 lawyers in order to change their culture and standards. I think they were surprised by the uproarious laughter in the room when they said this.

**Dr Posen:** Yes.

**The Lord Bishop of Durham:** With your background, coming from the States, you are very aware of the very different cultural approach. You have talked about “big dumb rules”; where would you see the key levers for changing culture and standards?

**Dr Posen:** That is an excellent question, Lord Bishop. As a trained economist but not a ridiculously blind economist, I tend to believe that a lot of what we call culture does respond—at least in commercial areas—to incentives. Part of the issue is that when capital is impeded at these banks, when these banks have compensation schemes that reward deal-making and international deal-making over high street lending, and when they have short-term objectives and compensation schemes that emphasise short-term trading, those things produce a certain culture. The swaggering, macho, somewhat nasty fraudulent culture that emerges reinforces it.

I say that with some evidence on my side. One of the happy stories coming out of Japan—most people think that Japan, post-crisis, is having a very sad story—is that they did reform and recapitalise their banking system in 2002-03. The Japanese banks have behaved better according to whatever economic criteria you would like, not perfectly by any means, but much better than they did. No one would suggest that Japanese society has undergone a major cultural shift in the past eight years.

I do not want to deny the importance of culture—I know that there is a conference under way; I am part of an inclusive capitalism group, one member of which is trying to teach new ethics in business schools. There are a lot of things that you can do, but in terms of my own

expertise, it is more about that we change some compensation rules, and make sure that the banks are properly capitalised.

One of the most important mistakes—not the most important—was what you said about the belief, as prevalent in the US as it is here, that if banks simply sign up enough compliance officers, that constitutes a change of culture, rather than constitutes a tax that they are paying to make sure that they are not legally liable.

**The Lord Bishop of Durham:** I don't think you would find many people here differing with you.

*Dr Posen:* No, I assume not.

**The Lord Bishop of Durham:** To be clear on the incentive compensation, and picking up on what you said earlier, if a change of culture that meant very high levels of compensation, derived from relatively short-term operating and horizons, led to people saying, “Well, in that case, we'll go and work somewhere else”, your own view is that we would not be that much worse off, if at all.

*Dr Posen:* No. One of the cultural myths of the past 20 years, which is even stronger in US than it is in the UK, is the idea of the magical CEO or CFO, or future CEO, and this person—usually male, but not always—is someone of great perspicacity and leadership. If you got someone who was in some abstract way less good, the company would never perform. Frankly, there are 60 million people in the United Kingdom, plus several million people, myself included, who are attracted to live in the United Kingdom under the proper circumstances, and very few people are irreplaceable—although they may be in your job, your grace. People can substitute for one another and one bank's CEO is pretty much like any other bank's CEO. Facetiousness aside, it is a real point.

Moreover, going back to the utility image, I am not one of those people who says that banks should literally be turned into utilities, but there is something to be said for the idea that a lot of a bank's social and economic value comes from very straightforward, not rocket science, valued added activities. Therefore we don't need to compensate bankers that much, and we don't need to pretend that it is that wonderful to be a banker. It is like being a small-town lawyer; it is a worthwhile activity, you need to be trained and probably a little smarter than average, you need to work hard, and you need to have some sober characteristics, but you don't necessarily need to be—pick the name of whatever Canary Wharf person you think is important. It does not matter.

**The Lord Bishop of Durham:** Thank you. I think the culture point about the magic CEO has lurked into the Church, and is equally a force there when they look at future leadership.

**Chair:** Any Archbishop will do.

**The Lord Bishop of Durham:** There are 10,000 clergy who could mostly do it equally well.

**Lord McFall of Alcluith:** As they say on the football terraces here, “There's only one Archbishop”.

During the financial crisis in 2008-09, I wrote to urge my colleagues in the Labour Government to nationalise the Royal Bank of Scotland and break it up into a bad bank and a good bank, but also to establish a national investment bank. I was mindful of some of the comments that you made about British banking needing a spare tyre. The suggestions were rejected in part because they were seen as a bit too left wing, a bit too statist—the private

sector could do better. Could you give us a non-partisan, economic, utilitarian reason for us as a country having a national investment bank?

