HOUSE OF LORDS

Financial Services Regulation Committee

Corrected oral evidence: Growth of private markets in the UK following reforms introduced after 2008

Wednesday 2 July 2025

10.15 am

[Watch the meeting]

Members present: Lord Forsyth of Drumlean (The Chair); Baroness Bowles of Berkhamsted; Baroness Donaghy; Lord Eatwell; Lord Grabiner; Lord Hill of Oareford; Lord Hollick; Lord Kestenbaum; Lord Lilley; Baroness Noakes; Lord Sharkey; Lord Vaux of Harrowden.

Evidence Session No. 1 Heard in Public Questions 1 - 15

Witnesses

I: Professor Kern Alexander, Chair for International Financial Law and Regulation, University of Zurich, and Director of Studies in Law and Finance, Queens' College, University of Cambridge; Professor Simon Gleeson, Visiting Professor, Faculty of Law, University of Oxford, and Consultant, Clifford Chance.

USE OF THE TRANSCRIPT

1. This is a corrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.

Examination of witnesses

Professor Kern Alexander and Professor Simon Gleeson.

Q1 **The Chair:** Welcome to today's meeting, which is the first oral evidence session as part of the committee's inquiry into the growth of private markets in the UK following the reforms which were introduced in 2008. Thank you, Professor Alexander and Professor Gleeson, for attending.

As this is the first evidence session of this inquiry, it is a requirement that members of the committee declare their interests or any relevant interests orally when speaking for the first time so that they are on the record. The session is open to the public, is broadcast live, and is subsequently accessible via the parliamentary website. A verbatim transcript will be taken of the evidence and will be put on the parliamentary website. A few days after the session, both of you will be sent a copy of the transcript to check it for accuracy, and it would be helpful if you could advise us of any corrections as quickly as possible. If after this evidence session you wish to clarify or amplify any points made during your evidence or have any additional points to make, you are welcome to submit supplementary evidence to us.

Perhaps I can begin by asking the first question, which I suppose is more directed to you, Professor Gleeson. Has bank lending to the real economy in the UK reduced as a proportion of the total volume of finance provided annually since 2008, and if so, to what extent can this change be attributed to the reforms of the UK regulation of bank capital and liquidity requirements?

Professor Simon Gleeson: The easiest way to answer that is to say that you can orient this by three data points—this is all derived from a speech by Nick Butt of the Bank of England not such a long time ago. There are three key points. Non-banks now account for around half of total UK financial assets. Over the last two decades, non-banks have accounted for the entirety of the cumulative increase in new corporate lending in the UK, and non-bank financial institutions now account for 50% of the stock of corporate lending. So, one way of looking at what has happened over the last 20 years is that bank lending has remained relatively constant as a proportion of corporate finance, and non-bank finance has effectively accounted for the whole of the increase.

Where that leaves us is, if you look at the stock of financing of UK private corporates, by and large, about 32% of that comes from UK banks, 12% comes from non-UK banks, about 40% comes from the debt securities market—we do not know who holds those—and 16% is non-bank lending. It is extremely difficult to measure non-bank lending because we do not really have a workable definition of "non-bank", so these figures are arrived at by effectively looking at bank lending and filling in the gaps. What we do not know is what the nature of those loans are. For example, a significant amount of that non-bank corporate lending probably consists of loans that were originated by banks and were then sold to CLO vehicles for onward transmission.

But the key point is that it is not really the case that there are banks in one camp and non-banks in the other that are in competition with each other. There are a large number of interconnections; banks lend to non-banks, non-banks lend to banks, and so on and so forth, so it is quite a hard thing to disentangle.

As to the second part of your question on to what extent this is to do with the UK's regulation of bank capital and liquidity, it is unquestionably the case that the bank capital regulatory changes that have been made since the crisis have reduced banks' overall balance sheet capability. That is true across the world—it is not a UK thing—and I do not think the UK is in any way different from the United States or anything else in terms of its regulatory structure in that regard. But the point here is that these figures that about 50% of corporate funding come from non-banks are by no means unique to the UK. That is exactly the same pattern that we see if we look worldwide, and specifically at major markets such as the US and, to a lesser extent, the EU.

The Chair: Just to put this in layman's terms, the exam question for the committee is really whether the reforms that were introduced after 2008 have resulted in lending moving away from the banks into the shadows, and therefore whether that has created unintentional but nevertheless real and unknown unknowns in respect of risk, and what can be done about it. I do not know whether you want to come back on that, or if you want to, Professor Alexander.

Professor Kern Alexander: I might also comment. I agree with Professor Gleeson that the increased capital requirements of Basel III have been implemented more or less on a uniform basis, with some exceptions in jurisdictions around the world. So you see, across the EU, US and UK, lower growth in credit provision by regulated banks, and the greater increase in the provision of credit has come from the underregulated financial firms, the so-called shadow banks, some of which in these jurisdictions are not subject to prudential regulation and capital requirements.

I add that one issue that should be looked at a bit more closely is that since 2010, in the G7 countries we have had massive quantitative easing. Central banks have increased dramatically the supply of money available in the system. At the same time the banks came under these constraints under Basel III that they had to price so much credit in a certain way. But the QE has contributed in part to the massive growth in this non-bank financial sector lending, and now the Bank of England tells us that we are in a process of quantitative tightening—QT. But this has been very incremental. In the US, in the same way the Federal Reserve has been undergoing QT. But still, the effect of the QE for 15 years is massive on the financial sector, and I think that the rise of the so-called shadow banking sector in the private markets has in part been contributed to by this massive increase in supply of credit from the central banks.

The Chair: What about the risk point?

Professor Kern Alexander: The risks are not well known. I believe that as a policy matter we ought to think in functional terms: the same risk, the same regulation. So, where non-bank financial institutions create externalities or systemic issues, they should be subject to some type of regulatory capital requirements, for instance. But I submit that many non-bank financial institutions are not systemic lenders; therefore, probably the prudential regulatory regime may not be suitable for them. But it is something that should certainly be looked at more closely by the regulatory community.

Q2 **Lord Lilley:** How has the regulation of bank capital and liquidity requirements affected the ability and willingness of banks to provide lending to the real economy? I ask the question in the context that I have seen a number of studies which showed that, since 2008, bank lending in the States has returned to the rate of growth it was prior to 2008, but in this country—and, I believe, to a similar but perhaps lesser degree on the European continent—it has been growing much more slowly. One would have thought that if it is a result of regulation, it would be the same both sides if the regulations are the same, unless they are being interpreted differently. So it is either that the supply is more restricted here than in the States, or the demand is more restricted, or limited, here. Can you unravel my question and try to answer it?

Professor Simon Gleeson: The answer to that is actually to do with catalysts. It is not simply a matter of banks' capacity going up and down. One of the consequences of the way in which we regulate banks is that banks have become considerably more risk averse. You can see that in the movement towards real estate finance and collateralised financing—it is one of the reasons why it is hard to look at absolute numbers. But the problem with SME financing, and corporate financing in particular, is that it is quite high risk. Banks are heavily disincentivised under the existing capital requirements for taking equity risk—indeed, anything that looks even remotely like equity risk—so bare SME lending is quite hard.

