



Financial Services Regulation Committee

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

Wednesday 23 July 2025

11.20 am

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

Evidence Session No. 4

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Questions 39 – 47

Witness

I: Professor Arthur E. Wilmarth Jr, Professor Emeritus of Law at George Washington University Law School.

USE OF THE TRANSCRIPT

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

Examination of witness

Professor Arthur E. Wilmarth Jr.

Q39 The Chair: Welcome to the second part of today's meeting, which is the fourth oral evidence session in the committee's inquiry into the growth of private markets in the UK following the reforms introduced after 2008. Thank you, Professor Wilmarth, for attending; I know that it is very early in the United States. We are very appreciative of your helping us not just by doing this session but through the paper you produced, which will be available on our website once this session is over and you have had an opportunity to take into account any of the questions asked. Do you want to make an opening statement by way of introduction or otherwise?

Professor Arthur E. Wilmarth Jr: Thank you very much; it is a pleasure to be with you this morning. I have been studying the banking and financial system, mainly in the United States but also on your side of the Atlantic, for the past 50 years.

The two largest changes that have been made during that period, which are very much implicated in this hearing, are these. First, we have allowed banks to get far away from their traditional business model and, in a sense, to embrace all aspects of the financial markets, which is a dramatic change from where things were in 1975. Secondly, we have allowed many other types of institution to get into the banking business, in effect, by engaging in what has become known as shadow banking—engaging in banking activities, by offering short-term financial claims that function as deposit substitutes and providing credit, but without the regulatory safeguards and requirements that we apply to banks. Both developments have caused many of the problems that we have experienced over the past 25 to 30 years, including many of the problems that you are looking at today.

The Chair: Has the differential treatment between large and regional, community or smaller banks in the implementation of the Basel standards in the US influenced access to credit for SMEs? Who is lending to SMEs in the US, and what factors are driving that lending?

Professor Arthur E. Wilmarth Jr: What we have seen in the United States—it is certainly partly a result of the crisis and its fallout—is a dramatic reduction in smaller, community-oriented banks. The number of what we would consider community banks is now around half what it was 25 years ago; it is down from about 8,000 to 4,000. Their share of banking assets is also down, from about 28% to 12%. In my opinion, that has certainly impaired and reduced the availability of credit to SMEs. Community banks still do an excellent job; there just are not as many of them, and they do not have as many assets.

The capital ratios that they maintain, compared to the large banks, are dramatically higher. Community banks generally have tier 1 equity/capital ratios that are, on average, well above 10%. For the largest banks, it is around 7% now, down from about 9% in 2017. Those

large differences in capital ratios cannot be explained in any other way than as a result of the too-big-to-fail policies we have followed in the US, as have many other countries, and those policies have given the large banks a tremendous advantage over smaller banks.

Unfortunately, large banks have not shown much interest in providing loans to SMEs. They cut their small business lending drastically after the global financial crisis; in my opinion, it has never come back. They make their small business loans primarily through credit cards in a very standardised manner. You do not see large banks making what we would consider classic relationship loans to classic SMEs. There may be support for some venture capital start-ups that are considered very hot. For example, I am sure that, if you present yourself as an AI business model, you might get some interesting attention from the bigger banks, but, if you are a classic small business operating on main street—what you would call the high street—there is not a great deal of interest among the big banks.

The Chair: Can you explain why that is?

Professor Arthur E. Wilmarth Jr: You hear from the big banks that it is just too costly. Of course, small businesses generally do not have credit ratings. They operate in niche markets, both geographically and in terms of product markets, so it takes a great deal of inquiry and familiarity with the geographic and product markets that they are serving, and with the entrepreneurs who own those firms, to determine whether or not they are creditworthy. Small businesses have a much higher rate of failure compared to large, well-established companies with good credit ratings.

I believe the big banks feel that there is not enough of a profit margin on loans to SMEs. I have made the suggestion that, if we required large banks to get back to the traditional business of lending and to get out of the capital markets business, perhaps they would then have an incentive to identify more creditworthy borrowers among SMEs. In the first six months of this year, the five biggest Wall Street banks have reported truly extraordinary trading and investment banking revenues; they amounted to about 20%¹ of their total revenues. Wall Street is celebrating, but I do not see that as a healthy indicator of what banks should be doing. This is certainly the direction we have been moving in the past 30 years, but it has had an inevitable and adverse impact on the traditional business of lending.

I was looking at the FDIC's statistics. The ratio of total loans and leases to total assets is around 40% for banks with over \$250 billion in assets. That figure would indicate that they are not devoting most of their attention to lending—they are doing other things.

The Chair: I was fascinated that, in your paper, you suggest that these smaller community banks are overregulated and that, by focusing simply

¹ Note by the witness: The correct figure is around 30% and refers to trading and investment banking revenues.

on capital and liquidity requirements, a whole load of regulation and therefore cost could be dispensed with. Do you think that there are lessons there for the UK?

Professor Arthur E. Wilmarth Jr: Yes. I believe that there are two problems with our community banking regulations. One is that the full suite of Basel III risk-based rules is not necessary. I am pleased that the regulators have adopted a community bank leverage ratio approach, which is, if you look at it, fairly demanding. It requires strong evidence that the bank is well managed and well run. If they also maintain a tier 1 leverage ratio above 9%, they are excused from the Basel III risk-based requirements under the so-called standardised approach. That is a very favourable approach. I noted that about 40% of community banks have opted for that approach, so they obviously find it valuable.

