



House of Commons
Treasury Committee

**Financial Stability and
Transparency:
Government Response
to the Committee's
Sixth Report of Session
2007–08**

**Twelfth Special Report of Session
2007–08**

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The Treasury Committee

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Committee staff

The current staff of the Committee are Colin Lee (Clerk), Sïan Jones (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young and Jay Sheth (Committee Specialists), Phil Jones (Committee Assistant), Caroline McElwee (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

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Twelfth Special Report

The Treasury Committee published its Sixth Report of Session 2007–08, *Financial Stability and Transparency*, on 3 March 2008, as House of Commons Paper No. 371. The Government Response to this Report was received on 1 July 2008, and is appended below.

Appendix: Government Response

Introduction and overview

1. The unfolding crisis of confidence is important to keep in mind because of its widespread impact on financial markets, its particular impact on the United Kingdom via Northern Rock, and its emerging impact on the real economy. (Paragraph 1)

The Government welcomes the Committee's continuing interest in these matters. The Government, with the Bank of England and Financial Services Authority set out its proposals for addressing the issues arising from the recent turbulence in the financial markets in *Financial Stability and Depositor Protection: Strengthening the Framework*, published in January 2008 (the 'January consultation') and in a follow-up document *Financial stability and depositor protection: further consultation* published on 1 July (the 'July consultation').

2. The market turbulence since August 2007 has propelled the issue of financial stability to the top of the political agenda. The terms "financial stability" and "serious threat to financial stability" are used in the Banking (Special Provisions) Act without a legal definition. There is a continuing lack of clarity about what is meant by financial stability as well as what events constitutes a "serious threat to financial stability". We believe there is a need for clarity from the Tripartite authorities about how they define financial stability so that stakeholder can assess whether particular events constitute a threat to financial stability. This clarification should be in advance of Parliamentary consideration of the Banking Reform Bill. Such a step would ensure that policy interventions to maintain financial stability would in future take place against a more objective backdrop and would be particularly important in aiding the work of the tripartite authorities in promoting financial stability. (Paragraph 7)

The Government intends to provide the Bank of England with a statutory objective for contributing to the maintenance of financial stability. The Court of the Bank of England will be responsible for setting the objectives and remit for the Bank of England and the Financial Stability Committee.

Changes in financial markets

3. The 'search for yield' has spawned the growth of complex new financial instruments as well as new types of institutional investors. This 'search for yield' encouraged many investors to invest in high-yielding complex products that it turns out they did not always fully understand and is at the heart of the problems which have affected

financial markets from mid-2007 onwards. We discuss the consequences for financial stability of this ‘search for yield’ in greater detail later in this Report. (Paragraph 15)

The Government notes the Committee’s comments. As explained in paragraphs 2.2 to 2.3 of the January consultation, the Government agrees that the ‘search for yield’ that preceded the disruption in global financial markets is an important factor in understanding recent events.

4. The increased prominence of hedge funds makes it important to analyse the role they play in financial markets. We intend to examine the role of hedge funds as part of our ongoing work on financial stability and transparency. (Paragraph 20)

The FSA has primary responsibility for mitigating the risks associated with hedge funds and has taken a number of important steps in that area. In respect of the risk that the solvency of a broker/dealer could be compromised through losses on lending to hedge funds, the FSA conducts a regular Hedge Funds as Counterparties survey to assess risks across the system. It is also working with prime brokers to drive further improvements in their risk management in this area. The FSA also regulates all UK-based hedge fund managers under a regime considered one of the more stringent in the world

5. We are continuing our work on private equity, examining the proposals in Sir David Walker’s report as well looking at the impact on private equity of the changing economic environment. We will also continue to explore the implications for financial stability of the growth of private equity in recent years as part of our ongoing work on financial stability and transparency. (Paragraph 26)

The Government notes the Committee’s comments and looks forward with interest to the Committee’s views on the effect of Sir David Walker’s proposed code and its adoption by the BVCA and its members, and also on the financial stability implications of the growth of private equity.

6. We recognise the important role that Sovereign wealth funds have played in helping to stabilise the financial system through their investments in financial services firms in 2007. However, the increasing prominence of such funds as institutional investors does raise valid public policy questions about governance, transparency and reciprocity. We intend to examine the role of Sovereign wealth funds as part of our ongoing work on financial stability and transparency. (Paragraph 30)

The Government is supporting policy development on sovereign wealth funds (SWFs) through multilateral discussions taking place at the IMF and OECD. The OECD progress report - released at the Spring Meetings - set out guidelines for countries receiving SWF investments. This included policy principles to only use investment restrictions where existing powers prove inadequate to address national security concerns, and where this is the case regulations should be transparent, proportional and accountable. The UK endorses these principles. The IMF is developing a set of best practices for SWFs, which we expect to be ready in time for the Annual Meetings.