*Dr Posen:* Thank you, Lord McFall. The first time I appeared before the Treasury Committee was under your chairmanship so I am very glad to pick up the discussion with you. I think I can give you one reason: it would not be partisan but it might not satisfy those who have, if you will excuse the term, a religious belief against statism. The basic idea that mainstream economists—the vast bulk of mainstream economists—would say is that you only want to put in a Government institution where there is an identifiable market failure and where there is, again, a set of incentives that allow the public sector to be held accountable for what it does. The market failure in terms of investment in this country—I think you and I probably differ a little on this. My view is that it is really about new business, small business formation. A national investment bank is sometimes thought of in terms of great public investment projects. There is a legitimate case to be made there, although I am little less worried about that, frankly. Forgive me if I am misrepresenting your past views.

So the question is: what is the problem there? The answer is you have a market failure because the banking structure has gone down a certain road with certain institutions having incentives, and so it is failing to do what the system previously did only partly well, but did much more of, and which the financial system in other countries has done. It is a market failure, in that the information flows about small business or new business inherently are more difficult to assess. It is inherently more difficult to assess the worth of a new business for all the obvious reasons. Usually in markets where there are major information failures, markets that matter for society, the Government tries to standardise and make public and available more information so as to alleviate the market failure. It does not mean you try to get rid of arbitrage of information—if high street bank A does a better job of recognising a good business than high street bank B—but that you get it out there.

A third thing which I think is important to recognise is the state has the advantage in many of these areas, including in research and development, including in infrastructure, but also in this area—of thinking of itself as having a heavy and very broad portfolio. This is politically difficult, right? So you can fund 10,000 businesses and if 4,000 of them failed—that would be a significantly high percentage—but anyway, say you funded 10,000 small new businesses and 4,000 failed; no doubt the officials who had promoted the investment bank would then be called to task. From an economic point of view, for the good of the country, that might actually be an excellent policy. You are not protecting the individual businesses that are taking the risks from failure. There is competition but those 6,000 businesses that survive—and presumably after surviving some of them grow—more than offset the losses on the 4,000.

Again, that is something that Governments have done sometimes in areas like R and D. It is not that you want the Government to decide which particular genetic molecule or which particular jet engine to subsidise, but you want some sort of criteria to fund these things that don't always get there, and hire or subcontract some people with expertise. So I think you can think of a similar sort of model for a small business bank. Or you can go one step further. Again, I am very open to this. The Kreditanstalt für Wiederaufbau in Germany is by no means perfect but in its role in helping Germany recover and rebuild after the war, it essentially passed criteria and very conditional amounts of money on to actual banks. Those banks made the individual lending decisions. It wasn't the state. They got into trouble later a bit when KfW was under political pressure and said, "We would really like you to lend to this sub-region or lend to this industry." That is a risk. On the other hand, after seeing the performance of the financial sector for the past few years, the sort of "night and day" view that a private market outcome would not have engaged in that is clearly false.

I am sorry to keep coming back to it, but it all comes back to having to think about the UK the same way that the UK thought about itself when Prime Minister Thatcher came in, or when the IMF shows up at a country to do a review or the OECD does a review. What are the structural deficiencies in this economy? What are the places where there is obviously a gap between what the UK is doing and best practice? What are the institutions that seem to function that are lacking? We did that in this country—if you will forgive my using the first person—over labour markets when they got way out of whack. It is time to do that in banking markets. As I tried to say briefly in that *Prospect* article, there are countries such as Malaysia, Korea and Brazil that are doing that now and rapidly improving their financial systems.

**Mr McFadden:** I want to continue on this theme, Dr Posen, and ask you a few questions about the structural mix and the size of banks. Continuing on from what John McFall asked you, you have been an advocate of some kind of public sector business bank for SMEs. Those of us around this table who have constituencies regularly meet SMEs who talk up the problems of getting funding from banks for new ideas. The Government have talked about some kind of investment bank. Can I ask what you think the gap is between what is in your mind and what is on the table?

**Dr Posen:** As I understand what is on the table, based on the Chancellor's autumn statement and various other things I have picked up, I think the gap between what is on my mind and what is on the table is a few things. First, the most obvious is scale. Even if you assume that this will be a bank like any bank that has a certain amount of capital that gets leveraged up, the initial amount of money being put up is rather small. Secondly, one doesn't want to go too far with the idea that every banker is replaceable by each other. A banker is not replaceable by a non-banker. There are maybe a bunch of unemployed bankers or young bankers who should be hired for this. I don't get the sense that there is a real effort to build up the human capital of a cadre of people who are qualified to do this work and would do it well.

