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Witnesses: Sir John Vickers

Jonathan Symonds and George Culmer

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Members present

Lord Hollick (Chairman)
 Baroness Blackstone
 Lord Forsyth of Drumlean
 Lord Griffiths of Fforestfach
 Lord Kerr of Kinlochard
 Lord Lamont of Lerwick
 Lord Layard
 Lord May of Oxford
 Lord Sharkey
 Lord Teverson
 Lord Turnbull
 Baroness Wheatcroft

Witness

Sir John Vickers, Warden, All Souls College, Oxford, and former chair of the Independent Commission on Banking

Q1 The Chairman: Sir John, can I welcome you this afternoon? It is four years since you published your report and two years since you came before us. When you came before us at the end of 2011, you made the point that there were quite a lot of other moving parts with the aim of trying to make the banking system resilient, and clearly over time they would need to be looked at and considered. We have a number of questions this afternoon that probe those issues.

Perhaps I could start off with a general question. Are you feeling happy—maybe that is not the right word—with the way the ring-fencing in particular is being implemented? Obviously this is against the background of a fair amount of diverging views, shall we say, from the banks as to whether it is appropriate or whether it goes too far. It would be useful just to have your overall perspective on where we are.

Sir John Vickers: Thank you very much for inviting me back. On ring-fencing overall, and indeed on the complementary measures—because ring-fencing we always saw as part of a package—I would say of the UK reforms, “So far, so good”. The legislation completed its passage at the end of 2013, on ring-fencing and on depositor preference and the bail-in option. It is very much in line with what the ICB recommended. In some respects, it goes further as, for example, with the electrification power, which I welcome as a reinforcement of that regime.

Since then, we have had secondary legislation from the Treasury on core activities, exclusions and prohibitions, and the PRA has been working on the implementation of ring-fencing legal structures, governance and so on, which seems to be well on track. I would say that the case for those measures is every bit as strong today as it was when we made our report four years ago—arguably, if anything, stronger still. I would say that broadly I am very content with how UK reforms have gone so far. In Europe more generally, there are some unresolved issues about structural reform following the Liikanen report, and that space is still to be watched.

The Chairman: Were you surprised that HSBC announced recently that ring-fencing was one of the considerations that they would take into account when they came to review the location of their head office?

Sir John Vickers: I am sure they take all sorts of things into account. I was a little surprised by some of the emphasis that was put on that, because HSBC had, indeed before the Parliamentary Commission on Banking Standards, expressed some support for ring-fencing in 2012. The fact is that it is now the law, and I think it is a good piece of law. It is not only the law, the Conservative Party manifesto recently reaffirmed the commitment to finish ring-fencing. In many ways, we saw ring-fencing as helpful to the international business of UK-based banks in the following way. A side benefit of ring-fencing was that we could recommend the higher capital standards that we thought were necessary for domestic banking, without having a parallel upwards move in the capital standards for international investment banking conducted out of the UK. The Chancellor of the Exchequer has described this as resolving the British dilemma of how you have safer capital standards and other measures for retail banking at the same time as the international standards applying to international activity. I had not seen ring-fencing as antithetical to the global position of UK-based banks. In many ways it is the opposite.

The Chairman: You would not agree with the comment that has been made, I think by HSBC again, that the benefits of ring-fencing are, “more perceived than real”.

Sir John Vickers: I think it is an enormous deal more than perception. This is part of the readiness for the next crisis, whenever it comes. One can surely say, though, that you cannot read financial history and think that there will never be another crisis, because surely there will be at some point in the future. I believe that we are in a much better and much more robust place with measures such as this in place. It is very important for the whole economy, of course, and for financial services in general, that our banking structures are safer.

Q2 Lord Forsyth of Drumlean: Sir John, perhaps I should declare my interest as a director of a bank, as on the Register of Members' Interests. Can I just ask you about something that is puzzling me, because the whole emphasis on bringing in ring-fencing, I thought, was to increase competition and to have more stability within the banking system? If we look at what is actually happening, the larger banks have a huge competitive advantage, because of the rules on capital funding and the payments infrastructure, over their competitors, and the market is becoming increasingly dominated. Lloyds, for example, dominates the consumer account market, and RBS dominates the small and medium-sized enterprise market. Therefore it is arguable that these large banks could never be allowed to fail, and yet, with the changes in the rules, they have an enormous advantage over their competitors. For example, on mortgage funding, the risk-weighted ratios for a business like Lloyds would be 16%, whereas for a competitor bank they would be 35%. Have we really moved on from a position where we are very dependent on a small number of large banks and where competition is limited because of the very rules that have been introduced?

Sir John Vickers: There are a number of points in that question. Let me try to address some of them. The remit of the Independent Commission on Banking was financial stability and competition, and we made a number of recommendations on the competition side in addition to the ring-fencing and the loss-absorbency recommendations on the financial stability issues. Those concerned easier switching, the competition duties of the FCA and other regulators, and the Lloyds divestiture.

Our financial stability recommendations were important for competition in a couple of ways. One is that an uncured too-big-to-fail problem favours the large at the expense of the small, relatively speaking. Everything that diminishes that problem helps to level what can, as you indicate, be a very unlevel playing field. That is one point.

The second is that our recommendation on capital requirements and on what we called primary loss-absorbing capacity—bail-in-able debt, in short—was a gradient. A larger institution would have to have more such protection and a larger such buffer. For sure, those measures do not do away with all competition problems and competition concerns. The crisis itself had, as one of its casualties, competition. We had the Lloyds/HBOS absorption, and we had a number of the small players go to the wall. The competition issues were greater post-crisis than pre-crisis. Of course, a number of the very important ones are now before the Competition and Markets Authority in its inquiry. They, unlike the ICB, depending on what conclusions they draw, have remedy powers, which of course the ICB did not.

Finally, part of your question is, I believe, about the calculation of risk weights: the 16% versus 35%. It is helpful if the financial regulators have a pro-competition duty to look at those issues. It is perfectly clear, with hindsight at least, that there was far too much laxity in what institutions were allowed to do in risk-weighting. That favoured the large rather than the small, because they would have some big whizzy model that would say, “This is not very risky”, and that in the old regime allowed them to put very little capital behind that. Internationally, in the Basel process and otherwise, including domestically, some things are being done on that front, but I would certainly not claim that a total solution is at hand.

Lord Layard: Could you say a bit more about why you think capital and liquidity requirements are not enough and why you need ring-fencing in addition? Related to that, the chief executive of Lloyds has said that he believes ring-fencing will reduce capital requirements. Could you comment on that?

Sir John Vickers: Let me try to. Perhaps a good place to begin is the international baseline for capital requirements which, in the Basel III process, is capital of 7% in relation to risk-weighted assets, which takes us immediately back to the question of how the risk weighting is done. There is to be a supplementary backstop on leverage of 33 times, allowing banks to be 33-times leveraged.

If I am teaching first-year students, their jaws drop when I say that. They say, “That is ridiculous. That cannot be right. How can you run a market economy that way?”, and I say, “That is the post-reform world. We were in a much worse situation with 40 or 50 times leverage”. This is a question on which the first-year student reaction is absolutely right. It is an extraordinarily thin capital layer for the core of the financial system.

It is perfectly true that the international community is elevating those capital requirements for the global systemically important institutions on a sliding scale that goes up to 9% or 9.5%. One of our recommendations for the UK substantial retail banks was that that 7% should be 10%, and we recommended a pro-rata shift of the leverage cap to 25 times, which certainly strikes me as still a very large number, but against an international backdrop of 33 times on that leverage metric there is a limit to how far any one country can shift against that background.

We also recommended—and this is echoed in the international community for the global systemically important institutions—a layer of loss-absorbent debt, bail-in-able debt, on top of that. The G20 in November last year approved that recommendation from the FSB.

In the scheme of things, is that adequate loss absorbency? It seems to me there are much stronger arguments for saying that it is not enough than for saying that it is excessive. I am

not somebody who thinks that all banking should be wholly equity funded or the equivalent. That would squeeze out deposits altogether, which would be economically and socially very unsatisfactory. We are still talking about a very thin capital layer on the balance sheet as a whole, and when one does simulations, stress tests and the rest of it, we are certainly safer than we were, but it is not at all impossible to imagine circumstances where that capital layer could be eaten through. If you are at even 25 times leverage, you only need to lose 4% on your asset side and you are under water.

As to the interaction between ring-fencing and these loss-absorbency measures, there are a number of very important self-reinforcing aspects. One that I have mentioned is that this was a way of having higher capital standards for UK retail banking without them applying across the entire global balance sheet of the UK-based banks, which I thought was pro the competitiveness of those banks being based in London.

Another important part of it is about resolution schemes—and this is when the debtholders are bailed in. The credibility of those schemes in the case of complex banks is much greater when there has been some pre-structuring along the lines of ring-fencing than when not. The probability that bail-in would actually happen satisfactorily, if push came to shove, is much greater if one has a ring-fencing regime in place than when not. For those reasons and more, we saw the loss-absorbency measures and the structural measures as a package of complements that are self-reinforcing. It is certainly not the case that once you have done one element you do not have to do the other. You do the package. That is the whole point.