In addition, we just have not approved enough new community banks. The de novo bank formation in the US has fallen very far compared to what it was before the financial crisis of 2008. I believe that less than 100 new banks have been formed since 2008, maybe less than 80. That is a very low rate for the US historically. It is ironic that the regulators seem to be so focused on not approving a new community bank that will fail. I understand that failures are disruptive and costly, but we do not seem to apply the same degree of stringency to much larger banks that take much larger risks. Those banks seem to assume that, when they run into trouble, they will get a lot of support, which they do.

The Chair: It has been suggested that the current US Administration will likely relax banking standards or possibly withdraw from Basel altogether. Do you agree that this is likely? If so, what aspects of US bank capital and liquidity requirements do you expect to be scaled back?

Professor Arthur E. Wilmarth Jr: You have seen the first step, which is that US bank regulators are proposing to reduce the enhanced supplementary leverage ratio for the eight G-SIBs to a range of between 3.5% to 4.25%, which would be a good deal below the current minimum of 5% for G-SIB holding companies and 6% for their subsidiary banks.² That would be quite a drastic and unfortunate change. I have provided statistics in the paper regarding the leverage ratios of banks that either did or did not survive the crisis of 2008. For example, Citigroup essentially had a leverage ratio of 4% in 2007, and the Bank of America one of just under 5%. Both banks received enormous bailouts. You had your own experiences on your side of the Atlantic with banks that had relatively low leverage ratios because there was no leverage requirement at that point.

The other thing that seems likely is that there will be proposals to adjust risk-based requirements for the trading book. The Basel III endgame proposal would have put significant new requirements on the trading

² Note by witness: There are eight US Global Systemically Important Banks (G-SIBs). The current minimum enhanced supplementary leverage ratio in the US is 5% for G-SIB holding companies and 6% for their subsidiary banks.

book. Those have been withdrawn. It seems likely that regulators will propose to liberalise risk-based requirements further. The big banks seem most focused on the leverage ratio; the fact that there is so much focus on making the leverage ratio weaker strikes me as a fairly good argument for making it stronger. If it is affecting the way that they do business and they are really focused on that, strengthening the leverage ratio is worth considering.

Q40 Lord Sharkey: Thank you for your very comprehensive written report. I would like to ask you about summary paragraph E, which talks about private equity funds facing severe challenges imposing growing risks on bank lenders, captive life insurance and so on. Private equity funds and private credit funds are now seeking to sell risky and illiquid investments to retail investors, as well as pension funds and investment funds that serve those investors. To what extent does this present systemic risk? How would that manifest itself?

Professor Arthur E. Wilmarth Jr: It certainly raises some troubling possibilities. The statistics that seem to be widely accepted are that private equity firms are sitting on more than 3,000 portfolio companies with more than \$3 trillion of assets that they have not been able to sell. There was an enormous rush of private equity transactions in response to the tremendous pandemic stimulus of 2021 and 2022, so you had some \$5 trillion of transactions accomplished during those two years. Of course, then interest rates rose rapidly, which made it very difficult to exit those investments.

We have seen significant pushback from institutional investors indicating that they are no longer willing to put more money into private equity, generally speaking. In fact, some big university endowments are now struggling to liquidate and get rid of some of their private equity investments, even at a loss. It is not a surprise, therefore, that private equity firms are saying: "Let us sell these investments to retail investors, retail mutual funds and pension funds that serve ordinary people". That should be a concern. Could those investments crash the economy?

One thing that concerns me greatly is that economies around the world are so highly leveraged in so many ways that there is little margin for error. If one class of investments were to go wrong and there were to be a stampede out of those investments, there would be a contagion effect and a domino effect. You can see these risks not only in the longer-term illiquid private equity space but also in the hedge fund space, in sovereign debt markets where the repo market has become enormous. We do not know how large it is, but it is well north of \$15 trillion, maybe closing in on \$20 trillion. This is all short-term money that can move very rapidly. We have seen a number of disruptions and near crises on our side of the Atlantic in the Treasury bond market in 2019 and 2020, and more recently in April this year. You had your own experiences in 2022 and early this year.

For any one segment in isolation, one could argue it is not absolutely a systemic risk, although the private equity space is now very large, with

over \$10 trillion of assets under management. If you look at all the sectors together—how leveraged and how fragile they are—there has to be a concern that that you could see this domino effect. Your prior witnesses have pointed to the life insurance industry. We are already seeing troubling signs of excessive risk-taking by captive insurers controlled by private equity firms. One might imagine how that might spread if you then give private equity firms the ability to sell to what we call mutual funds for retail investors and retail-oriented pension funds.

Lord Sharkey: Where in all this are the regulators?

Professor Arthur E. Wilmarth Jr: That is a good question. Currently, unfortunately, on our side of the Atlantic, the attitude seems to be: “We need more risk-taking and fewer restraints”. Certainly, this has been shown most dramatically with crypto assets, which are not the focus of your inquiry but could well become the focus of this inquiry or a separate one, because all the problems that I see in the real economy are now showing up in the crypto economy. To call it an economy is unfair; it is an empire of thin air that is now drawing a lot of investment, which is very unfortunate.