A third piece of it is the ability of this bank, entity, whatever it is—if it gets built—to offload its lending. That's why, when I started advocating along these lines, I paired it with a proposal for a securitisation.

**Mr McFadden:** Yes, I was going to ask you about that.

**Dr Posen:** If that's not the case, you have to think about something else such as the Bank of England actively discounting the loans, although that is very difficult when you are dealing with individual small business loans; hence, the move for securitisation. There needs to be something that allows the bank balance sheet to turn over.

Another piece of it goes back to the implementation point. You need a sense from the legislation, when it is put forward, of the criteria you'll be using and perhaps the infrastructure for helping small businesses apply for loans, and to provide standardised information.

I don't want to be dismissive of what the Chancellor and the Government propose. I would rather have them say they are going to do what they are doing than nothing. However, I do think there is a gap in size, scale, implementation and depth of human capital, which is the way that I would put it.

**Mr McFadden:** The phrase "picking winners" has been used for several decades in the UK to avoid backing any number of good ideas and to justify standing back from active industrial policy. Given the flaws in current gaps in the way that banks fund business, do you think it is time to kill that phrase and get over it?

**Dr Posen:** Again, as someone who still considers himself something of a market economist, I don't necessarily want to kill that phrase. There are certain markets and certain Government decisions here and elsewhere where picking winners is a problem, but—

**Mr McFadden:** Not as big a problem as picking losers.

**Dr Posen:** There you go—good line! I guess the thing is that there are any number of excuses for inaction. Picking winners is one, and that is why I gave the example, which I think is entirely relevant, of the thought experiment: you pick a portfolio, you devolve the choice to the individual loans—

**Mr McFadden:** I can see the parliamentary hearings now, under that—

**Dr Posen:** I understand, but if it's going to be an investment bank that does investing, that's how you judge a bank. I'm not making light of that. It's just the reality.

Another phrase is, "This will fall foul of state aid rules in Brussels." That's another phrase that is used repeatedly as an excuse for not doing something, which is fascinating because so much of UK policy is premised on not caring about what happens in Brussels. There are any number of excuses. The picking winners issue becomes most important when you are worried about what the people who advocated picking winners would call a strategic industry. Since I am on record and I don't see any contradiction between having a state business bank and not saying that this is a strategic industry—the financial industry needs to be subsidised and protected; if anything, it goes the other way.

**Mr McFadden:** Can I ask you about the second new institution that you have argued for, which is some kind of Fannie Mae or Freddie Mac type institution to securitise SME loans? Can you expand on that a little further for a British audience, because we are not always familiar with what Fannie Mae and Freddie Mac do?

**Dr Posen:** Yes—that was blessed by American chauvinism as a term of art among people in the field. On what Fannie Mae or Freddie Mac—or Sally Mae, which does student loans in the US—ideally do and what they used to do, think of them as a warehouse and a retailer. They warehouse loans. The banks come to them and say, "I've got a bundle of loans, all of which are to small or medium businesses in the size range of £1 million to £15 million turnover and all of them are in north-east England"—or some other transparent way of telling you what is in that bundle. The idea behind Fannie and Freddie is the law of large numbers, which is that if you have a large number of investments or objects that have similar properties, each one individually may be subject to "weather", or that labour councilman's demands, or that protest, but overall the distribution will have some properties you can expect.

**Mr McFadden:** Wasn't that the theory behind securitising mortgage packages?

**Dr Posen:** Yes, and it worked for 35 years. The breakdown was twofold. First was that the banks and rating agencies started lying about or misrepresenting what was in the bundles. At Fannie and Freddie, the people there stopped scrutinising as well as possible. This goes back to culture and other things. Until the early 1990s at a minimum, they were pretty good about scrutinising and therefore the industry did not give them stuff that was hard to discern.

The second thing that happened—this goes back to the statist line, which was the issue Lord McFall was raising—was that Fannie and Freddie were the US version of quangos, so they were Government-guaranteed, but supposedly for profit. Through the first 20 or 30 years—I don't know exactly—the profit motive was secondary. They behaved like utilities: they took these bundles, they checked them out, they repackaged them with clear labelling of

what was in them, and they shoved them out the other end and sold them to investors. I said that it was a warehouse of a salesroom because they were not supposed to stock up inventory. The stuff in the warehouse was supposed to be there only long enough for them to go through it, quality check it, repackage it and put it on the shelf. When that shelf gets sold, the next tranche comes.