What makes the difference is private equity, which is one of the species of non-bank finance. If you have a non-bank private equity funder who is prepared to put some chameleon capital or some sort of capital-like thing into an SME, it suddenly becomes much easier for banks to lend to that corporate. What we are seeing in the US, to a large extent, is private equity houses coming in and putting that sort of intermediate capital into the corporate. The banks are then much happier to lend to that corporate. This is why we have cov-lite and all the rest of it: as far as the bank is concerned, if you have a sensible PE running the corporate, it is very happy to take on that risk.

We are not nearly as advanced as the US in having that sort of facilitation. We are still slightly stuck in the equity and debt paradigm. Since banks are heavily discouraged from holding anything that looks like an equity exposure, they are in effect discouraged from providing that sort of loan financing to that sort of borrower. If we had more PEs, we would probably be closer to where the US is.

Lord Lilley: Why are we lagging behind? It is just that British bankers are a bit behind the times?

Professor Simon Gleeson: Our regulatory system is heavily inimical to the development of that sort of non-bank financial institution.

Lord Lilley: Are there any specific pointers as to what kind of regulation is inhibiting that development?

Professor Simon Gleeson: To some extent, it goes back to MiFID. It is about who the private equity house can raise finance from. We restrict that quite heavily. We have got to the stage where a number of them are now financing themselves in borrowing from banks—that is insane, by the way—but the particular issue we have here goes to Solvency II and the restrictions that we place on insurance companies, which you would expect to be the ordinary providers of financing to private equity houses and the like.

Professor Kern Alexander: I might just add something about the US banks. You pointed out, very correctly, that they continue to lend now. They were covered in a lot of their lending. One reason is that most US banks are not covered by Basel III—only the biggest systemic US financial holding companies are—so you have a different regulatory regime for the small and medium-sized banks. The regulatory capital requirements are lower for these institutions, for example.

As I understand it, in the UK and in the EU, the capital requirement regulations generally apply across the board to all banks, but the PRA has tried to make a flexible framework for small and medium-sized banks in the UK; it says that on its website. Yet, as a general rule, the Basel framework applies to small and medium-sized banks, whereas, in the US, it simply does not.

Lord Lilley: Do they choose not to apply it?

Professor Simon Gleeson: Yes.

Professor Kern Alexander: The US chooses not to apply it. It is at the bank supervisor's discretion under US banking law. The Federal Reserve applies it to large financial holding companies, such as JPMorgan, but it does not apply to the many thousands of small and medium-sized community banks.

Lord Lilley: May I add a supplementary on something slightly different? I am puzzled as to where non-bank lending comes from. Being a simple-minded economist, I was taught that banks had a great advantage in that they can borrow short, so that people who deposit their money have it liquid, and lend long, which is why they are vulnerable. Anyone who wants to lend long would not do so through a bank—and would never have done so through a bank, would they? If they were prepared to let their money mature until the investment matured, they would always have done so. Where is the new source of that capital coming from?

Professor Simon Gleeson: For the answer to that, you have to start with the banking system and remember that it has extreme difficulty in raising new capital at the moment because the cost of capital is so much greater than the current return. There is, in effect, an absolute cap on the amount of deposits the banks can take. Corporate balance sheet cash balances have been going to the moon recently. If you are a corporate treasurer, you cannot put money with the bank because the bank does not have the balance sheet capacity to hold those deposits. This explains the development of things like money market funds and the securitisation boom for AAA. There is a large demand in the corporate sector for places to put its money; that is where the funding is coming from.

Q3 **Baroness Bowles of Berkhamsted:** I have some interests to declare. I am involved in capital markets and things as a non-executive director of the London Stock Exchange, Valloop Holdings and the Valloop Impact Captive.

I would like to probe a slightly different area: the regulation of private markets. In particular, how transparent are the valuations of the price discovery mechanisms and the structure of the ownership of assets associated with the provision of non-bank finance? Professor Gleeson, you have already mentioned things being sold into CLOs. There are already issues around the fact that the terms of loans seem to change at that point and bad things can happen to the debtor. So there is that side of it. It is quite startling when you delve into this and find that these things are happening. Can you shed some light on that side of things?

Can you also comment on whether there is enough investigation into and visibility of this via the Bank of England, whether through the Financial Policy Committee or elsewhere? It seemed to be caught out over LDI despite having spotted the fact that it was going on. I know that that is a bit all-encompassing.

Professor Simon Gleeson: The answer to the second of those questions is that the Bank of England has been very worried about precisely this valuation point—particularly in the context of things like PEs because, if what you own is shares in an unlisted company, the valuation has enormous potential scope. The same is true for loans to companies that are in distress.

The point here is that the vast majority of the companies invested into by a private equity fund fail. That really gives you a valuation problem. The Bank and the FCA have done investigations into this and are currently satisfied that the valuations being handed out are not too far away from reality, but what they are absolutely not doing is any sort of continuing, onward valuation. To that extent, there is, exactly as you say, a black hole as far as information is concerned. In an area where valuations can potentially move very fast, that will probably always be the case; it is inherent in the notion of a private market.

Professor Kern Alexander: I agree with that analysis of the UK situation. I would just add that the ECB has produced a report saying that there has been a lack of transparency in valuations and that there needs to be more disclosure of data in the private market sector by non-bank financial institutions.

In the EU, the problem is more around the fact that the ECB is the bank supervisor for prudential regulation but it cannot regulate the private markets. It is really up to all the member states to do that. The EU's disclosure framework is not so precise, so all member states do this rather differently. There are similar problems in the US around the disclosure of valuations and gaps in the data.

This calls for more attention from the Financial Stability Board, say, to link up supervisors in order to monitor, from a macroprudential perspective, these data gaps and the inadequacy of information regarding valuations. Some jurisdictions have been doing it better than others. I also think it is a problem that there is not really an exchange of information between supervisors in that regard; it should not be what it is now.

Baroness Bowles of Berkhamsted: You are saying there is a lack of data, and it is quite difficult to scrutinise a black hole. Do we need more compulsion for more disclosures—from which there are always unintended consequences; I am well aware of that—and for the exchanges between the regulators, to get their act together? Are they sufficiently joined up? Every time we ask questions about these things, they say that they are.

Professor Simon Gleeson: Most systemic supervisors would answer a strong yes to both those questions.

Lord Eatwell: Could I just ask, on the point about data: would it not be therefore desirable with respect to the non-bank sector to provide an incentive for the release of data? In other words, if you do not release the data, we charge you 1% or some other figure of your assets; if you release the data, that charge is reduced. Would that be a way to create a more comprehensive data system?

Professor Kern Alexander: I believe that creating regulatory incentives for disclosure of data is important. What the industry might complain about is that it is costly to provide all that data, and is the incentive offsetting the cost that they incur in doing so? That is the case especially for small and medium-sized non-bank financial institutions. I think Apollo Global Management and the big private equity companies could do it—but in wanting to a foster competitive new digital finance environment, having those mandatory disclosure requirements could be significant cost-wise. But still there is a need to have more data and more information.

Baroness Bowles of Berkhamsted: If you had data for just the large ones that could afford to do it, would that give you enough, without interfering with the smaller ones for which it would be a burden?

Professor Kern Alexander: The problem might be that the smaller ones, cumulatively, could become systemic. If you allowed them not to have substantial or significant disclosures, the risk might spread to the small or medium-sized loan providers. So it has to be carefully done. Disclosure generally is a good thing, and we want there to be more disclosure in markets. However, the mandatory disclosure that regulators require can sometimes be onerous and not necessarily economically relevant. Getting that mix right is very important.