There seems to be a lack of concern among regulators on our side of the Atlantic about the aggregates of risk-taking and leverage that are being taken on. I know that such encouragement for additional risk-taking puts great pressure on your side of the Atlantic, because everybody feels “We have to do what the United States is doing; we have to chase the United States”. I am afraid that we often do not serve as a very good example for our elder siblings across the Atlantic. To me, crypto is one of the most recent of those bad examples. I think that the amount of debt that we have allowed our economy to take on and our largest institutions to support is troubling.

The Chair: Could you just expand on this issue of life insurance companies and what you are doing?

Professor Arthur E. Wilmarth Jr: Before it turned to retail investment funds and pension funds, private equity first turned to life insurance companies. Most of the largest private equity firms have now acquired captive life insurers. They control about 10% of the US life insurance industry, with about \$1 trillion of assets under management. This has been an exceptionally favourable and profitable source of patient investment capital for them because, of course, the private equity owners are not going to complain about the returns that they receive or do not receive from a captive life insurer.

In our country, life insurance is primarily a matter of state regulation. You have 50 state regulators, and the Federal Insurance Office is primarily an advisory body. The Financial Stability Oversight Council has, in the past, designated certain very large insurers as systemically important and therefore subject to federal regulation, but those designations were all removed during the first Trump Administration and

not reinstated. So, essentially, there is no meaningful direct federal regulation of insurance.

State regulators have expressed increasing concern about the investment patterns of these captive life insurance companies that are tying their assets up in a lot more leveraged loans, junk bonds and private credit obligations, which are not traditional or typical for life insurance companies. But there has been only mild pushback to date. There have been some efforts to tighten asset regulation, but I do not think they have been very successful.

Q41 Lord Hollick: You spoke this morning and in the written evidence that you will submit about a high level of concern over the risks being taken. Those risks also include the public generally, through the process of mutualisation. I think you are right to draw attention to this. The private finance market is lightly regulated. Indeed, some have argued that that provides an arbitrage opportunity, which is being grabbed with both hands. It would be interesting to hear from you how the regulators should set out to look more closely at the interconnectedness of this market and the risks that are being taken by ordinary citizens as opposed to allegedly sophisticated financial institutions. How do we shine a bright light on what is going on in a market where information is scarce?

Professor Arthur E. Wilmarth Jr: The Financial Stability Board has issued a new report on leverage in the non-bank financial intermediation sector. I note that, when the FSB started monitoring what we now call NBFIs, it called them shadow banks, in the shadow banking monitoring reports. I thought that was very desirable, because these are shadow banks. They operate much like banks. Look at broker dealers, for example, and money market funds; certainly, the people who are involved in the repo market and money market funds expect their money back tomorrow or the next day if they want it, which to me is a banking deposit.

In the early days after the crisis, there was this focus on shadow banking, which was then changed to a more euphemistic term: non-bank financial intermediation. It is interesting, because intermediation used to be considered the most classic function of a bank. You take deposits from the public, you provide a safe repository for those deposits, and you make loans to companies that often cannot access the bond market. That was a classic bank function, and to allow non-banks to undertake it seems a drastic step, but it has been taken.

The FSB's most recent report makes a number of useful recommendations about ways to try to limit and control leverage through, for example, more disclosure, more reporting and moving systemically important markets such as repos and sovereign debt markets to clearing facilities, which should have their own capital requirements for participating clearers and margin requirements for customers.

Some of those efforts have been made. The SEC in our country tried to take some of those steps for private equity firms and hedge funds. It put out some disclosure requirements and they were knocked down by the courts. Attempts to implement these proposals have not been very successful, partly because we do not have the statutory basis to impose them on nonbanks in the same way that we do under the banking system. However, I definitely believe that it is important to move toward more disclosure and then begin to look at aggregate position limits and concentration limits.

My view is that the repo market should be brought entirely into the sunshine and some kind of clearing should be required for all repos. At this point, it is simply unacceptable that we do not know how big the repo market is. Disclosure, reporting, clearing and margin requirements are all good prophylactics that could be useful, but fundamentally we should reconsider whether this is the type of activity in which we want non-banks to engage. What are the risks and costs of doing that?

In 2008 and 2020, we saw all these wholesale non-bank funding markets being bailed out in the same way that deposits were. That created a very unfortunate perception that these markets were just as protected, but they are certainly not regulated in the same way.

Lord Hollick: Do you think it would be appropriate for regulators and the central banks to warn private investors, small pension funds and the like against investing in these areas, because they are rather opaque and the risks are not fully understood?

Professor Arthur E. Wilmarth Jr: For us, it is first a question for the SEC. I suppose it would be the FCA for you. Are these suitable investments that should be offered³ in the first place? If they are to be offered, you are right that there should be abundant cautions. Many institutional investors, for example, have been surprised—and not in a good way—by how badly many of these investments have turned out. It is impossible for the ordinary retail investor to make a well-informed judgment as to how well a private equity fund holding many portfolio companies, all of which are highly leveraged, is likely to work out.

Lord Hollick: I have a final point. Is it the case that life insurance funds, if owned and controlled by private finance, are in effect a way of smuggling these rather more dangerous and little-understood risks into the portfolios of individual people?