To increase their profits, Fannie and Freddie started keeping a whole separate warehouse for their own speculation, so stuff came from here and, instead of being sold off, just went back on to Fannie and Freddie's balance sheet, and they started speculating directly on those securities, which was contrary to the spirit, in my understanding, of their charter.

**Mr McFadden:** But essentially, you are arguing that, if the Government are going to get into the SME lending business, they will have to find ways of bundling things up to minimise risk. Is that right?

**Dr Posen:** They don't have to. There were long periods in the history of Britain and other advanced economies when securitisation didn't exist, but that subjects you to certain risks in the banking system. For example, if you have a bank that is totally focused on north-east England and Tyneside gets into trouble, everything at that bank goes down together, and you have a problem. Securitisation is the best guess I have for dealing with that—there may be alternatives.

**Mr McFadden:** May I ask you one more question, which is about banking size? You testified to the US Congress that, when nationalised banks in the US are brought back to the market from public ownership, they should be broken up. You have a very different model in the States, with a lot of small retail banks, whereas we have three or four dominant chains.

**Dr Posen:** Absolutely.

**Mr McFadden:** Why is smaller better, particularly given that there have been crises such as the savings and loan crisis in the US, whereby you had lots of small banks, but lots of them went down together? Why is smaller necessarily an insulation?

**Dr Posen:** It's not. I and several others probably fell too much in love with big banks 10 or 15 years ago because of the savings and loans crisis, which was clearly a result of small banks. The quick answer—I am aware of the time; I apologise and will try to be more concise—is moderation in all things. There is therefore a trade-off. If you have a small bank, it is inherently less liquid and has a less diversified portfolio, and is therefore more subject to localised risk. It may also be harder to scrutinise.

If you have a bank that is too big, it becomes difficult for the regulators to rein it in. There are all the “too big to fail” problems, which I am aware that this Commission has discussed at length. Plus there is the monopoly problem, aspects of which the Vickers Commission has dealt with. Here in the UK, the idea that you have the four big banks plus Nationwide is extraordinary.

The idea is therefore not that big banks are inherently bad, but that you come up with two reasonable criteria: one is, “What's a limit on ‘too big to fail’ or disincentives?”; the other is, “What's a limit from a competition point of view of having too few banks?” Then you break up from there.

That is my view, which is non-partisan. You are familiar with all the people on the Vickers Commission, which everybody in this country talks about. If you go the US, there is a Republican former presidential candidate who's saying this; there's Tom Hoenig, vice-

chairman of the Federal Deposit Insurance Corporation, who was an extremely conservative Federal Reserve Bank president, but is saying this, and there are people on the left, like Simon Johnson, who's a colleague of mine, at the Peterson Institute, saying this.

**Mr Andrew Tyrie (Chair):** We've got a couple of nearly fully or part-nationalised banks—83% and just below 40%. What would you do with them if you were Chancellor of the Exchequer? What would you advise the Chancellor if you were Governor of the Bank of England, given that they are the key drivers of SME lending, and they're dysfunctional?

**Dr Posen:** Lloyds HBOS has a huge piece of that. The first thing that you have to do—to be honest, I believe that the Chancellor, or at least his advisers, has done it—is try to make an honest reckoning of whether you think these banks really are still under-capitalised: that is, they have enough distressed loans and few enough good assets to make them behave badly because they still don't have enough capital. That is politically a nightmare to admit, but you must at least start by making that assessment. My guess is that they are much better capitalised than they were, but they are not yet all right. Accounting and Basel standards and all that aside, there is still a large bad book of loans that should be hived off. Even if you don't want to admit that, the first thing you do, as Lord McFall was saying, is talk about doing a “bad bank” on, say, the Irish model, where you very aggressively hive off the risk and the bad loans, or the bulk of them.

The second thing you do is look from a competition perspective. The Japanese went through this as well and took the wrong lesson. I don't necessarily need a world in which at every corner there's an RBS, Lloyds HBOS, Santander or Barclays. Maybe there should be more variety; maybe that branch network is key to barriers to entry. You try to sell those off at a profit. That is one of the few assets in these banks that can bring money back for the taxpayer. So you try to sell those off.