Baroness Bowles of Berkhamsted: So, we want more data but we are not quite sure how to get it.

Professor Simon Gleeson: There is another point, which is that we have to be very careful in throwing around the word "data". If we know what we want, we can ask for it. If we do not know what we want, as usually happens on these occasions, you end up with a requirement to tell us everything, which produces the nonsenses that we had with things like MiFID, whereby we had thousands of data fields in reports which, once received, were never reviewed. If you ask the question, "What is it we actually want to know here?", it comes down to not very much more than the things that these funds ordinarily provide to their own investors on a confidential basis, in any event. So I do not think that there is any particular difficulty in requiring that sort of disclosure on a confidential basis to central banks and systemic supervisors. If we want to go beyond that, it creates a real risk of regulatory overreach.

The Chair: Just on that point, in our last inquiry we got a lot of critical evidence, particularly directed at the FCA, about lots of requests for data and information and no real clarity on what the purpose was. As I was listening to this exchange, a little alarm bell went off in my head. We do not want to create an opportunity for more requests that actually, as you pointed out, helps the large and established banks but makes it much harder for new entrants and the smaller banks to compete. Is it possible to do this? If you do not know what you want and you start demanding information, that will be counterproductive, will it not?

Professor Simon Gleeson: There is another point, which is that this is not a national business. Private equity houses invest wherever they happen to invest. If you impose data obligations on those PEs run in the UK, you are not necessarily learning anything very interesting about the UK economy.

The Chair: Also, we have already seen, with the growth in the United States, that they have a comparative advantage over us.

Q4 **Baroness Donaghy:** My question will be about competitive advantage. However, I have a bit of a concern—this may be my ignorance of the subject—that if 50% of the system is insufficiently transparent and can lose its valuation very quickly, that sounds like a huge risk to the system as a whole.

Professor Simon Gleeson: It is a risk that has always been in the system as a whole. SMEs fail on a very regular basis. The issue here is who ends up bearing that loss. If the people who bear the loss are investors who voluntarily assumed it, that is not a problem. Where there is a potential problem is if the loss ends up with people who did not know that they were exposed to it. The paradigm of that is bank depositors. So the risk is not the existence of the risk in the abstract; it is the question of whether there are mechanisms out there that would have the effect of passing that risk through the banking system to individual bank depositors in circumstances where they were unaware that they were exposed to that risk. It is that point of the interconnections between the shadow banking system and the banking system which give rise to the real concerns.

Baroness Donaghy: But we do not know the extent of those.

Professor Simon Gleeson: No.

Baroness Donaghy: I would like to ask about what is probably a slightly smaller area. To what extent do non-bank financial intermediaries have a competitive advantage over regulated banks in the provision of finance to businesses? To what extent are any competitive advantages regulatory in nature?

Professor Kern Alexander: Alternative financial providers are not subject to the same regulatory capital requirements as the regulatory banks, so they have a compliance advantage. That is a cost advantage, certainly. In some cases, non-bank financial credit providers can be a source of innovation and competition that is healthy for the banking sector. It is not just a matter of regulatory arbitrage—it is the fact that non-bank financial firms sometimes have information about smaller companies and can plug a gap that is needed, especially in the British economy, where the large banks are not really taking into account the needs of small businesses as much. It is very difficult to open a bank account, if you are a small business in the UK. Non-bank financial providers have a niche in the market, which they are more competitive in providing that service for—then aside from that you have the regulatory compliance advantage as well.

Professor Simon Gleeson: I would like to make just a couple of points on this. As Professor Alexander says, there clearly is a competitive advantage, which is to some extent derived from regulation. However, arguably that is to look at things the wrong way around. The thing that makes a bank unique is that it takes deposits. We regulate banks not because they lend but because they take deposits; they are the gateways to the payment system and all the rest of it. If we regulate banks in their lending activities more closely than we regulate non-banks, one way to look at that is that we are giving the non-banks a competitive advantage; another way of looking at it is that we are regulating banks more strictly because of the extra power that we give them, in the ability to raise deposits to fund their activities. So I think that one has to be quite careful about saying that the regulatory system gives non-banks a competitive advantage. It might be more accurate to say that the regulatory system places regulated banks under some slight disabilities by reason of the fact that they are licensed to raise deposits, that being their unique privilege and something that no one else has.

Baroness Donaghy: To what extent does bank lending meet the financial needs of most businesses, in particular SMEs? We have heard that the issue that, in the UK in particular, scaling up seems to be a major problem for companies; that this is the stage at which they sometimes sell out to an American company. We do not seem to have got it.

Professor Simon Gleeson: That is exactly right, but one way of looking at this is that the reason why banks do what they do is to make a profit. The profitability of a loan decreases exponentially with the size of the amount lent because, by and large, the credit analysis for a loan is about the same amount of effort whether you are lending £1,000 or £1 billion. SME lending is always economically unattractive to banks unless they can charge the sort of rates they generally cannot get away with charging—and that is before you take into account the fact that, as I say, that sort of lending has a large equity component in it, which is something banks do not feel they are particularly able to do. So it is true that SME lending is relatively unattractive to ordinary banks.

The solution to that is not to force the banks to lend to SMEs—that is a dreadful idea, in fact—but to create for SMEs other sources of funding that enable them to raise equity-like, venture-like funding so that they are not presented with this binary option of either raising more debt somehow or selling out to an acquirer.

Professor Kern Alexander: This is where digital innovation has come in. The tokenisation of finance has allowed some firms to raise capital by issuing tokens, and the FCA and the PRA have set up a so-called regulatory sandbox to encourage firms to engage in this type of capital raising. It is precisely about the point that it is not profitable for the banks to make these smaller loans. Innovation is taking place in the market; you have new sources of this loan provision that can take place through tokenised finance, for example. It will evolve and tokenised finance will be a greater source of credit, especially for small companies,

Q5 **Lord Sharkey:** On that point, can I ask about central bank digital currencies? You say that they may be part of the solution to the problem you are talking about. Can you explain a bit more how they are going to help?

Professor Kern Alexander: As a general matter, I know a bit about the ECB's creation of a central bank digital currency. The idea behind it is to create greater financial inclusion. It is in a kind of testing phase at the moment, but the ultimate goal—

The Chair: For retail or for wholesale?

Professor Kern Alexander: For retail, and also for businesses. It is intended that, where banks are not providing bank accounts, customers or individuals will be able to open a digital currency account directly with the ECB. The ECB does not want to be a banker and take business away but there is a need for financial inclusion, which is an important objective in the EU. In other countries around the world and other large emerging market economies, we see greater use of digital currencies; it is overseen by the Government in India. Digital currencies are emerging in different jurisdictions.

Lord Sharkey: Sorry—I just want to ask about the problem with that, which is disintermediation. The banking system itself would be put under some strain if this were to go ahead

Professor Kern Alexander: Yes. The ECB will not pay interest on a digital currency account, so it wants to create an incentive for people to use commercial banks and, yet, the opportunity for digital currency accounts to be opened. The Swiss National Bank is also examining this. They do not want to remove the credit institutions, but they want to have at least an alternative access point for individuals or small businesses.