Q3 Lord Kerr of Kinlochard: Two questions, if I may, Sir John. First, I ask in complete ignorance: how do you envisage the board of the bank exerting the necessary control over the ring-fenced retail operations of the bank? Secondly, on resolution, part of Sir David Walker's argument, as I understand it, is that whereas you were up and running very quickly; now via the G20 agenda, slowly through Basel, through the Barnier dossier and the EU recovery directive, which is now in force, the rest of the world has caught up with you. We now have these legal obligations, which are laid down but not by the Act that results from your report. Is there an element of redundancy there? Sir David's argument was that your proposals, written down in our law, are redundant. Clearly you do not agree with that, but is there an element of overlap or redundancy?

Sir John Vickers: If I may, let me take the second question first. I would echo what I just said about resolution being made more credible by having a ring-fencing structure. It is perfectly true that, especially for a European bank, a recovery and resolution directive is very much in the spirit of the UK legislation. Indeed, these processes, the legislative process here after our

report and the development of that directive under Commissioner Barnier, were very much in parallel, and I think they speak to each other very coherently and well.

I would again say that in the case especially of these large and complex institutions, ring-fencing adds force and credibility to that directive. Far from being made redundant by it, it can be seen as a very sensible underpinning for it. It would be very desirable, in the EU generally, if proposals along the lines of Governor Liikanen's, which were very similar in broad architecture to the UK and the line we are taking here, were implemented. They would make that European recovery and resolution directive more credible across the Union as a whole, so again they are self-reinforcing and to my mind the opposite of redundant.

On your first question about governance within these institutions, could I just clarify that when you speak of the management of the bank you are referring perhaps to the board of the holding company, which may have within it a ring-fenced bank or even a ring-fenced group and other institutions?

Lord Kerr of Kinlochard: Precisely.

Sir John Vickers: The work that the PRA at the Bank of England has been doing speaks very much to that set of issues and goes into much more detail than we did in our report, where we laid down broad principles about independence. In many respects, normal company law and accountabilities would apply. There would be the holding company and the ring-fenced bank would be a subsidiary of that. The owner of the ring-fenced bank would appoint directors, but subject to regulatory requirements on that. There would be internal reporting and accountability. There would be group policies, and in the normal course of events all the elements of the group would accord with the group policies.

However, there may well be some occasions when the obligations of ring-fencing, the obligations in law, are in tension with group policy. It is then that you must have adequate independence of composition, remuneration, et cetera, of those who are responsible for the decisions by the ring-fenced bank, so that the integrity of the ring-fenced entity is protected and preserved. It is quite false to imagine that the ring-fenced bank can just go wandering off on its own in general, but one has to have provision, and it is there in the law. The PRA is developing the regulations whereby the independence of decision-making is there in the ring-fenced bank, particularly to safeguard the statutory and other obligations to preserve the good functioning of the ring-fence. That is not to cut across coherent group policies and suchlike.

Lord Lamont of Lerwick: Are you trying to have your cake and eat it, I wonder, at all? The integrity and independence of the decision-making of the ring-fenced retail operation could be

maintained even if successive chief executives of that board were fired by the decision of the overall board of the overall bank. The legal niceties could be observed, but the policy of the ring-fenced bank could be changed by a change of personnel. I do not see how you get around that.

Sir John Vickers: The cake, which you are suggesting I am having and eating—it always struck me as a good idea that I should do that—is being baked by the PRA. The way they are going about it appears to me to be robust common sense. The leadership of the PRA has been very clear and robust about things, yet will take a commonsensical approach. It may be that the mix of business in different banking groups calls for slightly different arrangements. I think there will be disciplined flexibility on that front.

Whether it is the independence of directors and non-execs not being part of entities in the rest of the group, whether it is about their remuneration structures—indeed there are some company-law statutory duties to the subsidiary, quite independently of the banking reform legislation, all those things together give a pretty strong protection of the ring-fencing provisions, and because of the review provisions that were put into the legislation there will be continual regulatory and indeed parliamentary vigilance on how these structures are working.

Lord Lamont of Lerwick: My approach would be rather the opposite of Lord Kerr's. I cannot quite see my way through this puzzle. Some banks have expressed concern. Why should we wish to own something that we cannot control if the board is going to be independent? You say it is fanciful to think that the board will just go wandering off on its own, but the board is to be independent.

Sir John Vickers: It is perfectly possible, and I believe that in our reports we touched on the possibility that a banking group required to ring-fence might take the view, as a commercial decision, that to separate itself was the best commercial course. On that, our view would be one of neutrality. That would be a matter for them. Certainly it would be very bad public policy if, where there was an uncured too-big-to-fail problem, with a substantial taxpayer implicit guarantee subsidy flowing from the retail side into global investment activities, that was an important reason why a bank was keeping the elements together. Then there would be merit, on wider public policy grounds, if a bank decided to separate itself in those terms.

I do not see a fundamental inconsistency here about a bank having coherent group policies, reporting lines, et cetera, within a holding company structure and yet enough independence in the board and other key decision-makers of the ring-fenced bank to safeguard the integrity of the ring-fencing as set out in the legislation. If, faced with that, a bank said, "I'm sorry, we'd

rather separate”, that is a decision for them. I would not see that as a killer objection to the scheme in and of itself.

Q4 Lord Turnbull: Where this has all gone wrong is the choice of the word “independent”. I do not see how someone who is appointed by the group as chair or non-executive director and works to the strategy of the group can be independent. There are only two requirements. One is that these people should not have other jobs in the group. The only area where they have a distinct role that is different from the group is that they have a special duty to maintain the integrity of the ring-fence. They should be able to report that to the group board or to the regulator if they think that is challenged. Otherwise, I cannot see that they are really independent at all, and it is unfortunate that we use that vocabulary.

Sir John Vickers: I am not sure that I have views on the vocabulary, but your point about protecting the integrity of the fence is the key thing. It is to safeguard against group policies just driving a coach and horses through that fence. The issue is to have a set of measures, reporting requirements and issues about the composition of that board that might vary from institution to institution because of the business-mix reason. That absolutely has to be safeguarded.

Baroness Blackstone: Would you or would you not be concerned if HSBC decided to spin off its ring-fenced bank? You have slightly implied just now that you were neutral about this, but that is a bit inconsistent with what the ICB said earlier about the dangers of this happening.

Sir John Vickers: I am not aware that we said anything about the dangers of that happening. On a possibly related point, we did not favour a regulatory approach that said that the entire industry must, as a matter of law, totally separate retail and investment banking. We did say that, but I do not think that implies a view on what one banking group might do in respect of its arrangements. I believe that we noted the possibility that a group might decide itself to separate. I do not believe that we were inconsistent, and I certainly hope that we were not. My view, and it is not an HSBC point in particular, would be neutral on that.

Baroness Blackstone: It would be neutral.

Sir John Vickers: Yes.

Baroness Blackstone: In spite of the fact that you had said that an undiversified retail bank that was separated off could get into trouble.

Sir John Vickers: The difference, if it were a requirement on the entire sector, is that one would have created one species of retail banks and a completely separate species of investment banks. I am quite in favour of some ecological diversity. If one bank decides to

adopt a different model from another, that is an entirely separate question. It is also a bank making its own commercial decision, rather than a regulatory or legislative fiat that an entire sector must take a particular view.

An echo of this question, I believe, came into the House of Lords debate on electrification where there is a reserve power in the law which I think was called in the debates the first reserve power, whereby, subject to all sorts of safeguards, the regulator could require an individual banking group to separate those activities completely. Some took the view—I did not share this—that there should be a regulatory power to split the entire sector. The reason I did not favour that was partly the reason I have just given in response to your question. Also, for the sector as a whole, as it were, if Banks B, C and D might get split up as a result of the misdemeanours of Bank A, there are questions of fairness and incentives, which made me cautious about that.

Lord Lamont of Lerwick: Could I just ask what the policy is on dividends? Can an RFB pay dividends to the parent?

Sir John Vickers: Subject to maintaining its capital ratios and the like, the short answer is yes, I believe.

Lord Lamont of Lerwick: The PRA document says that an RFB cannot pay dividends to other members of the group, but that would not be the parent.

Sir John Vickers: They cannot be trapped for ever, so there must be an outlet. These are questions, and the questions that the PRA is now dealing with are much more detailed than we got into in our report. We had 15 months from start to finish, and saw it as our role to make a recommendation as to the broad architecture. I think that has been very faithfully carried through and indeed strengthened in the legislation, and now the implementation is under way.

There is one point, which relates to this discussion, where I wish we had gone one step further, and that is that while we were very clear that ring-fencing would be undermined if the retail bank owned, let us say, the investment bank, because then it could get pulled down by it, we were more tolerant than I would be with hindsight about the opposite arrangement whereby the investment bank owns the retail bank. The PRA subsequently has been very clear about its expectation of a sibling structure, with a holding company and then the retail and investment banks, as it were, parallel. It is the PRA's expectation, and I think a very sensible one that is very much in line with the Parliamentary Commission on Banking Standards, that that would be the normal legal arrangement.