A third thing that has to be thought about in the broader context that I know this Commission is working with, is whether you want to split up some of these banks to some degree along functional lines. You can decide to do that with nationalised banks without necessarily signing on in full to some of the proposals of the Vickers commission. You can decide, just as a matter of prudence for the public purse, that a boutique investment bank or a very clean commercial bank may be easier to sell because it is easier to evaluate, easier to package, easier to identify a buyer of than the whole thing.

**Mr Andrew Tyrie:** You're referring, for example, to the RBS investment bank.

**Dr Posen:** Exactly. That is a perfect example. One need not say, “I don't want any British banks to have combined investment banks/high street banks.” But one can still legitimately say, “From here, to get proper competition in both pieces of the banking world, and to start getting back some return for taxpayers, I would sell off the investment bank, say, from RBS.”

The final thing I would think about goes back to my attempt to respond to Mr McFadden. With advice from the Bank of England, this Commission and the Vickers commission, I would try to come up with what I think is the maximum size of a bank, consistent with diminishing the “too big to fail” problem. I would use that to guide me. There is not going to be one number. On the other hand, going back to “big dumb rules”, there are clever attempts by some regulators in this country, the US and the euro area to say, “Well, you'll just have an increasing ratio of capital as they get bigger.” Or you put them on the SIFIs list—the systemically important financial institutions—and then somehow you are supposed to do it. I would go for something blunter than that: some size limit on share of total

deposits or total lending in the economy. You enforce that and then you take the banks that are currently under public control and make them conform to that.

**Mr Andrew Tyrie:** In other words, break them up.

**Dr Posen:** The ones that are too big, yes—in this case in the UK. I am not trying to dodge it; I am just trying to say that it comes from principle. I don't have any flag-waving desire. I wasn't looking to break up Bradford & Bingley or Northern Rock; they were too small. Would I look at the ones that are currently 83%, or—what's the other one?—roughly 42% or whatever?

**Mr Andrew Tyrie:** Just below 40%.

**Dr Posen:** Just below 40%; thank you. They are too big.

**Baroness Kramer:** Could we stay on competition for moment? Other than a headcount—the number of banks we've got or whatever—what would a competitive banking world look like? How will we know when we've basically got there?

**Dr Posen:** That's a very fair question. The answer is that we will never know when we've got there, but we will know when it's meaningfully better than it is now. You have to look at that along three dimensions. One dimension is, as competition authorities do the world over, you can look simply at size and number of actors in the given industry. Whatever the number is now—I believe it is 80% to 85% of all lending in the UK goes through the four big banks plus Nationwide. That is an extraordinary number. You would want something very much below that.

A second dimension at which you would look—and which is where the US, for all its failings in various ways, has come out ahead—is that you want a variety of alternative forms of finance, not just banking or strictly traditional banking. So there are issues such as: how much commercial paper you issue; how much in the way of syndicated loans; how much venture capital; how many non-banks—ideally, not surreptitious shadow banks, but entities out there—do lending and investing? Again, you look around the UK, and when I have spoken in the past and speak now about the lack of a spare tyre, it is partly that you only have four banks plus one mutual of any size, and partly because there are fewer alternative forms of finance. As Haldane has put it in a different context, you have a less diverse financial system.

So one dimension is purely the number of competitors, and the second dimension is alternative forms of financing. The third dimension is that, frankly, you have to look at straight-up normal consumer evaluations of oligopoly. Remember that the consumer is not just the household—although it certainly is that—it's also the business community. So, what are the fees? One of the things that the Bank of England has very constructively pointed out repeatedly in its Financial Stability Reports is what's happened to lending fees in the UK banking system over the last few years. The idea that there is no demand for lending, yet the fees keep going up, and there seems to be very little competition between the remaining institutions on the fees—that would normally be a sign of oligopolistic behaviour, of anti-competitive behaviour.

**Baroness Kramer:** Somebody else suggested retail banking: when you've got a good savings product, you probably have a competitive system, which is an interesting test.

You talked a little about barriers to entry earlier. When most people use the term “barriers to entry”, they are talking essentially about this process of application for a banking licence, which is now being fundamentally reformed, and those kinds of blockages. Seldom

do we get a discussion about capital requirements. Essentially, we have heard the future PRA put forward its platform of levelling up capital requirements for new entrants and existing small banks, but the big boys still get to do risk-weighted capital play. Does that mean that whatever we try to do, that capital differentiation has such an impact on the underlying cost that the banks will experience that we are going to limit severely our ability to get a flow of new entrants? I am trying to work out how serious that problem is.