Professor Simon Gleeson: I can declare a small interest here: I am on the Bank of England's consultative group for CBDCs. It is fair to say that the discussions of that group revolve largely around the exact question you just asked. I think it was Lord King who, in this committee's investigations, described CBDCs as a solution in search of a problem.

The Chair: That was actually the Economic Affairs Committee, which I was chairing then. That is what our report was on; it also pointed out the risks that arise if you do not have a limit on the amount that can be kept in there.

Professor Kern Alexander: Exactly.

Professor Simon Gleeson: Yes, absolutely.

The Chair: But let us not get into CBDCs.

Professor Simon Gleeson: Broadening the point slightly, there is an idea that, as Professor Alexander was saying, you could tokenise things to make them tradeable. You could tokenise SME funding, perhaps; investors would be able to buy chunks of corporate debt on the basis that they could sell them in a liquid market at some point. That might be a way of increasing the provision of liquidity. It is certainly a theoretical possibility; whether it is anything more than that, I do not know.

Q6 **Lord Vaux of Harrowden:** I have two separate questions. First, I want to step back to first principles here, because I am not totally clear what we are actually talking about when we talk about non-bank financial institutions. We talked about shadow banks having quite negative connotations, if you like. What institutions are we talking about? Is there any information on the amount of that 50% of corporate lending that each of that kind of institution is providing? That is my first question. This is fundamental but, at the moment, I am not sure that I understand what we are really talking about when we talk about these institutions.

Professor Simon Gleeson: The answer is that it is an entire ecosystem. There are possibly a dozen different types of non-bank financial institution. Technically, insurance companies are the largest of them; let us put those aside for the time being.

The largest component of the non-bank financial sector is money market funds, which are extremely boring things. They take in savings and invest them in government bonds, and they are not really relevant to what we are talking about here. The next largest chunk is what are called CLOs.

Lord Vaux of Harrowden: CLOs?

Professor Simon Gleeson: Collateralised loan obligations; the name tells you nothing about what they are, I am afraid. What happens is that a bank, having originated a bunch of loans, puts them into a vehicle and sells interest in that vehicle to other investors. That is the way in which these assets tend to get into insurance companies, pension funds and other types of long-term investors.

Then there are the private equity, venture capital types, which raise money not just to lend but, if you like, to facilitate lending. You can add to that real estate investment trusts and a whole bunch of other things, but the real point is that there is not a single thing called a non-bank financial institution: there is an entire ecosystem of different types of things doing different types of activities. I know that that is unhelpful.

Lord Vaux of Harrowden: It is not unhelpful but it leaves me more confused, because I cannot see that any of those are lending to SMEs—with the possible exception of the very last one that you mentioned, which is venture capital. Private equity certainly does not do so. It buys existing assets, leverages them up and, ultimately, packages them on again. So where is the 50% of corporate lending that is coming from this? Is it simply the fact that it has taken bank loans and packaged them up and they are now in someone else's existence; and that it is about not the lending that is happening but the ownership of the debt assets?

Professor Simon Gleeson: There are credit funds in existence which lend as if they were banks. Blackstone, for example, is I think the largest of them. They have credit funds which deal in loans in exactly the same way that a bond fund would deal in bonds. One of the important legal details here is that, thanks be to the good work of the Loan Market Association, it is possible to deal in chunks of loans to large corporates in almost exactly the same way as it is possible to deal in bonds issued by those corporates. Again, a lot of that is that you are dealing with loans originated by banks but acquired by non-banks.

Professor Kern Alexander: It is exactly as you said about the general business model of some private equity, but many of the bigger ones, such as Apollo Global Management, have credit funds that they use to make corporate loans.

Lord Vaux of Harrowden: They tend to be corporate loans to the things that they are investing in with the private equity fund. As I say, private equity ultimately is a way of sticking leverage into situations that otherwise institutions would not be able to get leverage into.

Professor Kern Alexander: Apollo Global Management made a $6 billion loan to InBev, for example, a few years ago. One of the reasons, I think, was because for the regulated banks it would have been too costly to make that loan for regulatory capital purposes. Yet Apollo could do it because it did not have the same regulatory requirements. Certainly, Apollo may have also been investing in InBev. But I think that in the future, we will see more credit funds created that are linked to investors such as private equity, and that is a trend in the market that will develop further.

Lord Vaux of Harrowden: To come on to that interconnection point, where do they get their money? Is that coming from the banks that do not want to lend directly and are doing it through—

Professor Kern Alexander: Yes, the banks. JP Morgan made the $6 billion loan, as I recall from reading the financial press, to Apollo Global Management for that deal. The risk weighting on that loan by JP Morgan is lower than if JP Morgan had made that loan directly, so this money is getting into the market through indirect channels.

Lord Lilley: I wanted to ask the same question: where does the money come from, and where did JP Morgan's money come from?

Professor Kern Alexander: Quantitative easing.

Lord Vaux of Harrowden: That brings me on to my second question. You mentioned the quantitative easing point, and you were suggesting that because of the constraints around what the banks can do, a lot of that money has gone off into the non-banking sector. I would just like to understand: what is the mechanism that allowed that to happen? How did it happen?

Professor Kern Alexander: Central banks engage in a number of activities. They purchase commercial paper in the market, they purchase corporate bonds and they also make money directly available to banks through the interbank market, through reserve accounts that banks have with the central bank. Both the Fed and the Bank of England have done this. The European Central Bank was even more known for purchasing corporate bonds directly from companies such as Volkswagen. This was at a time when the economies in Europe had slowed down. But the quantitative easing has sort of stayed in effect, and has only recently been slightly reversed. When it is reversed too much, it creates a type of volatility in the markets because the money is being taken out of the markets, and that is a financial stability risk that supervisors need to be concerned about.

But central bank money is really the origin of a lot of the growth in the non-bank financial lending area. It has just seeped into the market through multiple different channels. That is certainly the case in the United States, where the Fed has massively increased the supply of money through investments and through the primary dealers that they deal with, and so the money seeps into the market indirectly.

Baroness Donaghy: What is to prevent a repeat of 2008? It might not be on overleveraged mortgages but overleveraging something else. What is to prevent that with that system where this money is seeping in in various ways?

Professor Simon Gleeson: You cannot. What happened in 2008 was a market panic in the price of market-traded instruments. But as we saw with Silicon Valley Bank, exactly the same thing can happen even where the instruments concerned do not have a public price. If financial panics are inevitable, the question is whether they have unintended consequences.

Professor Kern Alexander: Regulation can also contribute to these crises. With Silicon Valley Bank, the US regulators did not require it to hedge its interest rate risk on its balance sheet, whereas in the EU they are required to do that. I am not saying that was the cause of the crisis, yet there were gaps in the US regulatory framework. Also, Silicon Valley Bank was one of those banks not subject to Basel III. So you had a lighter form of supervision for it; it was considered to be a medium-sized institution that was not systemic. I think that some of the risks can still occur that are systemic from medium-sized institutions, and that is what supervisors should be concerned about.

The Chair: In simple terms, what you are describing in answer to Lord Vaux's question is regulatory arbitrage.

Professor Kern Alexander: Technically, yes.

Q7 **Lord Hill of Oareford:** I need to declare an interest as an adviser to Santander and to Freshfields. Can we just jog back to the opening bit of the discussion? Professor Gleeson, I think that you said in your remarks in response to a question that you think—I believe you both do—that the effect of some of the capital requirements introduced after 2008 has been to limit the ability of banks to lend into the economy, and that the growth there since then has been outside the banking sector.