Baroness Wheatcroft: Is it your suspicion, Sir John, that actually once the ring-fence is in place, institutional investors anyhow will push for a split, because they just like their investments to be neater and cleaner?

Sir John Vickers: I am agnostic on that. If there are true synergies between the two, there might be very sound economic and commercial reasons for that not to happen. We said publicly during our work that we were very keen to receive evidence on such synergies from the banks, not that much came to us in response to those requests or otherwise. If there are no synergies between the two, the sensible commercial arrangement could indeed be as you say. The important thing is to get the incentives right, so that commercial decisions are broadly in line with the public interests more generally. Incentives are clearly not right if you have an uncured too-big-to-fail problem, because then the investment banking side is getting potentially an enormous subsidy from the taxpayer backstop to retail banking.

Q5 Lord May of Oxford: I would have had to declare an interest in involvement with HSBC until recently in that the previous director created a committee on corporate social responsibility, which addressed some of the shortcomings in the promotion of women in HSBC. However, that committee has just been disbanded under the new administration, and I approach much of this discussion with some worries. Am I right in understanding—and I risk embarrassment by asking this question—that this issue is rather like Glass-Steagall in the States: the separation of retail and casino banking, as it were?

Sir John Vickers: I would not call non-retail casino banking. Leaving that point aside, I would say that the three broad options are total separation, which is what Glass-Steagall did between the 1930s, and then it was watered down and finally repealed at the end of the 1990s—

Lord May of Oxford: They finally got rid of it. We would probably not have had quite what we had, if they had not got rid of it.

Sir John Vickers: Maybe, there are debates to be had on that. But that is total separation. The other extreme is what I call unstructured universal banking, where a group may be doing, literally on the same balance sheet, high street banking and commodities trading, investment banking all around the world, big derivative positions and all the rest of it. One of the reasons why our crisis was so bad was that, particularly in the case of RBS, the Government's completely understandable desire to save the retail banking activities upon which the economy very much depends necessitated saving the entire structure, even though the balance sheet was larger than a year's output of the entire economy, in that case. That is unstructured universal banking, where things are intermingled. There is no option to resolve this bit one

way and that bit another way, because there are no separate bits, even within the group structure.

Structured universal banking is a hybrid of the two, where you say that the group can do universal banking; it can do these things wherever it wants in the world. It can do trading, derivatives, commodity trading, but only on the condition that it ring-fences its UK retail operations and has the appropriate degree of independence—if I can use that word one more time—of the board and management of the ring-fenced group, if it has the elevated capital requirements and the rest of it. Structured universal banking, I think, is the most sensible way to go. It preserves whatever synergy benefits there may be between the various kinds of banking. It avoids this possible risk that you have the entire sector standalone, undiversified retail banking. Indeed, even post Glass-Steagall, the US has something like structured universal banking, because within the bank holding companies in the US, you have the deposit-taking part and the investment-banking part. They are tightening up the rules and regulations on what can pass between the two. In that sense, the UK, in very broad architectural terms, is converging with the US, because that has structured, not unstructured, universal banking.

A separate and further issue is Volcker, although the debate that we have been talking about is indeed the Glass-Steagall sort of debate, where I see those three things—total separation, structured universal banking, or unstructured universal banking—which is where we have been in the past.

Lord Forsyth of Drumlean: May I just quickly follow up on that? It would be true to say that RBS, as a bank separated from its non-retail activities, is still too big to fail. No Government could allow RBS to fail, even today, so as a result is there not an implicit subsidy there from the taxpayer?

Sir John Vickers: I think that some remains. It is diminishing, but it is still very sizable. An extremely important step to diminishing it further will be the full implementation of ring-fencing, because then, in the next crisis, the Government of the day will have an option—let us distance it from that bank—with a bank like that. It can adopt different policies for retail as for global investment banking, it will have a lot more capital in relation to its activities, and there will be the bail-in-able debt that can go towards meeting losses. The loss absorbency of the institution itself will be much greater, thank goodness, than in 2008-09, and the Government's options for resolving the bank, taking it forward while maintaining the continuity of provision of core services, will be in place. Will it work perfectly in all

circumstances? There is no guarantee of that. Nothing does that. This is a big shift in the odds that a satisfactory solution could be arrived at, unlike last time.

Q6 Baroness Wheatcroft: You have talked a lot about the importance of maintaining the integrity of the ring-fence. Bankers recently acquired a reputation not so much for integrity as for ingenuity, and I just wonder to what extent you think they will, if they have not changed the culture as we keep hearing, attempt to find ways through the ring-fence and how porous it will be. Can you really put your confidence in these independent boards of directors, because there is evidence that directors of banks—and I confess I was briefly one—have struggled to keep tabs on what was actually going on within the institution?

Sir John Vickers: Ingenuity is not to be criticised in general. One wants to channel ingenuity in socially productive directions, rather than where it was sometimes directed in the past in this sector. As I have just said in response to a different question, one can never be certain about the durability of arrangements of this kind. In some wide historical sweep, of course, nothing lasts for ever.

I do, however, think that the legislative framework and the regulation that is being developed to implement it is a strong structure, and I welcome the electrification power that, following the Parliamentary Commission on Banking Standards and parliamentary debates, was added to the legislation, because I think that gives quite a strong incentive not to flirt with the boundaries too much.

I once played in a cricket match where there was an electrified fence—I did not call it a ring-fence at the time—which I had not realised. When I had an encounter with it, I stayed well clear of it in future. Whether that reads across, we will see.

There are also, of course, to be reviews in the legislation of how this is working. I welcome a bright spotlight on this throughout. Only time will tell. If the thing became riddled with holes very quickly, the arguments for the total splitters would be stronger, but that is certainly not my current view.

Baroness Wheatcroft: In the meantime, do you think the culture in banking has changed?

Sir John Vickers: I do not feel close enough to give any sort of authoritative answer. In the light not only of the crisis of 2008-09 but of the string of retail mis-selling crises and misbehaviour, manipulation of the Libor, FX and all the rest on the trading side, and all the scrutiny that that has received, there are some changes in the culture for the better.

I do not, however, separate in my mind the issues of culture from the issues of incentives and structures. All these things go together. We in the ICB were mindful of cultural issues, but we were working before the Libor and related scandals came to light, and the Parliamentary

Commission on Banking Standards very much centred on those activities. Indeed, part of the legislation is on that front. I do not believe that these structural measures on creating a simpler structure for retail banking solve your point about complexity and boards not knowing what is going on, but they do go some way to addressing it. It makes it very clear what that part of the banking group is meant to be doing. It is not inter-scrambled with all the other things, so I would say that that helps without being a complete solution in itself.

Lord Lamont of Lerwick: On that point about structure, I have heard some critics of ring-fencing say that British banks would be at a competitive disadvantage because foreign banks, particularly Asian banks, would be able to do more cross-selling of products. Was cross-selling, in your mind, something of a risk, or was it more of an issue of conflict of interest? To me, cross-selling of products actually poses issues of conflict of interest, in that you have one part of a bank, let us say the banking part, securitising a loan and then it is passed to the private bank and gets to the clients of the private bank. Apart from risk, that raises questions of a conflict of interest, and yet the critics of ring-fencing have been saying that it is far too cumbersome to open tenders for different products, et cetera. I wonder if I make myself clear on this.

Sir John Vickers: Yes. Part of the rationale indeed for Glass-Steagall 80 years ago had to do with conflicts of interest, as well as the fact that federal deposit insurance and the taxpayer subsidy were coming in at the same time. I believe these are serious issues. Of course, there is quite a lot of cross-selling within retail, and that is unaffected by ring-fencing, because it can happen within the retail entity.

An example that we considered was whether the ring-fenced bank should be able to sell derivative products where it is bearing the risks of those products on its own book. Our view—and this is not the view that the Government have taken—was that it was better to say that the ring-fenced bank cannot sell such derivatives on its own book. We envisaged the possibility of an agency basis, where there would still be a one-stop shop for the customer and they could buy a derivative product—say a small business, a swap or something like that—from their retail bank and that would be sourced from the other side of the fence. The view that the Government have taken—I do not think is a fundamental issue and it may be the right view—is that for simple derivatives that sort of arrangement is okay.

I would be very surprised if this cross-selling issue, as it were cross-selling over different sides of the fence, was an issue of major commercial importance or public policy concern. I do not recall it ever being put to us as a very weighty consideration that we should bear in mind in recommending or not such a ring-fencing arrangement.

Lord Turnbull: Can I come to the bank levy? Do you think the banks have some justification for feeling rather aggrieved about this? Initially, the rationale was that they were in effect getting insurance but paying no premium, and this was a proxy for it. We do not really hear that argument now. The argument seems to have changed to, “This is payback time for the costs the Government incurred in the rescue”, but it is coming at a time when it looks as though those costs might not be quite as great as they were, because we are beginning to sell back. Also, the bank that is paying most of it is the bank that caused the Government least cost. It seems to me this is a tax that has started life under one justification and, rather dishonestly you might say, switched its justification to another basis.