**Dr Posen:** I think it is one of those things where the devil lies in the details. I must admit that this is not my area of expertise, so I am sure that you can find other witnesses who can give you better on this, but my sense of the numbers is that I would not have quite that much of a counsel of despair about it. There is something of an advantage to the larger institutions in terms of being able to risk a little capital. On the other hand, under the Basel rules and things being contemplated here, you also need a lower overall level of capital to be a small institutional mutual. So, as the various entry barriers go, it is one of several, but to me it is not the big one. It is not without merit that if we assume there is some correlation between the size and diversity of a bank's portfolio and sophistication of management—and that correlation is not perfect and should not be exaggerated—it is reasonable for a larger bank to have a more risk-weighted approach than a straight-up mutual or a bank.

**Baroness Kramer:** Lastly, does competition per se have an impact on culture and banking standards? Obviously we have the example of the US, where sub-prime occurred in a highly competitive market.

**Dr Posen:** Obviously—this has to be said—failure occurs in every kind of market. With the Savings and Loan crisis in the US in the '80s, there was certainly criminal behaviour and there was a competitive market. It can go either way. You could come up with arguments that, in a cut-throat competitive market, people are more likely to be criminal because they are desperate; or that, in a lax competitive market, they are more likely to behave criminally because they know they can't be hurt. Again, assuming there is some middle ground we are trying to achieve, as with so many things, I do think that the sense of comfort, bigness and unaccountability—thinking, "I'm too important"—and just the strutting aspect of it, which I think also hurts culturally, has gone too far with the big ones now. That is my personal opinion; I don't have any great evidence to back that up.

**Mr Andrew Tyrie:** I have two more colleagues wanting to come in. I shall ask them to be brief, not least because they will both have the opportunity to cross-examine you at 10 am tomorrow.

**Mark Garnier:** Some time ago you argued that the function of banks was twofold: so that depositors can manage their day-to-day transactions and have a safe place to put their money; and, on the corporate finance side of things, to act as an intermediary to be able to lend money and then look through to see validity. First, do you still hold by that view of what banks are actually for? Secondly, do you think our banks might have lost sight of what they are really there for in the first place?

**Dr Posen:** I am sure that there are theoreticians and practitioners who can give you articulated views for other things banks should be doing in either the public or private interest, but to me, as you have summarised it, Mr Garnier, that basically captures it. Banks are for people to be able to make transactions and have some place to put their liquid funds safely, and are there to make loans of a sort that other financial institutions are unlikely to do, be it to small business or whatever. You know the whole literature about why that is the case.

So, have they lost their way? The answer is clearly yes. How do you get back to that? One version that I know various people in the debate here in the UK and elsewhere have pushed is the possibility of narrow banking, whereby you create banks that are very much dedicated to the small depositor. There are a number of sophisticated people who claim that that is impossible, that it would not work and that it would do all kinds of terrible things. I am at least sympathetic, as I believe the Vickers commission is, to the idea that there should be some guaranteed safe harbour for small depositors and transactions. This is one of the places where perhaps statism comes creeping back in.

One thing that you see looking around most of the non-Anglo-Saxon world—be it the Post Bank in Japan, the Sparkassen network in Germany, or similar institutions in western Europe and Asia—is that this sort of semi-Government institution that caters to small depositors does exist. We, being economists, have tended to look very much askance at this, and I am very much part of that, because there is the tendency for both Governments and politicians to use that as a honey pot—they take the money and then do terrible or wasteful things with it. Partly as a result, the returns on savings are often very low in these institutions. But then you come to the “compared with what” question. If we get to the state we are now in—by “we” I mean everybody in the western world—of very low interest rates because of the crisis caused by banks putting money into terrible things, I am not sure how big the lost or wasteful money is compared with that.

**Mark Garnier:** There is one particular question—I had several, but I will ask just one—that I would like to ask. I have often held the view that any commercial organisation should balance the interest of shareholders, staff and customers in more or less equal measure. Do you think our banks currently get that balance right?