Do you think, then, that a measure or a set of measures that were introduced to increase financial stability have over a period of time started to have the unintended consequence of reducing financial stability? Is that the core of what you are arguing, in that with the risk that was identifiable, a measure was taken to reduce it, and maybe over time, the level at which those measures were set is having an effect one might not have wanted in the way that risk always does—it moves somewhere else and we do not know quite what is going on—and that therefore increases the risk to financial stability?

Professor Simon Gleeson: Yes and no. If we ask what we mean by financial stability, I would give a narrow answer to that, which would be the stability of the financial system and primarily the stability of the payments system. The most important thing about banks is that they are the providers of payment mechanisms to the economy, and the reason we had to bail banks out in the crisis was because, if that payment system failed, the entire economy would potentially go down with it. So there is a perfectly good argument that, by squeezing the riskier part of the business out of the banking system and into the non-banking system, we could be said to be improving financial stability.

Professor Kern Alexander: I add to that that we saw during the Covid-19 lockdown that the banking system demonstrated itself to be adequately capitalised and have adequate liquidity, and in part that was due to the Basel III reforms. So the banking system was able to withstand this crisis that occurred. However, the regulatory framework is a risk-based one, and banks should always be managing their risk-based capital and liquidity models in a way to take account of changes in the markets, and as the markets change, the regulatory standards need to adapt to those changes in the market. That is why we are at a point now where a lot of this credit provision is coming in non-bank financial firms that are not regulated. This is a development in the market that was not so substantial, say, 15 years ago, and therefore the regulatory scope needs to be adjusted to monitor this flow of credit where it is coming from, but also to understand that there could be economic benefits to more non-bank financial institutions making these loans: efficiency of provision; the banks normally charge borrowers a higher spread than some non-bank financial firms—so that should not be stifled by too much regulation. But we should be aware of the risks that come with that. So the market has changed in response to the evolving structure of the system, and regulation needs to change and to be calibrated in response to that.

Lord Hill of Oareford: On a narrower question, which you touched on a bit: on the existing capital requirements that are in place, do you think—as well as the points that have just been made by Professor Alexander about keeping an eye on the whole thing—that there is scope for looking again at some of those capital requirements, which would not increase financial instability and might increase the availability of capital?

Professor Simon Gleeson: Certainly yes, is the answer to that one. The policy behind Basel II was to try to fit regulatory capital requirements as closely as possible with the actual risk exposures of banks. That was very much set to one side with Basel III and Basel III.I, for reasons that we do not need to go into. Where we are at the moment is that there are certain types of exposures currently on bank balance sheets where the capital requirement bears no relation whatever to the actual riskiness of the exposure.

There is a more complicated point that might be worth raising. To go back to the 19th century, the reason why banks were the dominant source of lending was because your local banker had complete access to your payment records. He was in a better position than anyone else to do credit analysis on you and decide how much to lend you and on what terms. That has largely gone in the world as it exists today, for various reasons. It is entirely possible that the development of AI tools by payment banks could bring that all steaming back again.

The question that you are really asking is that, if a bank decides that a particular borrower in a particular set of circumstances is low risk and the regulatory system says that he is not, it is probably the regulatory system that is wrong.

Lord Hill of Oareford: Would it be possible for you, if you have any particular thoughts on the areas where it might be most fruitful, to look and illustrate that tension that you have just described? That would be helpful.

On one final thing, you said rightly at the outset that this is largely not a UK issue, in that all these rules were drawn up on the basis of international co-operation. We are now getting to the point in the United States where we are about to have a great big real-time pilot as to what happens when you start changing some of those judgments about capital requirements. Do you think that is a fair summary of what is going on in the US and that it might provide some real-time answers to some of these trade-offs between capital requirements and risk appetite?

Professor Kern Alexander: One of the key focuses in the US reforms that the new vice-governor for supervision made just a few weeks ago was that the leverage ratio should be rethought; it is a constrained amount of leverage that a bank cannot exceed, therefore it creates an incentive for banks to create more risk with that constrained amount of leverage. The US proposal was simply to not have the US Treasury bond market subject to the leverage requirement. Of course, it is self-serving in that it would help to fund the massive national debt, too—but they do not want it to be part of that constrained amount of leverage, as it now is. Those are areas that need to be looked at. The Fed has introduced this as an area of reform; it is a proposal and there is a consultation period out for it, and they are having a conference about it later this month. Another area that they are looking at is about reducing the capital conservation buffer in the Basel III framework for the individual subsidiary banks. That is another area to be looked at.

In my note, I made some comments that the Basel III framework has a 4.5% minimum tier 1 equity capital requirement, and that you have to meet this as a condition of authorisation. Ideally, capital should be available to cover losses for a bank as a going concern. Having this minimum 4.5.% level beneath which you are put into resolution or insolvency is simply not creating the right incentive. Possibly, that could be lowered in return for having a larger buffer that banks could eat into during the period as a going concern. What we want to do is to incentivise banks to improve their risk models, and to do that they have to hold enough capital to absorb losses as a going concern; that is ideally what we want them to do. By having this rather rigid minimum set at 4.5% does not serve the economic or regulatory purpose.

Q8 **Baroness Noakes:** I should declare an interest in that I have shares in a number of listed financial services companies. I want to explore the consequences of changing the capital requirements on banks. We have seen the increase in capital globally post the financial crisis, and a number of studies have shown the impact on lending. I wanted your opinion on what would happen if the capital requirements were eased, and whether it would likely lead to an increase in lending. The reason why I ask this is, following the stress tests in the States last week, which have been considerably softened, the response of all the big banks has been to raise dividends or share buybacks. That is to say, they are determining it as excess capital, not capital that is going to be kept in the business for the purpose of lending into the real economy. I am interested in your views of the mechanisms when you start to loosen capital, as opposed to tightening capital.

Professor Kern Alexander: The idea behind the capital conservation buffer is that a bank should meet it, but if a bank eats into that capital level, the supervisor has discretion to intervene and restrict distribution, with bonuses, share buybacks or paying dividends—but it is discretionary. That is a good approach; the problem with it is that, if there is a downturn in the economy, we want banks to have an incentive to lend more to help us to come out of that, but there is no real requirement from the regulator that they lend more—obviously, because they are a privately owned company. The Basel framework is built on the assumption that there is a flexibility such that banks will lend more if there is an economic downturn and that they should lend less if there is an upturn. That framework should be rethought, because its practical application has a lot of challenges.

Professor Simon Gleeson: There is a slightly more theoretical answer to that, which is that the American banks and, by implication, the American stock market, take the view that currently these banks are heavily overcapitalised, as a result of which the return on investment in their business is less than the return on a share buyback. I am not sure how much one can read into that specific development on that specific occasion. What it comes back to is that banks will invest in the real economy and in loans when the profit on that activity exceeds the cost of capital involved. At the moment, it does not.