Sir John Vickers: I would rather not be tempted too far into fiscal policy, which is the province of the Chancellor. Of course, levies and taxes are put in place for all sorts of reasons, above all for the raising of revenue. The Treasury is a much better judge of the effectiveness of a levy such as this on such a basis. Perhaps, though, I could link it to a remark I made some time ago about the attitude of some banks in recent weeks towards ring-fencing. I am slightly surprised that objections to ring-fencing are coming forward when an argument that some banks might make, one would think, would be along the lines of your question and would say, “Look, with ring-fencing in place, the exposure of the UK taxpayer to risks generated from activities far from the UK is much more remote. The fence helps to make those risks much more remote from the taxpayer, as do the other loss-absorbency measures, and so on”. That line of thinking, once ring-fencing is in place and bedded down, might lead to an argument that in relation to the far-away-from-the-UK activities and far-away-from-retail activities there is a case for easing that levy. There might be a point about the international pattern of the levy as it affects UK-headquartered banks that links very much to the measures that we are talking about. If that argument were to gain traction, it would be a reason why such banks ought to embrace ring-fencing, rather than the opposite.

Q7 Lord Griffiths of Fforestfach: First, I must declare an interest as a director of a bank. I would like to go back to your answer to the question regarding David Walker, because when you published your report I found myself in complete agreement that there was a case for ring-fencing. However, after the increased capital and increased liquidity, but particularly after the resolution and recovery directive, you said that the case against David Walker was that ring-fencing would actually strengthen the stability of the system. It seems to me that here ring-fencing is playing the role expressed in your concern that there is not enough capital in the system. That is what you started with: teaching the undergraduates and their horror at the leverage in the system and so on. If that is really the case, if your concern is that there is

not enough capital in the system, might it be better just to come clean and say, “Why don’t we have a simple regulation, which is we need more capital?”.

Sir John Vickers: We had to be realistic about where the global capital requirements were. Academically, I could imagine a world where capital levels were, let us say, five times higher than Basel. If the prospect of loss hitting the taxpayer became negligibly small, the incremental case for structural measures might be considerably weaker. However, we are nowhere near that, and if we were the cries of outrage from the City would be very great and possibly well justified, particularly if the rest of the world was at one-fifth of the capital levels of here.

On the package of structural measures and loss-absorbency measures, capital and bail-in-able debt, our view was that that was the smart and practical way, through these two complementary self-reinforcing elements of the package, to make banking here safer for the good of the rest of the economy, for the sake of the fiscal position, to go a long way to curing the too-big-to-fail problem, while not unduly jeopardising the position of international banking done out of London.

Now, there is one respect in which curing too big to fail does weaken the competitive position of some UK banks, if those banks have previously been riding on a big taxpayer-guarantee sort of subsidy. No sensible economic policy would say that is the activity that we want to subsidise, that we want to do it in this way and that there is some huge, but we hope small, probability of contingent risk whacking the entire economy. That is not a sensible policy at all. Apart from helping to cure that subsidy, I do not see our measures as detrimental to the international competitiveness of UK-based banking, and I think it is the smart combination of things. The fact that one element of the package is now in place does not weaken the case for the other element at all, just as building the walls does not weaken the case for putting the roof on top.

Q8 Lord Sharkey: I declare a tiny interest as a director of a think tank that is in receipt of funding from retail banks. Mark Carney recently said that systemically important banks, “will in future be resolved without recourse to the taxpayer”. Do you share that optimism?

Sir John Vickers: I believe that the word “globally” was at the beginning of that utterance by the Governor, because he was speaking, I think, with his FSB hat on following the Brisbane G20 and in the wake of the agreed measures on what the international community calls total loss-absorbing capacity—which I believe is a terrible misnomer, but that is what it is called. I certainly hope that the Governor is right. The probability of that statement being true has greatly increased, but I do not think one can ever say with certainty that there will never be

recourse to taxpayers in the case even of globally systemically important banks. Domestically, we and other countries around the world should be very concerned too about banks that may be nationally of systemic importance but not on the list of the global systemically important banks. I hope he is right, and I think the odds have shifted in favour of that, but I do not think it is certain. A lot more needs to be done, not only in relation to the GSIs, in the general international effort.

Lord Lamont of Lerwick: The size of banks and their relationship to GDP, which I gather Governor Carney talked about the other day, could exceed nine times GDP in 2050. Do you think there is any merit in limiting the size of banks?

Sir John Vickers: My general approach to that would not be to favour size caps, quantitative caps. However, there are a number of points to be made. One is the general competition point, which we touched on earlier. A very tight oligopoly of a very small number of enormous banks is unhealthy on those grounds. There is currently the CMA inquiry and there are the general provisions of merger law. Of course, in the Lloyds/HBOS case those were relaxed on that occasion.

My approach to the question is more one of trying to get incentives straight. If banks have bloated balance sheets because of an uncured too-big-to-fail problem or because of a merry-go-round of intra-financial institution lending—and a lot of the growth in the balance sheets in the decade preceding the crisis was that—if one straightens out the incentives, you will see the ballooning balance sheets come back down to a more sensible size. We have indeed seen a measure of that. Rather than say that no bank should be more than X% of GDP in some quantitative way, I would focus much more on the competition policy approach and trying to get incentives straight, so that the woefully misaligned incentives that led to some of this ballooning of balance sheets would not happen.

Also, the final point on this question is that the leverage ratio with which we began the discussion is very much on point here, because if banks have to stay within 25 times rather than 50 times leverage, for the same amount of capital they are going to be half as big, or they can have twice as much capital, and then they can be larger proportionately, but then there is much more loss absorbency should things go bad.

The Chairman: Can I just finish on the question of costs? There has been a great deal of discussion about what the costs of ring-fencing are, both initially and ongoing. The assumption, certainly Sir David Walker's assumption, is that this would be passed on to the customers. When you made your recommendations, what view did you have about the

increased costs, the likely proportion of increasing costs and whether it would in fact increase the cost of borrowing?

Sir John Vickers: We did a lot of work on that in the last few months of the work of the Commission, and helpfully from our point of view a lot of City analysts were doing the same. The catalyst may have been the Mansion House speech which the Chancellor gave in 2011, which made the financial community think quite seriously that some form of ring-fencing might indeed happen. We could use that work coming out of the City as a cross-check to our own work and, indeed, it was very much in line.

If you cure a too-big-to-fail problem and you get this implicit guarantee subsidy down, that itself increases the cost to the banks, but that is utterly desirable because it is taking cost away from the taxpayer, the Exchequer in general, towards the banks. There are some further costs over and above that, and our approach was to weigh those against the vast cost of crises when there is only a very limited toolkit to deal with those crises. If you look at UK GDP now relative to the track it had been on, we are now something like 15 percentage points lower. Of course, that is not all attributable to the crisis, but on any estimate an extremely large chunk of GDP has been lost, perhaps for ever, on the growth track as a result of the very severe financial dislocations. In terms of any costs being passed on to the bank customer, those costs have been passed on to us all, as taxpayers, citizens and benefit recipients, on an absolutely vast scale.

The sorts of numbers that we are talking about are in the low single-digit billions per year—it is a very large number—but against the gigantic numbers of crises, when you do not have adequate loss absorbency, a structure that enables the Government to take different approaches to different parts of a banking group, an adequate bail-in power or depositor preference, the cost-benefit ratio on our analysis very strongly favoured measures of this kind.

The Chairman: Thank you very much indeed. That brings this evidence session to an end. Thank you, Sir John, for your helpful answers.

Sir John Vickers: Thank you very much.

Witnesses

Jonathan Symonds, CBE, Chairman, HSBC Bank plc, and **George Culmer**, Executive Director and Chief Financial Officer, Lloyds Banking Group

Q9 The Chairman: Mr Symonds, Mr Culmer, thank you very much for joining us this afternoon. When a number of your colleagues were here two years ago, in response to a

question from my predecessor Lord MacGregor, they answered the question, “Are you in favour of a ring-fence and do you accept it?”, with an unequivocal yes, and to “Are you going to get on and implement it?”, they also gave an unequivocal yes. We are now two years on and there seems to be a bit of fraying at the edges, if I may say so. It would appear that there are some growing reservations about the ring-fence now, and it would be helpful to hear your overview of how you see it, particularly with a view to being in the hot seat of having to implement the ring-fencing arrangements.

Jonathan Symonds: On the point of unequivocally implementing it, we most certainly are. I would like to spend a few minutes at some point describing what some of the implementation challenges are. The reservations or the concerns that we had as a global bank were implementing some protective legislation in the UK without having resolved some of the more global aspects of resolution and recovery, particularly for an organisation such as ours, with a \$2.5 trillion balance sheet and very substantial activities in the US and Asia in particular.

In that subsequent period, a lot has been done to move towards a multiple-point-of-entry resolution. We are moving towards broadly ring-fencing our geographic activities. We are separating out all our servicing capabilities so that every bank can continue to service its customers irrespective of what happens elsewhere in the world. The capital and the loss-absorbing capital rules have been clarified. We certainly have a lot more capital.

