ECONOMY, ENERGY AND TOURISM COMMITTEE

AGENDA

1st Meeting, 2010 (Session 3)

Wednesday 6 January 2010

The Committee will meet at 10.30 am in Committee Room 2.

1. The way forward for Scotland’s banking, building society and financial services sector: The Committee will take evidence from—

   Rt Hon John McFall MP, Chairman, House of Commons Treasury Committee, and Eve Samson, Clerk of the Treasury Committee, House of Commons.

Stephen Imrie
Clerk to the Economy, Energy and Tourism Committee
Room T3.40
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The papers for this meeting are as follows—

**Agenda item 1**

Note by the clerk  EET/S3/10/1/1 (P)

SPICE briefing  EET/S3/10/1/2
Economy, Energy and Tourism Committee

Treasury Select Committee Reports on the Banking Crisis

The Treasury Select Committee has published a series of reports into different aspects of the banking crisis. These cover

- The impact of the failure of the Icelandic banks (Fifth Report)
- Dealing with the failure of the UK banks (Seventh Report)
- Reforming corporate governance and pay in the City (Ninth Report)
- International dimensions (Eleventh Report)
- Regulation and supervision (Fourteenth Report)

The reports are available [here](#).

The UK Government and the Financial Services Authority have responded to the first three of the reports listed above and UK Financial Investments (UKFI) Ltd has responded to the second and third. The responses are also available [here](#).

The reports of most relevance to the Committee’s inquiry are those on the failure of UK banks, reforming corporate governance and pay in the City and regulation and supervision. The most relevant material from the summaries of these reports is shown below.

**Dealing with the failure of the UK banks (Seventh Report)**

**Roots of the banking crisis**

“The origins of the banking crisis were many and varied, including low real interest rates, a search for yield, apparent excess liquidity and a misplaced faith in financial innovation. These ingredients combined to create an environment rich in over-confidence, over-optimism and the stifling of contrary opinions. Notwithstanding this febrile environment, some of the banks have been the principal authors of their own demise. The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed. Bankers have made an astonishing mess of the financial system. However, this was a failure not only within individual banks but also of the supervisory system designed to protect the public from systemic risk.”
The merger between Lloyds and HBOS

“The merger between Lloyds and HBOS has been described in some quarters as a 'shotgun wedding'. Lloyds Group Chief Executive Eric Daniels conceded that the merger proceeded swiftly on the basis of relatively little due diligence and that the Government was involved to the extent that it offered to waive the competition rules. We also note that the merger may have prevented the collapse of HBOS with the consequent loss of many thousands of jobs and also avoided the outright nationalisation of the company. Nevertheless, from the evidence we received, if the merger has had injurious consequences for Lloyds TSB we consider that the responsibility for this lies primarily with the Lloyds Board.

Government's strategic objectives for the banking sector

“We welcome the fact that the Government has attached conditions to those banks in receipt of public funds for the purpose of recapitalisation. The Government’s priority now must be to ensure that these conditions—in particular those relating to remuneration and lending levels—are adhered to. “That said, we are concerned about the contradictions of the Government's objectives for the banking sector especially with regard to the part-nationalised banks. There is a pressing need for the Government to clarify its strategic objectives and priorities with respect to the banking sector.

Bank lending

“Whilst noting some positive signs, we are very concerned about the availability and terms of credit to the small business sector, and the slow movement on this issue by the banks. We regret the reports of sharp increases in bank charges and arrangement fees which can often be more damaging to businesses than higher interest rates. We deplore the behaviour of a number of those banks who have received so much public money and behaved in such an insensitive manner particularly to established customers.

“There are currently a number of Government schemes aimed at encouraging lending by the banks. However, it is difficult to form an overall picture of how effective those efforts are, and how well they are working together. We recommend that the Government, via the Lending Panel, ensure that there is published a clear overall strategy, with each of the schemes outlined, indicating its aim and progress to date. At present, the approach seems to be piecemeal and disjointed.

The future of the banking sector

“The rebuilding of consumer trust is closely wound up in depositors having faith in the safety of their deposits, and the stability of payment systems and other utility aspects of banking. In our view, depositor reassurance can in the short term best be provided through improving and strengthening the regulatory regime for all types of bank. We do not lightly dismiss the Governor of the Bank of England's instinct that a separation of retail from investment banking functions is "very attractive". We believe that this is a live issue which requires further debate, and one to which we will return.
Reforming corporate governance and pay in the City (Ninth Report)

Remuneration in Lloyds and RBS

"Whilst there is a strong case for curbing or stopping bonus payments for senior staff in Lloyds Banking Group and Royal Bank of Scotland, we accept the argument that the position of the banks would be worsened if they could not make bonus payments. If bonuses were prohibited at these banks, they would struggle to recruit and retain talented staff to the detriment of the taxpayer as a major shareholder in both institutions. That said, we highlight the lack of transparency regarding the exact cost of bonus payments, including deferred bonus payments, and call on the Government and UKFI to rectify this problem.

Regulation and supervision (Fourteenth Report)

The Financial Services Authority

"By any measure the FSA has failed dreadfully in its supervision of the banking sector, but it has already begun to rectify its mistakes.

"We note that the regulatory philosophy of the FSA has changed. It has less faith in market forces than before; it is more willing to challenge firms' business decisions; it now considers the competence of new bank directors and appears more willing to remove 'the punchbowl from the party'. All of this is good, but all of this is also fashionable. The FSA must develop the confidence to take unpopular decisions when the economic boom begins again, in the face of both industry and the political class.

Too big, too complex

"Many banks are systemically significant because they are too big, they conduct many types of business, or they are too complex and interconnected. We believe it to be unlikely that all banks could be shrunk to a size where they posed no systemic risk, but the Government can and should still act. First, it should ensure that there are no banks which are 'too big to save'. It should review the wisdom of allowing a banking market to be dominated by firms whose balance sheets are larger than the national economy. Second, banks must not operate under any incentive to grow large just in order to benefit from the status of being 'too big to fail'. We suggest that this market failure be addressed through a 'tax on size' administered through the capital requirements regime.

Reducing risks

"We conclude that it would be intolerable if banks took advantage of the implicit Government guarantee for deposits to take risky bets on proprietary trading. We urge the FSA not to rule out a prohibition on proprietary trading by deposit-taking banks at this early stage in the debate.

"We conclude that the more complex and interconnected a bank is, the higher its capital requirements should be, reflecting the greater impact they would have on the wider financial markets and real economy if they were to fail."
“Substantial reforms to capital and liquidity regulations are now required. The Basel capital rules did not work in preventing the financial crisis. Arguably they made things worse by distracting the attention of leading experts. We therefore support the introduction of a leverage ratio, to complement the more risk-sensitive minimum requirements under the Basel II capital accords. We also support an element of counter-cyclicality in capital regulation. These requirements should be based, as far as possible, on simple rules with a more limited role for discretionary judgements by the prudential supervisor.”

Response

The UK Government’s consultation paper “Reforming financial markets” is, in part, a response to the Committee’s report.

Jim Dewar
SPICe Research
17 December 2009

Note: Committee briefing papers are provided by SPICe for the use of Scottish Parliament committees and clerking staff. They provide focused information or respond to specific questions or areas of interest to committees and are not intended to offer comprehensive coverage of a subject area.