Professor Arthur E. Wilmarth Jr: I am sorry; I am not sure I fully received that last question. Perhaps you could speak up just a little bit—sorry.

Lord Hollick: I am wondering if the ownership of life insurance companies by private finance allows, in effect, highly dangerous or risky

³ Note by the witness: Refers to investments offered to retail investors and the funds that serve retail investors.

investments to be smuggled into life funds, which therefore exposes the public to those risks unknowingly.

Professor Arthur E. Wilmarth Jr: Thank you; I appreciate that. Yes—absolutely. The average life insurance policyholder who buys a life insurance policy is looking primarily at the premiums and the coverage and has little understanding of what assets are behind that policy. It is worth noting that, during the first leveraged buyout boom in our country in the 1980s and 1990s, two very large insurance companies bulked up with a lot of junk bonds and failed in the early 1990s. So we have had experiences before where life insurance companies that were closely connected to the private equity industry and loaded up on their obligations later failed. There are certainly precedents for the situation we are facing today. So I agree that allowing life insurance companies to get heavily involved with private equity investments is a very troubling development.

- Q42 **Lord Lilley:** You mentioned that non-bank financial institutions are offering shadow deposits. Can you expand a little more on when a deposit is not a deposit and when a non-deposit is a deposit, and on why the law has not caught up with us? I thought that you had to be registered if you wanted to be a deposit taker—in this country, anyway; I assumed it was so in most Anglo-Saxon countries. If the difference is that things that are a bit like a deposit are not protected, is that not just the risk that people are taking? Perhaps we ought not to allow them to take that risk, I do not know; I am just puzzled as to why someone can get away with taking deposits and not being regulated.

Professor Arthur E. Wilmarth Jr: I take a very functional approach to the definition of “deposit”. My view is that a deposit is, in essence, a financial claim that you issue to me. I give you money and you issue me a financial claim; that financial claim gives me the right, or the very strong expectation, that I can get my money back either on demand or within a short period of time. I have proposed that there ought to be a 90-day cut-off; 90 days is the conventional understanding of a cash equivalent. If people expect their money back in 90 days or less, that to me looks very deposit-like.

In our country, it started with money market mutual funds or money market funds. Interestingly, they were structured as equity investments. They are not formally a debt claim but the understanding has been from the beginning that, if you put your money in a money market fund, you can get it back on demand. They promise to maintain a net asset value of \$1, so you will get your money back. It is the same thing with a repurchase obligation, which is a secured loan for a very short period of time—often overnight, perhaps seven days at the outside. Again, the person who lent the money expects to get that money back with, in essence, a de facto interest payment. There is collateral but, if they have to liquidate that collateral, there could be problems.

The money market mutual fund industry is now worth over \$10 trillion. As I said, repos are probably north of \$15 trillion, closing in on \$20

trillion. The wholesale markets expect those claims to be paid; we saw in 2008 and 2020 that the Government, the Federal Reserve and the Treasury ensured that they would be paid. Those to me are deposits, but they are not being regulated like deposits.

It was obviously very convenient for participants in the financial markets and, to some extent, ordinary investors to get higher rates of interest with less regulation. There really are not strong capital requirements for the non-banks that are doing this. As is often true, when you do things without guard-rails and protections, you can do them more cheaply and you can perhaps pay higher yields, but there is no margin of safety. Then, suddenly, when things go bad and there is a run on money market funds—as there was after Lehman Brothers collapsed and defaulted on its commercial paper—or if there is a run in the repo market, as there was when many of the repos turned out to be backed by toxic mortgage-backed securities, the Government will have to say either, “We’ll allow these markets to collapse and pay the consequences”, or, “We’ll protect them”. I think that Governments have no choice but to protect them, but, in my view, Governments should not have allowed those markets to develop in the first place.

There is a statute in our country that says that you may not take deposits unless you are a chartered or regulated bank. The term “deposits” is not carefully defined but it is reasonably clear; it is much as I have described it. In 1979, there was an effort to enforce that statute against money market funds. The federal Government refused and said, “No, we’re not doing that”. That, to me, opened the floodgates in our country in terms of allowing these non-deposits to develop. Now, they are so large that it would take quite a significant policy judgment to move the needle back to where it was in 1975, but it is important that policymakers understand the consequences of not enforcing what I would consider to be strong structural rules about who is entitled to engage in banking and who is not.

Lord Lilley: If they were regulated, would the quantity of these pseudo-deposits shrink dramatically? In that case, would the lending that they are being used to finance shrink dramatically, and would we have to reinvent them?

Professor Arthur E. Wilmarth Jr: Yes. Of course, the non-banks could no longer offer these deposit-like claims, so those would go back to the banks. Because banks have, as you pointed out, capital requirements and liquidity requirements, one would expect to see at least somewhat less of this happening.

Of course, some people would say that more credit is always better and less credit is always bad. I think that one has to look at the current debt aggregates in almost every country and say, “Are we on a healthy path towards a sustainable future?” I realise that what I am proposing seems like strong medicine but, as I point out in my paper, we have had a series of escalating booms and busts and bailouts. My question at this point is: who thinks that we could finance another bailout like the last two without

perhaps crashing the sovereign debt markets? If we think we cannot, do we not have to consider taking a different path from the one we have been taking?