**Dr Posen:** I have less of a principled view on that; I would not know what the ratio should be. But I do think that, for whatever reason—well, for a bunch of reasons we can guess at—the ability of customers to sanction their banks for bad behaviour is somewhat limited. Just think of how much of a hassle it is for any normal person, yourself included, to switch banks. Take NatWest, for example. Six months ago, as I recall, its computer system broke down for a week. That was really bad. Could I then walk out and say, “Well, I really want to transfer to bank x instead”? It turns out that that it is a hassle: you have to redo all your automatic payments; you have to figure out which bank you are going to; you have to get all your documents; and you have to do all this—for working people, that is hard. I do not want to overdo this but, going back to competition, that is one example of the market pressure on these companies. This is not a left-right thing. To me, a “free-market liberal”, in the British *The Economist* magazine-sense, looks at the banking system here right now and says, “This is bad.” The consumer’s ability to vote with their feet and say, “I don’t like this bank; I want to reward a better bank with my business,” is limited.

**Mr Love:** Can I return to regulation? Both the PRA and the FCA have announced that they will be looking to have a principles-based system of regulation, rather than rules-based one, and they have cast some doubt on rules-based regulation. Right at the beginning of your evidence, you said that what we need is regulators with little discretion and large rules. Do you have a sceptical view of principles-based regulation?

**Dr Posen:** Yes.

**Mr Love:** Tell me more. Everyone is looking towards principles-based regulation to resolve some of the contradictions of years passed.

**Dr Posen:** You are right to raise this, Mr Love. Chairman Tyrie started the session by asking what the lessons learned are, and I think that that was where I came in with this. People of good faith, including my senior colleagues at the Bank of England, sat there with people in government and said, “Okay, what’s the lesson of the failure? Obviously we blew it.” One lesson that was taken was that tripartite does not work, so we should fold it all back into one institution, but let us leave that aside for a moment because that is rearranging the deckchairs on the Titanic—I do not think that the forum matters very much.

Another big lesson that was taken was that we had—again, you have heard several people say this before this Commission, the TSC and other groups—this culture of box ticking when banks were meeting the standards, but not meeting the spirit or intent of the law. I view that as a misreading of what actually happened. The interpretation, to my mind, that supports the argument that we must go with principles is that people say, “Wow, the banks were just really clever and they came up with these things that looked okay to the supervisors, but they were secretly doing this, this and this behind the back door. The banks are always going to be cleverer than the supervisors, so we cannot have a static rule because they will always have lawyers, brokers and other people to figure out ways around it. We have got to be very adaptable and loose to try to get at this.” That, to me, is the spirit of what goes behind the principles-based view.

I have an opposite interpretation of what happened. To me, what happened was that all the supervisors and regulators got the message from on high—not just in this country, but in the US and large parts of Europe—that we are going to err on the side of loose, light-touch regulation and supervision, on the side of assuming that the markets will police more than we do, and on the side of assuming that a lot of what we do is really of annoyance to the banks and we want to see the banks do their own value at risk weightings and whatever. So we are not going to scrutinise things very much, because the whole spirit of the exercise is that we are going to give these people a lot of rope.

To me, what happened was not that the banks were so bloody clever that they figured out ways to pretend to adhere to the rules while getting around them, but that the banks were seen so ideologically in the right and had so much political backing that the regulators and supervisors felt that they could not and should not do anything, and just let it all go. The lesson is not that we have to prevent over-clever dodges around the rules; it is that we have to prevent supervisors from feeling that they should not be implementing the rules, or that there is any room for them to retrograde on them.

**Mr Love:** I know that you have been critical in the past of American regulators for not actually implementing the rules. They are claiming that there were no rules, but there were and they were not implemented. You are saying that the same thing happened here, in your view, and that we have covered it up because we do not want to admit to light-touch regulation.

**Mr Andrew Tyrie:** Just a quick reply, if you can manage it.

**Dr Posen:** Very quickly, I am not sure that I would say “covered up” because I do not know enough of the details. What I would say is that while there was room for improvement with the rules, the main problems were indeed with the message that you should not be bothering the banks. If we had had big bright rules, the regulators and supervisors would not have been able to get away with that message. It would not have been a question of varying with the spirit of the times.

**Mr Love:** I have one further question, based on your American experience. You have a much harsher sanctions regime in America, for all sorts of reasons. There are higher fines and, if I may say so, longer sentences. Do harsher sanctions lead to higher banking standards?

**Dr Posen:** As far as I can tell—I am not a legal expert—if you look at it, there does not seem to be any particular advantage to the Americans through the harsher sanctions method.