Q9 **Lord Eatwell:** Can I follow up on the same thing? I declare an interest as an adviser to Palamon, a private equity company, and as a board member of Unity Trust Bank. The reduction in tier 1 capital worries me, because the tier 1 capital charge is related to systemic risk and the individual bank cannot measure systemic risk; it simply is not possible. So saying that you would reduce tier 1 capital to incentivise the banks to invest more in their models is a non-sequitur, because they cannot capture systemic risk. This whole issue of bank capital and buffers is tremendously difficult. As you point out in your paper, which you have submitted to us as evidence, once you start using the buffer, people know that you are in trouble. So you have a buffer that is supposed to be there to be used in times of trouble but, once you start using it, the market loses confidence in you. This is a problem that has not been solved. To put it crudely, playing around with tier 1 or buffer levels is not going to solve it, because it is a systemic issue.

Professor Kern Alexander: I agree entirely—it is a systemic issue—but I think that the regulator should think about how we can incentivise the bank to manage its economic and regulatory capital more effectively. As a result of what I propose by lowering tier 1 a bit, you would increase the buffer, precisely because, as you said, everyone knows that if you are eating into the buffer you are in trouble. So the bank has to maintain the buffer, and your de facto minimum is really beyond 4.5%; it is at 7% or maybe 9%. That is what banks are holding; in my note, in the appendix, you can see that they are holding 13% to 15% tier 1 capital.

The market senses weakness if you drop into those buffers. That is really the de facto minimum. As you say, the 4.5% minimum is an externality tax; we cannot really estimate exactly what it should be—but by adjusting it and increasing the buffer we might create a better incentive for the banks to manage their regulatory capital exposure a bit better. But I agree that there is a trade-off here, and the 4.5% is really not super-scientific; it was based on the assumption that we needed to get the capital level up in the system, which it did. It was a good thing; it stabilised the banks. We saw during Covid-19 that the banks had more capital and more liquidity, and they were more resilient in dealing with the economic slowdown. Now the market has changed—and my earlier point was that we had Basel III, and its requirements are very useful and helpful. But now the market has evolved, so we should think about how we might calibrate the Basel III framework a bit to respond to those changes in the market.

Professor Simon Gleeson: Can I make two quick points? On the systemic issue, the regulator has a specific power to impose a systemic buffer, which it varies according to its perception of the systemic risk. You can argue that that is covered separately. The second point is why we have bank capital requirements at all. We would not have capital requirements on something like Capita, for example, no matter how systemically significant it was. The answer to that is that, for non-financial entities, we are entirely satisfied that they can fail and be restructured with no interruption of the services that they provide to the real economy.

We have spent a lot of time and effort developing a bank resolution system that is supposed to do exactly that, and within that system you have the idea of the MREL buffer, which is supposed to be precisely the thing that is capable of helping a bank to restructure and recover without the necessity for intervention of any form. Nobody is going to suggest getting rid of bank capital requirements completely until we have done this a few times and we are satisfied that it works. Bank capital is a temporary solution to a temporary problem; there are other solutions out there. I do not find it difficult to imagine a world in which we no longer have bank capital requirements and we allow banks to set their own capital levels, provided that they have sufficient MREL or back-up to enable their recapitalisation in the event of a crisis.

Q10 **Baroness Bowles of Berkhamsted:** I wanted to intervene on the fact that we have this proliferation of buffers. Is that very helpful at all? Is anyone using the countercyclical buffer? That was the one that was supposed to be adjusted for economic circumstances, rather than for the bank's economic circumstances. I am sure that this proliferation goes back to Solvency II, when we started having buffers, and then everybody thought, "What a jolly good idea". What is the role of the countercyclical buffer, and has it been properly used alongside all these others to deal with what is supposed to be localised macroeconomic circumstances, or has it just been another little piggybank?

Professor Kern Alexander: The countercyclical capital buffer varies from jurisdiction to jurisdiction. The Basel committee published a model framework about how it should be used, which was more theoretical. In theory, it serves a good purpose, because you want banks to lend more if the economy is in a downturn and less if there is a boom in the market. But how do you determine when there is a recession or a point at which you want the banks to lend more—and then how can you make them lend more, when they may not want to? How do you determine the point in the cycle when they should lend less?

It is a very politically driven process in most European countries. Switzerland tried it; it had a countercyclical capital buffer for banks that made loans in Zurich, for example, but they found that it just was not manageable, because the housing prices were just going through the ceiling, so they withdrew it because it was just too difficult to apply and implement. In Denmark, there was a similar experience. So the practical experience in using the countercyclical capital buffer has not been good, because there is too much politics in setting and applying it. In theory it is good, but it has just not worked in practice. So in my note I have suggested that we consider doing away with it, because it is too complicated and there is too much politics involved in it, and we should focus more on the capital conservation buffer.

Q11 **Lord Kestenbaum:** I declare my interests in several investment entities associated with the Rothschild group, as well as being a director of JP Morgan Japan, listed on the stock exchange.

I return to a theme introduced by Baroness Donaghy to explore a little further the conversation about demand. Of course, the thrust of the question has been about the supply of capital, which obviously forces us to consider the wider relationship—what some call the ecosystem. As I think about that question, it causes me to think about those economies in the past decades that seem to have driven a wider ecosystem of both supply and demand. They seem to concentrate around certain cities: Bangalore, pockets of California, Tel Aviv and Helsinki once upon a time. There seems to be what you were alluding to: different pockets of capital and different pools of capital, with different risk profiles and different appetites for risk. That in turn seems to catalyse demand. These are all assumptions that I would love you to test.

Very much influenced by what you said earlier, Professor Gleeson, I make the obvious commercial point that most banks are disincentivised to lend, on pure commercial terms. First, what evidence do you have that catalysing wider pools of capital on the supply side in turn answers a genuine demand need? How would you respond to the demand cynics, who say that this is basically a moot question, because there is fundamentally an efficient lending ecosystem already and, therefore, these are all theoretical discussions? Following on from that, if that is incorrect—in other words, it is inefficient, and there are pockets of demand out there that are being unmet—what illustrations would you have of regulatory levers that you have seen that have gone to really catalyse supply and demand?

Professor Simon Gleeson: You are absolutely right in what you said about pools of local funding. Whenever you talk about this, we tend to come back to the Reg D market in the United States, which facilitates effectively local lending. If you imagine a situation where you have an accountant in Manchester with a growing SME as an audit client and a retired businessman looking to invest as an advisory client. If he puts those two in contact with each other, he is committing a criminal offence. Our regulatory system flatly blocks anything like that from operating in any way other than through authorised intermediaries, and those authorised intermediaries are then subject to enormous amounts of bureaucratic requirement.

It is all put in place with the best of intentions—to protect the investor—but, where these organisations have a space that enables that sort of intermediate funding, it seems to develop. There are all sorts of examples of that; there is clearly a demand for something like that. In this country, we flatly prohibit it on consumer protection grounds. That is, in many respects, the major problem.

The other point on this concerns when we talk about demand. This is purely anecdotal, but I have spent a decent amount of time talking to people in banks who are fairly passionate about increasing their own bank's SME lending. What they will tend to say is that, if you are a small business man who owns a growing business, you have two criteria. One of them is that you absolutely do not want to lose any of your equity. You want to maintain ownership of the whole damn thing. It is yours. You built it; why would you give it away? The second is that, if you are going to take in external funding—you must because you need it—you do not want a faceless entity lending on standard terms. What you would really like, more than anything else, is somebody you know—with a bit of money, preferably—who might get involved in the business and help you grow it.

In a funny sort of way, that is the venture capital model, but it is absolutely the case—certainly with the way the US market works—that you have local businessmen raising money from local investors who know, and have some relationship with, each other. It is entirely reasonable to see that a businessman who would be perfectly happy to take that sort of funding would be considerably less happy to take the same amount of funding from a global bank on standard terms with somebody with whom he had no relationship at all.