Q43 Baroness Noakes: In your paper, you describe the extensive and hazardous connections between universal banks and non-bank financial institutions. The stress tests that were recently carried out on the large banks in the US concluded that they did not need as much capital as they had. Were those stress tests not specified in a way that would reveal the hazardous nature or where the risks actually lay? Is there something else structural about the way in which stress testing is carried out in the US?

Professor Arthur E. Wilmarth Jr: There is a widely shared feeling among many that the stress tests have been made significantly easier over the past few years. There has been demand from the industry for more transparency around the factors used in the tests; of course, the more one reveals the factors that are going to be considered, the more the banks can adjust to those factors and tweak their business models to deal with them.

The original stress tests that were done between 2010 and 2016 were really quite tough. There were a number of failures in the sense that the regulators concluded that there were not sufficient buffers and that certain banks needed to strengthen their buffers. I do not think that there has been a failure of any major bank on a stress test since, perhaps, 2017; it has been a very long time.⁴ In my view, if almost no one fails a test, that indicates either that you have a remarkably smart class of students or that the test is not functioning as well as it should.

The 2023 series of bank failures indicated that we did not have a remarkably smart and talented class of students because three major banks went down and a number of others could have gone down. It is worth remembering that the Federal Reserve stepped in with something called the Bank Term Funding Program, which was supported by the Treasury. It said, in essence, that banks could bring their government securities to the Federal Reserve and get loans equal to 100 cents on the dollar based on the face value of those securities, even though they had become very depreciated because the interest rates had gone up and the market value of those securities had depreciated.

At one point, those government securities portfolios in the US banking system were underwater by some \$700 billion.⁵ The Fed was, in essence, guaranteeing that it would close that gap as long as necessary to prevent further bank failures, which indicates to me that the stress tests leading up to 2023 had not been strong enough. It is very surprising to me that the Federal Reserve allowed large banks to load up with long-dated government securities in 2020 and 2021 at a time when interest rates were very low and it was pretty clear that the only direction interest rates

⁴ Note by witness: To my knowledge only one G-SIB has failed a stress test since 2017.

⁵ Note by the witness: This refers to the end of 2022. The correct figure is around \$620 billion.

could go was up. Why would regulators allow banks to go far out on the maturity and yield curve with government securities under those conditions?

My view is that stress tests are extremely important, but they have to be made strong enough so that you can be reasonably sure that, as you say, the banks really do have the margins of safety that they claim to have.

Baroness Noakes: And that would include their exposures to non-bank financial institutions.

Professor Arthur E. Wilmarth Jr: Yes, to the extent that the current statistics indicate that the banks are holding about \$2.3 trillion of exposures to non-bank financial intermediaries. It is important that we know about the nature of those exposures, in particular the longer-term, illiquid ones, and about, as you say, the protections in terms of collateral or otherwise.

Baroness Noakes: On a slightly related point, you say in your paper—indeed, you have said so today—that the banks have been trying to argue against the leverage ratio and trying to bring it down. Is the leverage ratio the binding constraint in the US, or is it the risk-based capital ratio? In the UK, the leverage ratio is rarely described as a binding constraint. Are the structures in terms of what is important in capital in the US different? Do they not like any kinds of restrictions?

Professor Arthur E. Wilmarth Jr: US banks are involved in a lot of off-balance-sheet activities with securitisations and derivatives. The supplementary leverage ratio really confines those activities because it takes account of their off-balance-sheet exposures.

The other thing is that banks are heavily exposed to the Treasury market through repos. If sovereign debt is risk weighted at zero, you do not have to hold any capital against your sovereign debt exposures, but, again, the supplemental leverage ratio would say, "No, those exposures have to be taken into account". Hedge funds are reportedly holding more than \$1 trillion of basis trades creating net short positions in the Treasury market. The feeling is that, through their subsidiary broker dealers, banks are, as prime brokers, funding most of that. I must say, that strikes me as a very risky thing to do. As I mentioned in my paper, banks are receiving about \$60 billion of investment banking fees every year from private equity funds and hedge funds. That is a very lucrative source of revenue, but \$60 billion does not seem like a lot of money when you are talking about \$3 trillion-worth—or more—of exposures.

Like all of us, banks tend to be short-term orientated; they look at this year's results or this quarter's results. They generally do not tend to pay as much attention to longer-term risks unless someone requires them to do so. The off-balance-sheet nature of many of the largest banks' operations and their heavy exposure to the Treasury market explain why the supplementary leverage ratio has been so bothersome to them—at least, that is my opinion.

Baroness Noakes: Thank you.

Q44 **Lord Hill of Oareford:** I want to go back to some of the things that we have already touched on. To what extent do you believe the regulation of banks post 2008 has contributed to the rise of private credit, which we have been discussing?

Professor Arthur E. Wilmarth Jr: The decision made by G20 countries in 2008 was not to change the basic business models that had brought us the financial crisis—universal banking and shadow banking, as well as their interactions—but to try to make both of them safer through stronger capital requirements, liquidity requirements and stress tests.

Of course, those enhanced requirements were applied only to banks. To be fair, the drafters of the Dodd-Frank Act assumed that the Financial Stability Oversight Council would designate systemically important non-bank financial institutions, and those institutions would be subjected to the same capital and liquidity requirements that applied to big banks. In fact, FSOC designated at least four of them. GE Capital was one. The other three were major life insurance companies. Not surprisingly, they included AIG to begin with; Prudential and MetLife were the others.