The point I would make today is that, given all the other tasks that we have to do to improve the quality of our bank in the UK, this is a very substantial set of extra challenges, which I am not totally convinced bring the strength that perhaps was envisaged for our business at the time.

George Culmer: Two years ago, we said that we were in favour. We very much remain in favour. We are obviously a different type of bank from HSBC, but going back to some of Sir John’s closing comments, we certainly see a ring-fence as part of a proportionate response to the crisis. One measure in itself is not going to suffice, but a combination of the capital strengthening, the action on leverage, the change in liquidity rules, a change in the nature of regulation, recovery and resolution, and obviously the structural reform, taken as a proportionate package, to us gets close to doing the job without creating onerous strains, obligations or requirements upon banks and, ultimately, their customers.

Yes, as I said, we are a different type of bank. We have some £460 billion of assets, loans and advances. Some 97% of those we would expect to be within the ring-fence, so perhaps we take a different view of that. We think as a collective that while there has been a lot of action

on shoring up and strengthening the individual and the banking sector, some of things that the ring-fencing brings—some of them may be obvious, but I do think they are worth stressing—such as transparency of activity, may be incredibly obvious but in terms of knowledge of what activity is taking place they are, to me, hugely important. The pre-eminence of the provision of the retail and SME deposit base and deposit service, and that being able to continue, is massively important. While we have obviously made massive leaps and bounds in resolution and recovery, given the optionality and the flexibility should one, God forbid, get to that situation again, it opens up opportunities that would not exist without the ring-fence. We were in favour, and we remain in favour.

I suppose there are two questions about implementation, given the other advances around capital, liquidity, proportionality, et cetera. As I said, we would definitely be in the “yes” camp, because it is a package of stuff and it works. It was ever thus that the devil is in the detail when it comes to implementation and defining products in/out. What still lies ahead, which is critical to us, is again some form of proportionality in how one actually operates a ring-fenced and a non-ring-fenced bank and, to use the parlance, how high the wall will actually be. That is very significant to us, and a level of pragmatism in how the banks are run and governed is something that we still see as critical to making this happen.

Q10 The Chairman: At the recent AGM of HSBC, Douglas Flint cited structural reform as one of the factors—not the only factor—that was going to be taken into account in considering where best to locate the headquarters of HSBC. Could you give us a bit more detail on that matter?

Jonathan Symonds: We have since identified 11 factors that we will take into account in determining where, optimally, our head office should be located. One of those is local regulation. I do not think you can point to the ring-fenced bank, because irrespective of where our head office is we have to do this. Perhaps I should emphasise that despite some reservations about the proportionality of it, I can assure everybody here that we are devoting enormous resources to put it in place, so there is no equivocating whatever. In fact, rather than just take it that we follow the letter of what is required, I think we are entering into the spirit and actually trying to create a very strong and competitive bank in the UK.

Within the 11 criteria, I do not think there is any one element that you can say pushed us into reassessing it. We will look at it as a whole package, and as of today the board has not considered any conclusion or any proposal coming out of that.

Lord Griffiths of Fforestfach: Lord Chairman, I wonder if I might ask Mr Culmer a question. You said that you would be happy with it, provided the regulatory authorities were pragmatic. What do you mean by “pragmatic” there?

George Culmer: As I said, a vast majority of Lloyds will be within the ring-fence, which leaves a small amount of entities that sit outside it. Our absolute desire is to continue to be able to offer products and services to our clients and customers. The continuation of service is what we want, and that is what we think we are able to deliver.

However, that is based upon a presumption whereby, given the shape of our business, you get a number of synergies that one is able to use when sharing data, customer information and some of the platforms that will reside in the ring-fenced bank, which you can utilise to support a non-ring-fenced entity. We see that there is a structure that works. However, should that not be the case—and I take this as an extreme example—I have to build my non-ring-fence from scratch, with separate platforms, separate systems, separate personnel, et cetera. Ultimately these non-ring-fenced entities have to be viable. If my cost base is such that it cannot support the small amount of income that I get, that causes me issues with viability. If my only option, in terms of making this profitable, is to grow some of those activities, I would have to think hard as to whether I actually want to do that. That is what I mean. That is the practical way. There is another bit of governance in terms of how you actually manage this, but that is the build bit.

Lord Turnbull: I wonder if I am the only one who is finding your explanation inconsistent, Mr Symonds. Clearly there seems to have been a cooling in HSBC’s statements from the statements made to the Parliamentary Commission, which I was a member of, and statements made to this Committee about the ring-fence: now being actually slightly hostile to it, but knowing they have to do it anyway. Your explanation was that there were queries about implementing protective measures in the UK without proper regard to what was happening elsewhere. That would be a case where, if we introduced a lot of measures and no one else did, we lost competitive advantage. You went on to indicate that actually the opposite was happening. Gradually, through the Financial Stability Board and so on, the rest of the world was catching up, and therefore the relative disadvantage to us should have diminished, so I cannot understand why you are not more comfortable with it now than you were two years ago.

Jonathan Symonds: It is perhaps based a little on the last comment, and it is the scale of what we require. As you know, I chair the UK bank, and as a board we have set five very clear priorities for what we have to achieve. One of those is the implementation of these structural

reforms. Secondly, we have to increase significantly, and rightly so, a lot of the capital planning and stress testing, but we also need to restore the trust and the confidence of our customers in the UK in the activities that we perform. As we have an investment bank, we have to ensure that we have the appropriate culture so that none of these terrible situations that have occurred over the last few years occur again.

When I look at the resources that I have to devote to each of those, the ring-fencing activities take up a very substantial set of activities. Unlike Lloyds, which is 97% of its business, ours is about 30% to 40%. I have to move 16 million customers in an 18-month period. I have 250,000 customers who will have to change their sort codes. Just imagine how many standing orders you have. I have to employ in the order of 450 or 500 people to practically do that. I have 350 systems that I have to separate and I need 250 software programmers. I am consuming a very substantial amount of the productive capacity of the bank to implement this when I really would rather be improving culture and customer service quality. The difference is that it is really more of a pragmatic issue rather than a point of principle, I would say. It is when we look at the priorities that we have in front of us.

Lord Turnbull: Just one final comment. I would have thought that one of the best ways to generate trust would be to embrace these reforms enthusiastically and get on with them without complaining.

Q11 Lord Forsyth of Drumlean: Can I just address my question in particular to Mr Culmer? You have ended up, because of these changes, with less competition in the market and you still have a comparative advantage because of your size, effectively because of your dominance in the current account and mortgage market. You are effectively too big to fail, so you have that implicit government subsidy, which gives you a competitive advantage, but you also enjoy competitive advantages because of the more generous rules on funding, because of your dominance of the payments infrastructure system and because of regulatory advantages. The proposal that came to divest the TSB has resulted, again, in less competition in the market and less effective challenger banks, which was the European Union's original proposal. What has really changed, from the point of view of the protection of the consumer, as a result of these changes? From your point of view, it has actually been quite helpful.

George Culmer: I am not sure I would entirely agree with your characterisation of the market and what has happened, and I do not see that the sale of TSB, for example, has taken away from the competition. There are other aspects.

Lord Forsyth of Drumlean: It has certainly not increased the number of competitors in the market, has it?

George Culmer: The separate sale of TSB to Sabadell?

Lord Forsyth of Drumlean: Yes.

George Culmer: That is not an extra competitor?

Lord Forsyth of Drumlean: It is an existing competitor taking on another one, is it not?

George Culmer: Sabadell was not present in the UK. If I can address some of those things, I do think that Lloyds as an institution is a fundamentally different business from four or five years ago. We have gone through a fundamental re-shaping of our balance sheet. We have gone on a fundamental de-risking of our business. We are holding capital ratios that are significantly higher than previously.

On the extent to which Lloyds outperforms as a business, we have some fantastic brands and some fantastic distribution, but we add value to our customers through our market-leading cost efficiency. If you look at things like our cost-income ratio, which is a standard way of measuring effectiveness of a bank, at around about 50% we are basically the most effective and most efficient in the UK. We think that our low-cost approach brings great value to our customers and at times can benefit other stakeholders, such as shareholders. I can do that through combining that tremendous distribution and the iconic brands that we are lucky enough to have. Behind that, we try to be as efficient as possible so that we can add as much value, as I say, to both customers and to other stakeholders.

Lord Forsyth of Drumlean: You are efficient because you enjoy certain competitive advantages. For example, the capital provision that you have to make on your mortgages, where you are very dominant, is, I think, 16.5%, whereas your smaller competitors have to make 35%. So you do have a competitive advantage that enables you to appear to be more efficient than your competitors.

George Culmer: Again, I am not entirely sure I would agree with the analysis. Our 16% is in the same line as Barclays. Nationwide, for example, has about a 5% ratio, so Nationwide actually has a significantly lower capital requirement for its mortgages than that which we carry.

Lord Forsyth of Drumlean: Agreed, but you agree that the other competitors, the smaller challenger banks, have 35%.

George Culmer: That is where you come to the evolution from standardised into model adjustments when it comes to how one calculates RWAs. I agree that there are varying levels of capital requirement, dependent upon one's maturity, but that is not an issue for me to solve, I am afraid.