Q12 **Lord Grabiner:** I should disclose that I currently have investments in financial services entities; I currently have nothing else to disclose.

Earlier on in your evidence, Professor Gleeson, you helpfully told us—I found it helpful—that, as a negative point, there is no working definition of non-banks. Then, in answer to a question from Lord Vaux, you put a bit of flesh on that. Can I talk you through a scenario? Does the non-bank go to the bank and say, "I have a business that consists of lending money to SMEs, and I accept the risk associated with the lending that I commit to. Will you lend me money for that purpose?" Is that what is happening? What sort of conversation takes place?

Professor Simon Gleeson: It often tends to be the bank that is the expert in originating assets. Often, the investor will go to the bank and say, "I will buy a portfolio of loans that you have made from you, thereby extending your money to get you more".

Take a slightly more complicated example. Imagine a private equity house going to a bank and saying, "I would like to borrow money from you. What I am going to do is take that money and use it to support a number of businesses. Those businesses, once I have put intermediate capital into them, will then require senior lending. So, if you capitalise me, you can have first dibs on those loans, which will now be to much more attractively capitalised borrowers because they will have this stuff in the middle".

This, by the way, explains another big part of the jigsaw. When the Bank of England asked banks, "What are your exposures to non-banks?", they could not give an answer because it very much depends on whether your exposure to non-banks includes loans to companies in which non-banks are partial investors or where the non-bank arranged for the bank to make the loan to the non-bank. To confuse matters further, the European Central Bank is conducting an investigation into the funding of banks by non-banks because credit funds, in particular, spend quite a lot of money particularly buying banks' short-term commercial paper as a repository for their own funds.

So the interconnections are incredibly complicated. There is an IMF paper on this. It tries to draw out the various connections—they are almost impossible to describe in total—but, more importantly, there is not really a typical transaction type.

Lord Grabiner: It sounds as if there is a hidden element to the economy. How does the bank go about evaluating the quality of the loan? Does it dig into the potential investments that the non-bank is contemplating, or does it simply assume that the non-bank knows what it is doing?

Professor Simon Gleeson: The latter, because the non-bank will generally not come with an existing pool of investments. It will generally come and say, “If you give me this money, I will invest it”. It is not massively different from the offering of a hedge fund manager, for example.

Lord Grabiner: Tell me this: how do SMEs get finance, then? Private equity is not interested in doing it, and banks are not interested in doing it, so where do they get their money from?

Professor Simon Gleeson: At the moment, it is still primarily from banks. Banks are the largest lenders to SMEs. However, the reason why we have had goodness knows how many government initiatives on this, going back to the British Business Bank and all the rest of it, is that it is still perceived that there is a big gap. I think that is true. Again, if you talk to the people in charge of SME lending at the big banks, they will tell you that SMEs are not prepared to borrow—or, to expand that, they are not prepared to borrow at a price at which it will be economic for the bank to lend.

Lord Sharkey: Or if it involved a personal guarantee.

Professor Simon Gleeson: Yes.

Lord Grabiner: Or, as you said a moment ago, if they do not want to give up any equity stake in the business that they are growing.

Professor Simon Gleeson: Exactly.

Lord Grabiner: Does that mean there is a lot of talent out there that is potentially available but for ever unrealised?

Professor Simon Gleeson: Absolutely.

Q13 **Lord Sharkey:** Can I turn to the subject of dry powder? We are told that there is an enormous stock of dry powder and that it grows very quickly. Are there any implications for the real economy in that? Would it not be better, at least in theory, if this money were invested somewhere in the appropriate way? Why is it, if it is the case, that the stock of dry powder is rising and is so high?

Professor Simon Gleeson: Well, dry powder is generally undrawn, so it is a commitment to advance funds at some point in the future. It is clearly right that, to the extent that a funder has committed to fund in the future, he is probably not going to use the same money for something else today, so, yes, it must have a stultifying effect.

There is the point the other way round: committing to an investor of that kind is a cost to the person making the commitment. If his commitment is not taken up within a reasonable time, he is going to get fairly cross. You could argue that it is a self-solving problem, but I agree that it is a problem.

The Chair: On Lord Grabiner's point, I want to understand what you have said. You said that there are out there a lot of talented small and medium-sized businesses that could be growing and could be delivering but cannot get finance at a reasonable price. Is there a regulatory solution to this?

Professor Simon Gleeson: Yes.

The Chair: What is it?

Professor Simon Gleeson: You can remove the regulatory inhibitions that prevent something like a Reg D market developing in the UK.

The Chair: Can you explain what they are?

Lord Eatwell: Surely that cannot be right, because the market did not develop when the regulation was not there. The imposition of regulation has not stifled a lending market to SMEs; it was never there. Before 2008, there was no lending to SMEs—

Professor Simon Gleeson: I am sorry—I am not talking about bank regulation—

Lord Eatwell: I beg your pardon—we are talking at cross purposes.

Professor Simon Gleeson: I am talking about straightforward securities regulation. The way that this market works in the US is that you can offer more or less anything provided that the offering is not too big to anyone with investable assets of $200,000, not including their main residence or demonstrable annual income in excess of $200,000. You are basically saying that once potential investors exceed a particular threshold, it is perfectly legal to go and talk to them and see if they want to invest. That is what our regulatory system prohibits, and it does not prohibit it capriciously; it is a quite deliberate policy decision based on investor protection.

Professor Kern Alexander: In the US, these investors are so-called accredited investors and are high net worth or in the business of finance themselves. So the company can have limited offerings of securities; at a conference, say, all the individuals in the room can be offered investment securities in a new start-up company, which would not require a prospectus or any type of listing requirements. I think the EU framework permits countries to do that. Some countries have a concept of accredited investors, where companies can raise capital from a certain limited scope of potential investors without having to go through huge compliance costs. I think this current Government are trying to promote more of that now. In the US, the framework is called Regulation D—Reg D: it is an SEC regulation, which Professor Gleeson has mentioned. I do not think there is really anything equivalent right now in the UK that allows that. Something like that might help facilitate more investment in small start-up companies from accredited investors.

Lord Vaux of Harrowden: Does PISCES go some way to do dealing with that?

Professor Kern Alexander: Yes, exactly—that was just recently announced. So that is a recent initiative.

The Chair: Could you, between you, give us a note on this, on how it could work and what the barriers are? There is probably not time to go into it in detail now.

Q14 **Lord Eatwell:** I was very struck by one particular paragraph in the paper you put in, Kern, discussing the IMF report, where you discuss the way in which shocks to non-bank institutions could be transmitted into the banking sector—it was LDI on steroids, basically, that you were looking at. The issue then is: is it simply that systemic risk has been like a balloon and we have squeezed it in one point and it is grown up in another, and so it is still there and has just assumed another form? If that is the case, what should we do about it?

As you point out in your paper as well, a significant amount of the crisis derived from liquidity issues, which were then translated into capital issues by redemptions and the general collapse in values, and so on and so forth. Should we, for example, therefore give more institutions access to a lender of last resort, or should we have more access to a credit window of some sort? After all, the lender of last resort requires lending on solvent assets, therefore it is not just free cash. Or is this just a character of systemic risk in the financial system, which ultimately depends on trust in the financial instrument and, if trust disappears, you are out of luck?