That would have created at least something of a more level playing field had it continued but, of course, it did not. Under the first Trump Administration, all four were declassified, and no others have been classified since that time. At that point you had a completely unlevel playing field where large banks had these higher requirements and resented them but large non-banks did not have them.

As you say, it is not surprising that you would see more of a migration to the private capital side. As I suggested in my paper, if you look at today's private equity firms, they very much resemble the big five securities firms that existed before the crisis: Goldman Sachs, Morgan Stanley, Lehman Brothers, Bear Stearns and Merrill Lynch. They do much the same thing. They all have large broker-dealers and, now, they all have captive life insurers. So we have recreated the business model of the big five. Of course, we should remember that one of the big five failed, which was cataclysmic, and that the other four either merged into bigger bank holding companies or became bank holding companies themselves. That seems a disturbing set of precedents to which we ought to pay attention.

Lord Hill of Oareford: In the political world we now inhabit, particularly on your side of the Atlantic—this is reflected in many ways in other jurisdictions—the likelihood of there being the kind of regulation that you would have wanted 15 years ago seems slight. In those circumstances, which is the lesser of two evils? In your view, is it to carry on with the current imbalance between banking regulation and shadow banking regulation, or would it be even worse to think about how you could try to reduce some of the regulatory burdens on banking?

Professor Arthur E. Wilmarth Jr: Taking the existing regulations off large banks is a recipe for sure disaster. With all their complaints about

non-banks, the biggest banks still hold the whip hand, in my opinion. They are still the ultimate source of liquidity for the markets. They have the strongest connection to the federal Government and the federal safety net. They will not be allowed to fail. Weakening them would be catastrophic.

As I indicated, the Financial Stability Board's recent report on reducing leverage on the non-bank side has a number of useful recommendations. They include moving more of these fragile markets into a clearing house-type facility, requiring substantial capital for the clearing facility and substantial margins for customers. We have seen some positive developments in the Treasury market and, to a limited degree, in the repo market. Those would be positive steps.

The best that we can try to do in this current environment is persuade people that Governments and societies simply do not have the capacity to do another set of bailouts like the last two. If that is true, the only answer is to have stronger prudential requirements for financial institutions on both sides of the line.

Lord Hill of Oareford: We touched on the decline in small and community banking in the States right at the beginning. We have similar challenges here. The challenger banks never got going after the financial crash. What are your thoughts as to what we could do to try to help that part of the banking sector?

Professor Arthur E. Wilmarth Jr: Giving more focus to the formation of new banks is essential. One thing that has happened in our country is that it is virtually impossible to launch a new bank in any community of any size without \$20 million of equity capital; that is, in essence, the price of admission. For many smaller communities, \$20 million is out of reach.

Again, I do not favour forming banks that are doomed to fail and do not have a reasonable chance of succeeding, but it seems to me that there must be ways of solving the capital puzzle, whether it is by stretching out capital contributions over a period of years or by having some government programmes that help with initial capital then require it to be paid back. Simply saying, "If you don't have \$20 million, you can't open a bank", dooms a lot of smaller communities in rural areas to having no banks at all.

I know that, in my country—and in yours, I am sure—you can see what happens to a community's economic development and civic life when it does not have a bank. The formation of new banks should be a top priority. Simplifying the regulatory requirements for those banks should also be a priority, but not by making them weak. If you have a leverage common equity ratio of more than 9%, that is a pretty strong bank, if it is well managed and has a good business model; that kind of bank does not need the full panoply of the Basel III risk-based requirements if, again, it is providing a classic, traditional banking service.

Q45 **Baroness Bowles of Berkhamsted:** I have a little ragbag of questions; perhaps we can take them individually because they are not necessarily related. Following on from the discussion with Lord Hill, what we are saying is that what is in the shadows does not stay in the shadows. It can go into banks, where you have levels of regulation or supervision; if it is not in the banks, one can have clearing obligations as a way to get a handle on it. Does this mean that we should introduce more mandatory clearing obligations to address things such as the repo market and so on?

Professor Arthur E. Wilmarth Jr: Yes. It is certainly essential for sovereign debt markets that there should be central clearing; it is just too important. We have seen repeated disruptions. As sovereign debt markets keep getting larger, the need for transparency and for the kind of liquidity that central clearing gives you is essential. Some people will say—this is true—that central clearing facilities can themselves be a source of systemic risk. I agree, but the way to respond to that is to have robust capital for the clearing facility and robust margin requirements for customers. Again, those are not foolproof, but they serve the same kind of function that capital and liquidity requirements serve in banks. If they are strong enough, they should certainly help a great deal.

The repo market cries out for much more transparency—and, at this point, full clearing. Unless I am missing something, the market is probably north of \$15 trillion, perhaps \$20 trillion. In my paper, I pointed out a recent Federal Reserve staff study that said that the repo market in the US was \$12 trillion and that more than a third of it was sitting in the shadows in these bilateral repo transactions that are not cleared and not transparent. That was quite a surprise. Perhaps other than those who really knew, I do not think many people, such as me and others outside the largest banks, thought that the repo market in the United States was \$12 trillion. What the authors of the study did was simply to take reports from broker dealers, which are available from the SEC—some of them are independent and most of them are bank-owned—and extrapolate, and that extrapolation seemed reasonable.