Lord Forsyth of Drumlean: On the implementation of ring-fencing, is it true that you have requested a waiver from the Bank of England for having the ring-fenced entity not to have a different board of directors from the parent group? What is the reason for that?

George Culmer: It is something that we take very seriously and it goes back to the original comment I made about the shape of Lloyds. Within our banking business, 97% of my business sits within my ring-fence, as I say, and just 3% of it sits without. To us, the notion that one has a separate ring-fence bank board and then a separate board above that in charge of the whole banking business does not make sense, given the massive preponderance of our activities within the ring-fenced side of our business. For us, since I have that 97%, having that double structure of governance does not seem to us to be required, given our particular structure. That is how we come at it.

Q12 Lord Lamont of Lerwick: My question is for Mr Symonds. We have heard quite a bit about the alleged disadvantage on British banks internationally and possibly causing a move away from London, but what about the ring-fencing disadvantages relative to foreign competitors that have branches in this country? I understand that banks such as JPMorgan Chase and Deutsche Bank are not going to be subject to ring-fencing in the UK. Is this going to be a significant problem? Could I also ask you, as I asked Sir John Vickers, about this issue of cross-selling products, which I see from information that I have here was highlighted by Sir Philip Hampton in particular? I do not know whether you see the limitations that might be placed on cross-selling of products as a particular disadvantage.

Jonathan Symonds: First, on the point of competitive advantage, we want to compete ultimately with the quality of service and the quality of our products. I do not think we are yet at a place where we want to be, which is why I emphasise the amount of work that we will be doing on internal plumbing over the next couple of years, rather than really investing and being able to build systems and products that really offer significant competitive advantage. In the short term, it is really the opportunity cost.

In terms of cross-selling, we have taken the decision to put the entirety of our UK retail—16 million customers—and our corporate bank into the ring-fence. We had a choice as to whether we had a narrow definition or a large definition. Going with the very wide definition, we should be able to provide customers in that ring-fenced bank with the vast majority of the services that they want.

We will need to go into the network, and this is an element of cross-selling, because not all the services available to customers will be available from the ring-fenced bank, but they will have to buy some products from the investment bank. More importantly, they will need to

enter into the HSBC international network. Outside retail banking, the fundamental benefit that we bring customers is that we give them access to international trade. To that extent, we will still seek to offer customers access to that international element and a degree of cross-selling. Now that we have the stronger boundaries in it, we will need to make sure that both sides are documented and that a transfer pricing process is in place, so that the board of the ring-fenced bank effectively polices the boundaries and makes sure that fair value is achieved over that boundary. We will still seek to give our customers access to the international network of HSBC, as they require it.

The Chairman: Just following up on that, will the ring-fenced bank in the UK have its own treasury operation and will it be able to generate its own derivatives and credit default swaps for its customers?

Jonathan Symonds: We have not decided on that final element of design. Obviously the ring-fenced bank will have to manage its capital position. It will have excess deposits that it will have to place, probably in government debt. It will have to manage its capital position. In terms of where those products sit on the boundary, we have not finally decided whether we will put derivatives into the non-ring-fenced bank. Clearly there are some restrictions as to the kinds of products that you can offer.

The Chairman: Is there not a cost implication to that, because if you can source the products that your customers want from one treasury platform, you are going to be able to do it very cost effectively and you will be able to subsidise different products within that platform? If you have to go outside, that opportunity to cross-subsidise will go and you will have to charge more for the plain vanilla loan.

Jonathan Symonds: This is one of the issues about how we will actually satisfy those customer needs. We have not yet fully decided.

The Chairman: That is work in progress.

Jonathan Symonds: Yes, it is still work in progress. I do not think we will wish to duplicate the infrastructure that we have at scale in the non-ring-fenced bank.

Q13 Lord Sharkey: Sir David Walker recently said, “It is hard to see how the complex structural re-engineering involved will further boost the resilience of banks beyond the new capital and leverage requirements that have been put in place elsewhere”. Mr Symonds, do you agree with that?

Jonathan Symonds: I have chaired the bank for just short of 18 months. In that period, I have seen some pretty dramatic changes in both the capital base and the target capital base. In 2008, our capital was 10.5%. It is now heading towards 16%. The stress testing and the

capital planning have changed dramatically. Obviously the loss-absorbing capital requirements are going to be pushed down into the bank. We have a very good dialogue with the PRA about capital matters. They are very forceful in debating where we should be. I think a lot has changed.

I would feel comfortable as chairman of the bank, and with the independent board that I have, that we can adequately address, independently, the short, medium and long-term needs of the business, as we do today. The fact is that we are separating and we are vigorously doing it.

Lord Sharkey: What I was really asking, I suppose, is whether you believe that ring-fencing is still necessary.

Jonathan Symonds: I think it is a somewhat moot point now, in that it is the law and we are embracing it.

Lord Sharkey: Briefly, Mr Culmer, António Horta-Osório suggested last week that ring-fencing would reduce the amount of capital required by banks in the long term. Can you explain why that might be?

George Culmer: Yes, it is a view on the cost of funds and the capital requirements based upon the risk borne. Again, if you look at it from our perspective, there are these two very different beasts: my ring-fenced bank in terms of the deposit funding, which is very prescribed as to whom it can borrow from and what form it can take, so you have a fundamentally lower-risk bank; as opposed perhaps to a non-ring-fenced bank, where you have a different type of instrument. On the cost of funds and my capital requirement, I would expect to pay a higher cost of funds for those non-ring-fenced activities.

However, when I look at that ring-fence, when you think that capital and the cost of funds is a consequence of risk borne, when I have that transparency of activity, when I know that that activity is essentially lower-risk, and when I get comfortable with that existence and with recovery resolution, why should that not attract a lower capital charge than a commensurate bank that has a more blended mix of exposures and a different type of activity? That is the essence of what António meant: capital as a consequence of activity. If ring-fenced banks are lower risk by definition, the logic flows that ultimately one should hope to be able to see a lower capital requirement attracted to that type of business.

Lord Lamont of Lerwick: That does not really apply to you, does it? You are 97%. You are ring-fenced before you start it, practically.

George Culmer: That is about the extent to which that is actually manifested, but that is the theory of how one looks at the banks.

Lord Forsyth of Drumlean: Surely that was the point that I was trying to make to you earlier. You countered it by pointing out, for example, that on capital requirements on mortgages, Nationwide only required 5%, whereas you required 16%, but smaller banks required 35%. I took his remarks to mean simply that if you were broken up into a series of smaller banks competing, you would have a higher capital requirement, so that is the point.

George Culmer: No, that is not what António would have meant. António's comment was, as I said, about the lower-risk exposures of a ring-fenced bank and the certainties around resolvability. That should, as a consequence, if capital is a factor of risk borne, end up with a lower capital amount.

Lord Forsyth of Drumlean: Does a larger bank not represent a larger systemic risk?

George Culmer: A larger bank could represent a larger systemic risk, I agree. If one is looking at a statement perhaps on where one is now compared with a position in the future, in answer to the comment that we are currently 97%, so ostensibly a ring-fenced bank, yes, we are, but we still have a lot of regulation to get through: TLAC, the recovery and resolution stuff that we are still part-way through. Once that gets enshrined and is in place, I am in a safer position. Once the ring-fence is established and you have greater certainty around the activity that we are carrying, all those things should lead to us to being able to see it as a lower risk and perhaps as a consequence as a lower cost of capital or lower capital level.

The Chairman: Would it not make your life a lot simpler if you just said, "We're just going to be the 97% bank and we'll get rid of the 3%"?

George Culmer: As I said, our objective and our desire is to continue to serve our customer base, and that means operating on both sides of the ring-fence. Within our commercial business, we are a large player in the SME markets and mid-markets, as well as with the larger global corporates. Within that, while one can serve simple derivatives, et cetera, from inside the ring-fence, there are certain activities, be they more complex derivatives or accessing debt capital markets, where we would still like to be able to support our customer base. Our overwhelming desire is to be able to support those customers and build a viable non-ring-fenced entity, so that we can continue to provide that full coverage of products and service to our existing customer base.

Q14 Lord Griffiths of Fforestfach: I wonder if I can come back to the question that was asked by my colleague on my left here. Sir David Walker had a very distinguished career in banking, including being the Executive Director of the Bank of England for a long time. He says quite categorically, "Ring-fencing's role in effective resolution—crucial to protect the

taxpayer—is also now redundant as banks adopt comprehensive standalone mechanisms as part of the EU recovery and resolution directive”. Do you agree with Sir David or not?

The second question is: is not the issue that we have been discussing this afternoon—whether it is a question of where HSBC should be headquartered or, Mr Culmer, your remarks, in the implementation of all this, on the regulatory authorities’ need to have a certain pragmatism—about whether the UK can be part of a global banking industry and decide, from the point of view of public policy, what sort of regulatory structure it wants for capital, liquidity, compensation structure, recovery and resolution planning, and ring-fencing? If we want to be part of a global banking industry, does that not limit the independence that we can have in the kind of regulatory structure that we devise? Is the one that we are now devising not becoming, as John Kay says, excessively complex?