Professor Kern Alexander: That is an excellent point, Lord Eatwell. I would emphasise that in most jurisdictions, the lender of last resort can only be made available to licensed credit institutions, even though the broader liquidity injection by the central banks can purchase corporate bonds and do more across-the-board stuff.

Generally, though, I think that the spreading of systemic risks to the non-bank financial sector is a real challenge: first, for the authorities to monitor and to identify and try to create mitigants to this type of risk developing. But then, when the risk manifests itself in a crisis or a liquidity shock, how do you address that? Central banks obviously will be involved in some way, but the playbook is not really that clear. It is better to have a regulatory framework of disclosure and transparency so that the macroprudential supervisory authorities can monitor how this risk is moving to this ecosystem—this non-bank financial system. That is the first step, so they can attempt to identify where these risks are going.

Then, once they do that, they have to make decisions on regulatory requirements. Some firms in this ecosystem are more capable of observing their losses than others, so those which are able to absorb losses maybe should not have such strict regulatory requirements. Others that seem to be more precarious in their business models might have stricter conditions for operation applied. A playbook is a real challenge that supervisors really have not come to agree on. I think that is what the IMF paper is trying to point out, that regulators see these risks coming but they are not really sure how to address them.

Lord Eatwell: I have another question, on a quite different level, on the SME funding bit. The standard history of the 19th century is that Germans invented industrial banking in order to put money into equity positions in the growth of German industry, so Deutsche Bank always sat with Siemens throughout its investment career, and so on and so forth. Deutsche and Commerz and so on become more like European banks now, or British or American banks. But do the Landesbanken still have a way of taking equity positions, and if so, how do how do they square it with their Basel III obligations?

Professor Kern Alexander: Where they do, the Basel III obligation would require them to hold capital against that equity asset. That was one of the big issues with Credit Suisse. Credit Suisse had equity exposure to its subsidiaries but also to some other companies. But the regulator in Switzerland gave them an exemption from holding regulatory capital on the bank’s equity positions in both the subsidiaries of the bank in foreign countries but also in companies where Credit Suisse was a shareholder. So now I think good practice, in the light of the Credit Suisse situation, has been that banks should be able, if they want, to hold equity in companies, but they should be holding risk-based capital against that. That is with the understanding that the equity capital is very risky, it will go down in value, therefore you are not going to get a low-risk weighting for this; you may have a higher-risk weighting.

The Chair: I should point out for the benefit of people watching online: Professor Alexander, you have agreed that we can put your paper on our website as evidence, but you are going to update it to take account of some of the points that have been raised by Lord Eatwell and others.

Q15 **Lord Hollick:** I declare an interest in three companies: KKR, GP Bullhound and Salica, managed private equity venture funds and credit funds.

I want to come back to a discussion that we had at the start of this meeting about valuation, and to look at the intersection—the interrelationship—between liquidity and value. Private investment funds typically publish quarterly reports on investments, and they use the BVCA or other accepted means of valuation to present the position to their fund investors and those who lend to the fund via credit—often, the regulated banks. So that is all well and good.

However, at the moment, we are living in a time when liquidity is very challenged indeed. Funds that would typically run for five or six years are now running for up to 12 or 15 years. Naturally, investors are anxious to get their funds back. In order to do that, they take advantage of the opportunities in the secondary market, where, in order to gain liquidity, those earlier valuations have to be discounted by 20% or, now, by up to 40%.

This raises a question around the regulated element of the funding side of these funds: have they marked these valuations and these liquidity problems sufficiently accurately to put the capital weighting and that of the regulatory requirements in the right shape? As the chair mentioned, we are not necessarily trying to increase regulation, but, in terms of the regulation of this area of the market, do you feel that there is sufficient transparency and data that are being taken notice of by regulators in this growing market, which could provide a significant systemic risk?

Professor Simon Gleeson: No is the only possible answer to that. This issue hits a rather painful dividing line in bank regulation because traded assets have to be marked to market and valued regularly. Banking book assets are generally carried at the originating value until maturity. If you have made a three-year loan, you cannot revalue that loan unless your auditors agree, you have had the revaluation signed off and all the rest of it. It is not as bad as it was but, in some respects, you could say that banks are prevented from taking those adjustments because of the rules about not marking to market long-term assets.

To be fair, the same rule works perfectly well the other way round. You would not want to see a bank increasing the value of its loan because the assets of the borrower were doing particularly well. You are quite right that there needs to be some mechanism for at least monitoring that exposure; however, there is no such thing in the regulatory system as it currently stands.

Professor Kern Alexander: I can add to that. In the IMF report that Lord Eatwell referred to—I note this in my report—one of the criticisms of the non-bank financial institutions framework and ecosystem is that the valuations are often done mark to model and not mark to market. So, if any type of liquidity shock hits the system, you suddenly have to try to sell assets that have a higher valuation based on mark to model, which is not really realistic in the marketplace. That is one of the critiques that the IMF makes; the ECB has said that as well.

Lord Hollick: If we go back to 2008, it was in essence a liquidity problem. If the assets that are being held by the banks are, in effect, illiquid and would cease to perform providing the interest or whatever, that could spark a liquidity run. Against that doomsday scenario, which we want to avoid, what steps should regulators in the UK be taking now to satisfy themselves that that risk is at an acceptable level and that further buffers or other things should be done to protect against a return of 2008?

Professor Simon Gleeson: The regulators have taken steps in that direction. It is fair to say, I think, that the banks have pushed back, the essence of the bank pushback being that it is not the role of a lender to act as a quasi-regulator of the borrower. That is not an entirely unreasonable point but, realistically, the only thing that can be done at the moment is roughly what the regulators are doing, which is requiring the banks to try to accumulate considerably more information about the state of affairs in their borrowers.

Even though this is not something that could be mechanically plugged into a Basel-type system, it needs to be considered as part of the Pillar 2 assessment; in particular, it needs to be taken into account in the context of stress testing. My answer to your question is that the best regulatory response would be in the stress testing of this aspect of the portfolio.

Professor Kern Alexander: I agree. I would add that the regulator might focus on what the Swiss regulator has called regulatory filters so that, when the banks are making loans to companies in this so-called non-bank ecosystem, the risk weightings of these loans and of the provision of credit can be looked at closely and not be given a lower risk weighting than if the bank had made the same loan itself. That is a mitigant around the edges but, of course, it does not address the general problem of what happens if you have a liquidity shock across the system. We therefore get back to the Basel III liquidity coverage ratio, which is very important and which the UK has implemented faithfully in the regulatory framework.

There are some problems with the LCR, though. As I highlighted in my note, banks are actually holding far in excess of what they are required to hold by the regulator. They are hoarding liquidity on their balance sheet rather than making it available to small companies to be loaned out. That is something. Banks do not have to do that; the regulator is not making them do that. It may be because there is a lack of demand or the banks just do not think that there is enough money to be made by making that available.

The Chair: We have had almost two hours of fascinating evidence, for which we are extremely grateful. We can probably bring this to an end and release you. We look forward to having any further information that you want to add to your paper; if you, Professor Gleeson, want to follow up on anything, that would be extremely helpful. Personally, I am very grateful for the clear way in which you have both expressed some of the issues that are going to concern the committee in this inquiry. Thank you very much indeed.