But a market that large cannot sit in the shadows. I think you put it very well: what is in the shadows does not stay in the shadows when trouble comes. Warren Buffett used to put it more bluntly by saying “When the tide goes out, you find out who is swimming without trunks”, which is a good metaphor for a financial crisis. It is the same with the repo market; it did not remain in the shadows during the crises we saw in 2008 and 2020.

So, yes, central clearing with good capital and good margin is an important first step, but that does not address the longer-term illiquid asset exposures of the private equity industry and, now, an increasing part of the life insurance industry. Again, one could talk about disclosures, concentration limits and diversification requirements. A professor named Andrew Tuch wrote a very good article called *The Remaking of Wall Street* several years ago, in which he pointed out that these private equity firms have, in essence, replaced the old big five Wall

Street securities firms. If these firms are as important as I believe they are, they should be subject to these kinds of prudential requirements.

The requirements on the old securities firms perhaps were not sufficient, but they did have capital requirements and they were monitored, to some degree, for these kinds of asset concentration problems. The big private equity firms should similarly be subject to this type of regulation, and we obviously need to pay more attention to the life insurance industry now. Not having a significant federal regulatory presence for life insurance companies in our country has been a continuing problem that needs to be addressed.

Q46 Baroness Bowles of Berkhamsted: I will move to issues with insurance and captives. For these purposes, I had better declare an interest as a director of a captive insurer and its parent company. I am not sure that it is terribly relevant, but I have to do it for form.

You indicated your concern over what captive insurers were holding in their portfolios. I think this was largely to do with life insurance, so it is the captives of an insurance company rather than the captives of manufacturing industry. Or do the problems extend into those kinds of captives? That is the first question on that.

Secondly, we are possibly about to launch into allowing captives in the UK. It has been announced but the Bank of England PRA has been reluctant about captives for a long time. What should we be looking out for here? Are we opening ourselves up to them being just a repository for deadbeat private assets?

Professor Arthur E. Wilmarth Jr: I agree with you that captive life insurers probably cause more immediate concern than the typical captive portfolio company, although we could discuss those as well. The captive life insurers raise particular concerns because, as I mentioned before, the typical life insurance policyholder really has very little idea of the assets the insurance company is holding. The policyholder assumes that regulators are watching that company to make sure that it is safe and, if it carries some kind of AM Best good rating, that the ratings agencies have paid attention as well.

As you say, we are seeing the captive life insurers loading up with leveraged loans, junk bonds and private credit obligations that obviously serve the interests of their masters but may not serve the interests—probably do not serve the interests—of their policyholders. That is a concern. If a life insurance company is not being managed in the long-term interests of its policyholders, that is a serious problem that needs to be addressed.

The same issues have been raised with non-financial portfolio companies of private equity firms, in terms of loading them up with debt and removing safety parameters and things like that. These include manufacturing companies and healthcare companies. It raises a whole

series of similar issues, but not in the financial sector as much as it does in the broader societal sector.

Large holding companies are always worth watching, because the question becomes whether the subsidiary is being run in its own interests and the interests of those who have invested in it, such as bank depositors or life insurance policyholders, or is simply being used as a vehicle for wealth extraction by the parent. Holding company regulation has tried to address those problems but, as I indicated, we do not have a strong federal holding company regulator of the insurance industry in the United States, and that has been problematic. I am less familiar with the UK's approach to insurance regulation, so I cannot make the same comment there.

Baroness Bowles of Berkhamsted: That gives us some things to dig around in as we move forward in the UK. My final question is on how we get or do not get to having community-type banks in the UK. There are lots of issues around trying to do that, but we do have ring-fenced banks. I am just wondering what you think about the ring-fence and whether it is in the right place. They are not really challenger banks, but our more modest-sized banks are ring-fenced and they complain that they end up with higher capital requirements and cannot do the sorts of lending that they want to. That is probably largely due to the lack of an internal model, but you said that that situation pertains in the US, as well: in general, community banks are holding 10% versus 7% for the big multinational G-SIBs. Is that an inevitability? When we want to bring down the capital requirements on these smaller banks, will we be fighting the inevitable?

Professor Arthur E. Wilmarth Jr: I will take that in two parts. I paid a lot of attention to the Vickers commission report when it came out, and I have called that ring-fencing approach internal Glass-Steagall; it separates the deposit-taking aspects of a universal bank from its capital market activities, and prevents the deposit-taking side from subsidising the capital market side. I actually think that is a very prudent and sensible approach for large universal banks with large amounts of capital market activities. One of the most problematic aspects of universal banks is that they use their deposit-taking function, for which they pay almost nothing, to support these very speculative activities in capital markets. I understood ring-fencing to be a way of trying to stop that. For a large bank similar to HSBC or Barclays, that makes a great deal of sense to me.

Of course, the other advantage is that it makes the bank somewhat easier to resolve, if it fails. Although it would be very difficult to resolve a bank of the size of Barclays or HSBC, it makes it easier if you can more easily separate the deposit-taking and capital market sides. So I support what I understand to be the ring-fencing approach for the large capital markets banks, as I would call them.

I gather that the cut-off for ring-fencing has been based more on asset size than on activity; your cut-off has been £25 billion, I believe, although that may have been raised more recently.