Jonathan Symonds: On your first point, perhaps I would agree that, given all the regulatory changes that have now happened at a global level, the costs of implementation and distracting from serving our customers are disproportionate from the benefits that I believe we will get from it. That does not detract, in any sense at all, from the responsibility that I take to protect the bank, to protect our customers and to meet the expectations of regulators, but this is now a project of enormous proportions for us. I accept that it is very different from Lloyds.

I also believe, given that some banks are contracting in order to fit into this new ring-fenced bank jacket, that this country is externally focused trading internationally, and that our banks need to provide the customers with access into the international network, —which is what I believe the fundamental value proposition of HSBC is. We have a large investment bank, but it fundamentally supports trade. It does not create products, it supports the fundamentals of international trade, and I believe that that is valuable to HSBC, but it is also very important to the UK as well.

George Culmer: I would take a different view, as you might expect. I do not see it as redundant at all. I would see that it complements. Going back to the very start, we are trying to avoid a repeat of the circumstances of a few years ago. We think it is entirely appropriate. Going back to what I said earlier, yes, we are in a better position in terms of capital levels and liquidity, et cetera, but in terms of what it brings to that transparency and that certainty of activity and to optionality as to what one stands behind and what one lets go, I just think it would give an important and additional lever to those who might be in that position, should that fateful day come. We would see it again as a package of activity in terms of the consequence of the crisis. It works.

Q15 Lord Teverson: The two of you are the ultimate examples of how ring-fencing affects certain banks, as they are at the moment, at the opposite ends of the spectrum. Professor John Kay has said that the effectiveness of ring-fencing would be demonstrated by whether a bank wanted to split itself up or not. This is clearly quite topical for HSBC. How would you see the structure of the British banking industry post-2019, once this has been implemented? Will it mean that retail will tend to become separate entities?

I would like to come back to the cultural issue as well. One of the things that perhaps there is the opportunity for—and again this may come back to HSBC and the old Midland Bank that I remember years and years ago, which my parents used to have a bank account with—is a branding change on the retail sector that in some ways will try to portray a different culture or a different image to the public, or is that an impossible feat? We have the FX and Libor problems outside, and maybe the ring-fenced entities and PPI within it. How do you see that future evolving?

George Culmer: I can say this, because I was not part of the design or construction of ring-fencing, but I think it is pretty clever. On your point and sort of on a point that I was making earlier, it does not equate to separation. Take Lloyds, the 97% and the 3%, and the point that I was making earlier: separation would not work, because I could not be economically viable, because I would have to build an infrastructure, whereas with ring-fencing, if constructed properly—there is that pragmatism I alluded to, and I can share customer data, systems, et cetera—I can continue that coverage at the same time as achieving what the authorities want in terms of the separation of that risk. I think that ring-fencing and separation are two separate beasts. One could exist as a ring-fence and continue to exist as a ring-fence, and there is no inevitable evolutionary concept that says, “Thou must at some point separate”. I do not see it that way. Ring-fencing was a clever construct that gives you that benefit of diversified risk without the full onerous cost that would come with a separation. That is how I would see it.

On the cultural bit, it is interesting. All I can say is that it is an enormously important priority within banking institutions. You might say that this is all easy for me to say and that I would say all this stuff, would I not? I have worked in financial services for 20 or 25 years now. When you look at the language that is used internally now in presentation, priorities, imperatives, that whole customer concept and configuring things around the customer—is it to the customer’s benefit, et cetera?—you can see that there has been a massive reorientation in the last five years in how these financial institutions are run. A large part of that is because

of the outside looking in in terms of regulations. A lot of it is because of that growing awareness of doing the right things by customers, but you have a completely different situation now. Does that mean that I am going to be error-free on all those things? No, it does not. We are on a journey and there are some things that are still in our past, particularly for Lloyds in dealing with the PPIs, which I have to work through. In terms of that cultural position, the cultural priorities and emphasis today versus three or five years ago, you are in a fundamentally different position now in terms of the importance of it and in terms of that orientation of doing the right thing by the customer. I say that to you and please believe me: that is where we sit and that is what we try to deliver within our bank.

Lord Teverson: Does ring-fencing not actually reinforce that?

George Culmer: I do not know whether it does.

Jonathan Symonds: I do not want at all to give the impression that we are reluctant about implementation, because what has just been said about reinforcing and building a retail customer culture is very important. When we decided to relocate our ring-fenced bank to Birmingham, to transfer 1,000 people there, to rebrand it and to give it an identity of its own, it was a very deliberate step to create a bank that we can really incubate with all the customer and service attributes that we need to have to run a high-quality competitive bank. We are definitely taking advantage of that aspect.

It does not naturally follow that it will separate. The ring-fenced bank will have some very significant benefits from being part of a bigger global retail bank, such as in product development, internet banking, technology, investments, enabling customers to move as their wealth increases and access products outside the ring-fenced bank. There are some strong benefits.

I would urge the PRA to look at the developments on governance in the last few years, the introduction of the senior management regime. I chair an independent bank that is a subsidiary of HSBC, but I am under no obligation to follow what I am asked to do and I have very clear regulatory responsibilities on the protection of the deposit base and the protection of customers. I think that is sufficient and I would not wish to see further changes in the governance that sought to drive a wider wedge between the ring-fenced bank and its parent, because with the current governance we can take an independent position, we can meet the expectations of the regulators, we can meet your expectations in taking independent decisions that are for the benefit of the UK bank and gain benefits from being part of a larger international, global business.

Q16 Lord Turnbull: Can I continue on that theme? You were here earlier when we were talking to John Vickers about what “independence” means. What are the limits of it? You are not a wholly owned subsidiary to go freelancing. You cannot have a policy that goes against the strategy of the group. If you want to expand in some major way and contract in some major way, you have a different risk appetite or whatever. I wonder if you can give an example of where you might find you were being pushed to go one way and you did not think you should. How do you go about dispute resolution within the group, so that it does not get escalated and you do not end up having the regulator as the arbiter or whatever? How do you deal with it?

Jonathan Symonds: There have been a number of areas where we have entered into discussion with the group, whereby the view of the board was different from the view of the parent. There are some areas of risk appetite, particularly when we have a global investment bank that has at times been neutral about where those assets should be booked. If you have a big balance sheet in London, it can be a natural repository. We police our boundary very carefully, and we have very clear criteria about what gets booked into the UK and what would have to be booked for a Hong Kong customer in Hong Kong. We exert some discipline.

Conversations take place quite regularly on things such as dividend planning in the light of our capital needs and how we look at how we are building our capital to the requirements, the gearing ratio target of 4%—we are not at 4% today—so that we either retain more capital or go through a structured reduction in the balance sheet, and I believe that because we are very clear and have become very clear as a board about the things that are really important for us to understand and manage, we police those areas quite well. We have become more effective as a board, so the quality of the dialogue has improved.

Lord Turnbull: One other issue is one of the dimensions in which the subsidiary had to develop its own policies is remuneration. Now, HSBC is a huge organisation. Traditionally, people joined it and made a career in it. You start in Australia, you come and work in the group office, and go backwards and forwards, moving up in the organisation. That was probably one of its strengths: that people at the group office have had experience of both. How are you going to make this work when each of these subsidiaries is going to have its own remuneration policy?

Jonathan Symonds: We are dealing with that now, and we have dealt with it through the last year, because a very significant, or a large proportion, of the group of highly paid executives, particularly in the investment bank, reside in London and in my P&L, as it were. The policy is determined by the remuneration committee, which frankly is the policy required by the

regulatory standards today. We make sure, as a board, that we have a good understanding as to how individuals are selected for remuneration. I try to make sure that I particularly—and I know that many of our other board members do this—interact with these people sufficiently well, so that we can calibrate, particularly in relation to values and behaviour as opposed to what they achieve, because some of what they achieve will be in a different part of the bank. We are getting there, so that we have an opinion on the important matters.

Baroness Wheatcroft: Could I lead on from that? In answer to the remuneration issue, you were really talking about the people towards the top. I am interested in the people within the ring-fenced bank who will not be earning on the scale of the people outside it. Given the importance of service and the way you want the retail bank to look after its customers, do you think that the discrepancies between the two are actually justified?

Jonathan Symonds: It is very hard to justify on an absolute, because the people in the branches work incredibly hard and, as you say, they are not big bonus earners and are not highly remunerated. What is difficult is the market practice in the investment bank. We have to continue to press on that to make sure that while maintaining some degree of global competitiveness, we are appropriate. Of course, as you know, the rules have changed pretty significantly on deferral and clawback. I think it is work in progress.

I absolutely agree with you that outstanding customer service has to be rewarded wherever it occurs. We have taken steps, because of the frankly poor customer service that we have had, to make sure that we incentivise front-line staff in particular to make sure that they are well rewarded for outstanding customer service. We have taken some steps to increase their remuneration. We have taken a lot of steps to ensure that we increase the amount of time that front-line staff stay in role, so that they can build and strengthen customer relations rather than stay in role for 12 months and move on, because that does not build customer relationships in the way it should.