**Mr Love:** You do not think that it delivers—for whatever reason—higher banking standards.

**Dr Posen:** For whatever reason. The issue is that there were large parts of the American financial system that did not get caught up in the very bad behaviours and the self-destructive behaviours, but large parts of the large banks in the US financial system, as well as some small banks, did. That goes back to the regulators. We have been unsuccessful—I should not say “we”. The regulators have been unsuccessful in prosecuting or closing any of these cases. You know how few people have gone to jail or have been prosecuted for any of this, so that would seem to demonstrate that the sanctions regimes are not the problem.

**Lord Lawson of Blaby:** I am very interested in what you said about one or two things, particularly about the desirability of having a state bank for lending to SMEs. You have deployed this in a number of speeches that you have made, including one called “How to do more” in which you said: “Ultimately, this entity can and should be privatized”. Can you explain your thinking on that?

**Dr Posen:** Thank you, Lord Lawson. I will try.

**Lord Lawson of Blaby:** Because that is not the continental—

**Dr Posen:** Of course, and that is right.

As I said to someone earlier, a mainstream economist—I consider myself to be one—tends to advocate Government action when there is a market failure. If we were to create in this country a viable and sufficiently built-up SME or new business lending bank, it would presumably be making a profit over time. There would be no point in doing it if, on balance, it did not make a profit over time. It presumably would have some subsidy to the interest rates charged to small borrowers, in the sense that it is a Government entity and therefore has a lower cost of capital than a private entity. However, that does not necessarily have to be fully passed on to the small borrowers and that is never what I have suggested was the main advantage of doing this. It was never about passing on the subsidy.

Allowing that economics does not think of everything, the historical accretion of institutions matters, as you well know from your time as Chancellor. It is just through a series of historical developments that the British banking system has ended up where it is. The existence of such a public institution would, in addition to the other things that this Commission will recommend, take the British banking system from one state to another, where a more a vital and viable small business lending process exists. When you get to that other state, it should be possible then to privatise the entity. We can get into specifics—as we said with Fannie Mae or Freddie Mac—about whether you want to make it a quango-type structure or whether you really want to privatise it fully. There are several options, but if you can get the structure up and running properly, there is no reason why it has to remain in the public sector.

**Lord Lawson of Blaby:** But you went further. You said that it should be privatised.

**Dr Posen:** If it worked right, it should be. I don't have a set date for that, but absolutely, if it is set up properly, and is running properly, there is no particular advantage to why it has to be an ongoing Government institution. I merely believe that we will not get from the situation that we are now in to the situation where, reasonably, we want British banking to be through immaculate private acts, but it should be a private system in the end.

**Mr Andrew Tyrie:** And you're not going to get there by shaking up RBS and Lloyds, even along the lines you just proposed.

**Dr Posen:** It's a question of what gamble you are willing to take.

**Mr Andrew Tyrie:** But you are saying that that is going to push us in the right direction.

**Dr Posen:** Yes.

**Mr Andrew Tyrie:** That might do the job, but it might not be sufficient. Is that your view?

**Dr Posen:** Yes. My bet is that it would not be sufficient, but I would be perfectly happy to be proved wrong. My strong bet is that unless you gave some very specific instructions to some parts of RBS and Lloyds, it would not do enough.

**Mr Andrew Tyrie:** But on the basis of your analysis, we should certainly give it a go. That's the point you are making.

**Dr Posen:** Yes.

**Baroness Kramer:** May I ask a very quick question on that? A lot of the new small banks that are starting to appear, and are going for application, are targeted at exactly this market. Presumably, you want those institutions to thrive, and you could see the risk of having a big state institution that essentially offered better advertising, better terms and better everything else. How would you make sure that that did not happen, and that as the thousand flowers start to bloom, they aren't all crushed by another big elephant?

**Mr Andrew Tyrie:** With a brief answer.

**Dr Posen:** Yes.

I think it is a dozen flowers, rather than a thousand flowers. Even if they are not perennials, they can be replanted later, so if it turns out in this transition process that a few of those get banks get hurt, it is not something irreplaceable for society. Whenever Government intervenes, there are always some incumbents who get hurt. But if those dozen flowers were going to turn into a thousand flowers, I wouldn't be advocating this. I don't think you're going get there.

**Mr Andrew Tyrie:** Thank you very much for giving evidence. We will move straight on to our next witness.