I would say that the question of whether to apply ring-fencing ought to be based on a combination of asset size and activity. In other words, if you had a bank that had \$50 billion of assets but had no real capital markets activities—that is, it was not engaged in underwriting or in dealing in securities or derivatives—I could see why the concerns about ring-fencing that bank would be fewer: because it was not engaged in speculative activities in the capital markets. If the bank got to be as large as \$100 billion at some point, its size could potentially make it systemically important, but, from my perspective, I have always focused more on separating activities than simply applying an asset size cap.

If you had a challenger bank that, again, had \$50 billion of assets, but it was following a traditional business model by taking deposits, lending and serving SMEs, I could see why it would make sense not to require ring-fencing for that kind of traditional bank. For a bank that had \$20 billion of assets but had most of its operations in the capital markets, I would be more concerned about ring-fencing. I would focus more on the need to separate deposit-taking from risky activities in the capital markets than simply the asset size. Is that a helpful response to your question?

Baroness Bowles of Berkhamsted: I think so, but there is also this rider. We are looking at banks that do not do any capital markets activity. Why is it that they end up having to hold more capital than those that are doing things that we perceive as more dangerous?

Professor Arthur E. Wilmarth Jr: I do not see the need for what I would call exemplary or exceptional capital charges for a traditional bank—unless, perhaps, it reaches a size where you consider it systemically important. I would not think that size was £50 billion. Would it be £100 billion? Perhaps. In my opinion, systemic importance depends quite a bit on size but also quite a bit on activities, including how speculative and risky those activities are.

Q47 **Baroness Donaghy:** My question is about the chances of better international co-operation between the various supervisory systems. Before I ask it, are you able to say what is, in your view, the top priority in making the financial systems and institutions of the United States safer? What would be at the top of your list?

Professor Arthur E. Wilmarth Jr: My top priority would be to do the exact opposite of what US regulators are currently proposing, which is to establish stronger leverage capital requirements. I would want to increase the enhanced supplementary leverage ratio—I would prefer it to be 10%, or certainly somewhere towards that—because I think that it is the strongest restraint we have under current law.

My second priority would be to try to see whether we could do something about getting all of these shadow deposits into central clearing

arrangements with more capital, more margin and more transparency so that we would at least know what we are dealing with and there would be some safety buffers before a crisis comes.

Baroness Donaghy: That brings me on to supervisory systems internationally. They seem so different that one wonders how you could get some international co-operation on, for instance: visibility in terms of where all this money is flowing to and from; its valuation; accountability; and, of course, the political priorities, which we do not have that much control over. What do you think is the state of play on international co-operation on these systems?

Professor Arthur E. Wilmarth Jr: Central banks would be the most likely forum to start with, beginning with the Bank for International Settlements, which is effectively the central bank for central banks, along with the Financial Stability Board, which has generally played a positive role, although it has had its moments of being stronger and weaker. The Basel Committee on Banking Supervision sits within the BIS. The Basel Capital Accords are far from perfect, but they have been a significant step forward.

With the FSB saying that they really are concerned about non-bank leverage, there might be some opportunities to move towards more central clearing and stronger disclosure and position limits. I agree with you that it will not be easy. I tend to think that if the US, the UK and the EU could agree on a common approach, which is certainly easier said than done, they would inevitably carry most of the rest of the developed financial world with them, because most of the major financial centres, particularly for private enterprise, are in those three jurisdictions.

I sometimes get discouraged when people say that it is always a race to the bottom. That is certainly a temptation, but having the reputation of having the strongest banking system and the best-regulated financial capital markets has to count for something. With all our faults, there is a reason why the US continues to be a magnet for investment. I think that is because, on the whole, we have had strong banking and capital market regulation. It has certainly fallen short in many ways, but comparatively, we have done reasonably well. The UK falls in the same category; the EU wants to fall in the same category. Therefore, I would encourage the US, EU and UK to lead a race to the top instead of a race to the bottom.

Thoughtful policymakers like yourselves, through your deliberations and reports, can support what I think the BIS and the FSB are trying to do. They desperately need support. They are constantly being hammered by the financial industry for being luddites—frozen in the past. My own view is that the past teaches us some very important lessons about what is likely to happen in the future. We have seen these patterns of boom, bust and bailout recur repeatedly. We have to learn from them, not be afraid to look back at them.

Baroness Donaghy: Thank you very much.

The Chair: Professor Wilmarth, I think we should allow you to go and get some breakfast.

Throughout this session, I was reminded of our late Queen Elizabeth's remarks after the financial crisis, when she said, "Why did no one see this coming?" Listening to your evidence, you have given us a lot of food for thought, which is very much appreciated.

On a personal note, I particularly enjoyed paragraph 54 of your paper, which complimented the House of Lords Economic Affairs Committee on its report on quantitative easing, which you said showed great insight.

You said that we answered two of the questions. There is not time to go into the third question that you highlight, but if you felt able to answer it or at least give us your thoughts in further written evidence, it would be appreciated.

I have really enjoyed listening to you and the way in which you have shown such frank and careful analysis of some of the issues that are involved. On behalf of the committee, I thank you. Any further information or evidence you want to give us would be very much appreciated. That concludes the session; thank you very much.

Professor Arthur E. Wilmarth Jr: Thank you very much—I appreciate it.