Baroness Wheatcroft: Mr Culmer, I know that Lloyds is a different animal, but nevertheless PPI, et cetera, was driven by incentives. Are you confident that the structure you have now is very different?

George Culmer: I am confident of that. I cannot guarantee that there will not be some misdemeanour in the future. I do not mean a son of PPI, but we have, over the last couple of years, fundamentally reorganised and restructured the bank. As a huge part of that, we have completely overhauled our pay and performance processes and systems. We have removed all incentives, and front-line customer-facing staff are rewarded on customer service inputs, as opposed to sales incentives around products sold, so we have completely, as I say,

reconfigured how we incentivise and performance-manage those individuals. We have fundamentally overhauled that.

Going back to one of my earlier responses, that has been but one part of a fundamental cultural drive in what we are trying to achieve as a bank: the best bank for customers, et cetera. No action unto itself is going to change, but it will as a combination, one hopes. Dealing with those incentives is a massive, critical, part of that, and we have made that change.

Q17 Baroness Blackstone: Do you agree with the Chancellor's statement in the last Budget that given the restoration of profitability in the banks since the crisis, they could now make a bigger contribution to restoring the public finances?

George Culmer: Yes. Essentially, because of past losses, Lloyds currently pays no corporation tax, but despite that each year PwC runs the 100 Group, which is the top-100 businesses, and Lloyds is actually already the largest UK taxpayer. That is through things like national insurance, VAT, et cetera, so we pay something like £1.7 billion. That is with zero from corporation tax. It is our fundamental desire and conviction that we are going to make profits, we are going to pay corporation tax and we will add to that figure, so we will add to the contribution that the bank makes to the Exchequer's revenues.

Jonathan Symonds: The unequivocal position that I would like to be in is that our profitability is increasing because our customers are doing better and therefore the wealth of the UK is increasing, and that adds to the tax take across the whole of the UK. We have to align ourselves, our business and our performance with the performance of our customers. If we are successful it is because they are, and that is where you get that reinforcing environment of the importance of banks to the UK economy, which we are. We are a servant to the UK, and we have to get back to the position where we serve the UK economy to the standards expected by society today, and that is what I am in this job for.

Baroness Wheatcroft: It is one of the criteria that you are looking at, though, to decide whether you move the bank headquarters. What sort of weight do you give to the bank levy?

Jonathan Symonds: Not explicitly.

Baroness Blackstone: It is not one of your 11 criteria.

Jonathan Symonds: The current and prospective tax system is one of the criteria, and in the UK that is clearly one of the factors in it. I would not pull that out as a leading criterion. It is part of the overall package and the assessment that we will make at the end of the year.

Lord Kerr of Kinlochard: Can I ask a question about the cost of the whole ring-fencing exercise? We see Treasury numbers of a one-off cost, with the usual Treasury precision, of

between £0.5 billion and £1.5 billion, and then an ongoing cost, year on year, of between £1.5 and £4 billion a year. That is on the British banking industry as a whole. Listening to the description of the convulsions inside HSBC required to satisfy the law, it seems to me that the one-off cost estimate is more likely to be at the top end of the range. Sorry, the range was £0.5 to £3 billion—a very precise Treasury number. How much is it costing HSBC, how much is it costing Lloyds, and what do you think it is costing the banking industry as a whole, now and over time?

Jonathan Symonds: I am embarrassed to say, as a former CFO, that we do not have a number yet that we are really confident in, because there are a lot of moving parts. Our current estimates are around £1.5 billion. They are incremental costs, so they will not include any of the hundreds and thousands of people who are currently employed devoting their time to implementation issues. It is about £1.5 billion.

The ongoing costs are not isolated in the sense that, as was described earlier, it was introduced as a package of reforms. The package of reforms includes capital and all the other activities that we are doing, so we have not isolated it. The ongoing costs will not be substantial, other than the move to Birmingham and so on. The one-off implementation costs are pretty substantial.

George Culmer: For us, as you might expect, it will be a smaller sum. Again, I put out the caveat that it depends upon the final detail of the rules, but as we understand them the build costs will probably be in the several hundred million pounds. That would be spent on things like this: while we are able to use shared platforms, I have to move legal entities and be able to amend financial systems and policy systems to separate out policies and products. Again, the annual, ongoing, additional costs would be in the tens of millions of pounds. That would be our expectation.

Lord Kerr of Kinlochard: Thank you. That suggests that the numbers that we saw on ongoing costs may be an overestimate, but the numbers on the initial cost of the change are clearly an underestimate. If for HSBC alone you are talking about over £1 billion, then it is implausible.

Jonathan Symonds: It will vary from entity to entity. As has already been well understood, Lloyds and HSBC are at different ends of the spectrum in the UK. The piece that I am most interested in resolving with the PRA is that all this activity is going to take place in a very concentrated period of time. We are not going to wait until 2019 to get this done. We are going to be ready a year early, because we have to run this. I think that is the general view. In the second half of 2016 and 2017, we have to make sure that as a UK bank plc we carefully

manage the implementation of this, because there has been enough publicity about system outages. Some of the pressure that we will be putting on our internal systems, but also in expanding the payments network, could be quite substantial. There needs to be a carefully orchestrated implementation of this.

George Culmer: We would wholly agree with that. That concentration of activity and the finite resources out there in terms of specialist skills would put a strain on our abilities to effect the outcomes and the actions that we want.

Q18 Lord Layard: Can I ask you about the Basel committee's new proposals on risk-weighting? A number of people have suggested that this could lead to a serious reduction in bank lending, including to SMEs, on mortgages and so on. Do you have any comment on that?

George Culmer: You are right that they have come out with a number of proposed amendments to standardised credit risks, which would impact some of the smaller lenders and be onerous on them if they acted in that way. There is a journey between now and implementation. We are talking about 2019. Between then and now, there are these quantitative impact studies that look at the potential outcomes. There is a whole spectrum map, and taken to one extreme, if you move to the other end of the extreme one would have to put up significant amounts of capital and you would need to see a reduction in the credit offer or a repricing of that credit. If one takes a literal extreme reading, that could be the case.

We would take the view that as a combination of ourselves and what happens in Europe, a more practical solution of something that may deal with some of the more obvious anomalies of some of the risk-weighted system without having onerous impacts and massive changes is the right outcome. That is something that we will be lobbying hard for. It is something that we want to keep an eye on. On things like mortgages, where there are implementation flaws and people want to amend them, our position is that it is an incredibly model-able class of business. It is already stress-tested this way and that, to make sure one has sufficient capital. Let us deal with anomalies, but let us please not have unintended consequences that, to answer your question, flow through into the real economy in a reduction or repricing of credit. Keep a close eye on it.

Jonathan Symonds: I agree that there is still quite a lot of discussion to be had, but I also think that we have to get into a world where we are much more dynamic about asset allocation and balance-sheet management. We have to triangulate between a return on risk-weighted assets. We have to triangulate with a gearing ratio. We have to make sure that we can manage our business and meet our customer needs at the same time. We have a lot of

tools at our disposal and there have been changes to risk-weighted assets over the last few years anyway, so we have to debate our point but be more dynamic in how we manage our business and our asset allocation.

Q19 The Chairman: In the last two minutes, can I ask about this? You have painted a picture of great change and turmoil, in some ways, which is going on within banks. There is a cost to that. I think there is possibly a distraction to it as well. The cost of capital has gone up. The risk-weighted asset regime and other rules have required you to put more capital against some loans. Does that mean that as you look at your banks over the next two or three years, you will in fact be able to increase the amount of lending, or will the pressures that are on you, not only financial pressures but human-resource pressures, require you to keep the bank at the current size or maybe even shrink it a little?

Jonathan Symonds: As I mentioned earlier, the UK board has five very serious projects on its hands: the implementation of structural form; financial crime and money laundering; capital and stress testing; customer centricity; and culture and values. All those are the right agenda, but some are observed by the FCA, some by the ECB, and some by the PRA. I worry most about execution risk over the next three years. I worry even more about the burden on people. This is the discussion that the board spends more time on than anything else. The PRA and the FCA have exactly the same issue. We cannot fail to deliver on any one of these agenda items, and we are determined to do so. Until we are clear that we can deliver this agenda, we are going to keep really close to it, because it is not a trivial burden.

George Culmer: I would say that there is almost a perfect storm of activity, as you outline. The Lloyds story over the last few years has been around de-risking, reducing the balance sheet, et cetera, but, to answer your question, it is our objective, aim and desire to grow our business as we move forward. There are certain lines of business where we will grow in line with the market, such as mortgages. There are other lines of business, such as SMEs, where we have been growing at 5% and have continued to target growth at 5%. With markets, we would look to go to 3%. We would be looking to grow our asset finance business and our credit card business, so we have clear plans to take the business forward. Yes, there is a lot of regulatory activity. Yes, there is execution risk. We are here to grow our business and we are here to help the economy. We have an objective. We talk about helping Britain prosper, and that is our desire, and our plans are to expand the balance sheet and move the business forward.

The Chairman: Gentlemen, thank you very much indeed for some very helpful and informative answers. Thank you for joining us.