The Government does not favour reciprocity clauses. An important benefit to the UK comes from inward investment. Inward investment, from sovereign wealth funds and other foreign investors, provides increased competition, greater innovation, access to new

technologies, increased productivity and reduced prices for consumers. These benefits accrue even without the multilateral opening of markets. Such benefits will encourage others, over time, to also open their markets. Investment reciprocity carries with it the risk of legitimised protectionism and would undermine the Government's multilateralist approach to globalisation.

7. We will undertake further work on offshore financial centres in the context of our ongoing scrutiny of financial stability and transparency to seek to ascertain what risk, if any, such entities pose to financial stability in the United Kingdom. (Paragraph 34)

The Government notes the Committee's comments and looks forward with interest to the Committee's views on the financial stability implications of offshore financial centres.

8. Our inquiry has highlighted the complexity of many new financial instruments, such as Collateralised Debt Obligations. Nevertheless we are surprised that the Chairman of the UK branch of a leading investment bank could not explain to us what a CDO is, a financial product in which he told us that his organisation deals. The fact that senior board members may not have sufficient understanding of products that their organisations are originating and distributing is a major cause for concern. If the creators and originators of complex financial instruments have only a limited understanding of these products then it raises serious questions about how investors in these products can possibly understand such complex products and the risks involved in such investment decisions. We discuss this issue in greater detail later in our Report. such investment decisions. We discuss this issue in greater detail later in our Report. (Paragraph 39)

9. The relatively recent innovation of tranching, whereby a pool of assets is converted into low-risk, medium-risk and higher-risk securities, has led to a mushrooming of triple-A securities available for investment. Rating these securities has been an increasing source of income for the credit rating agencies. Tranching has proven successful at tailoring investment opportunities to meet the risk-appetites of investors, particularly those bound by strict investment mandates, specifying AAA investments. This market innovation has, however, led to greater complexity. (Paragraph 63)

Securitisation markets: product complexity investors and the role of credit rating agencies

16. We share Professor Buiters' assessment that many of the new financial instruments are ludicrously complex. Such products have introduced opacity into the financial system, as is demonstrated by continuing uncertainty over the scale and distribution of losses in the banking sector resulting from exposure to sub-prime mortgages. There is also heightened ambiguity about where risk is borne within the financial system. This is a serious concern because it exacerbates the risk that senior executives might not fully understand investments or strategies adopted by banks and so lack a clear picture of the risk-profile of their financial institution. (Paragraph 159)

The Government agrees with the Committee on the vital importance of enhanced transparency in securitisation markets. As set out in paragraphs 2.41 to 2.52 of the January consultation, the Government believes that, while securitisation is likely to remain an important element of the financial system, effective risk transfer requires transparency about the risks being transferred for it to be effectively priced. The complexity of some structured products has contributed to difficulties in valuation. It is also essential that financial institutions' boards and senior management take steps to strengthen risk management processes. The actions that the UK Authorities and their international partners are taking to achieve these objectives are set out in paragraphs 2.60 to 2.71 and 2.47 to 2.49 of the July consultation.

17. We are concerned by the sheer weight of evidence which suggests that many investors did not have sufficient understanding of the products in which they were investing. We share the Governor of the Bank of England's assessment that many investors were seduced into investing in products that they did not fully understand, and that this was in part driven by their 'search for yield', as well as short-termism on the part of many investors. The end result is that many investors appear to have 'thrown caution to the wind' when making investment decisions. Going forward, we agree with the Governor of the Bank of England's view that investors must take responsibility for what they buy and the decisions they make. (Paragraph 164)

18. We believe that there is an urgent need for enhanced transparency around complex financial products so that investors are able to undertake their own due diligence on the products they are investing in. Even where such information exists, it is, as the Association of British Insurers stated, often indigestible for investors. We believe the originators of complex financial products must ensure greater transparency of products whilst there is a pressing need for investors to undertake greater due diligence on the products they are investing in. (Paragraph 166)

19. The evidence presented to this Committee suggests that many investors did not have a sufficient understanding of, and failed to exercise due diligence on, the complex financial products they were investing in. This failure on the part of some investors is linked to the complexity of many securitised products. Detailed regulation of products is one response to the problem of product complexity, although not one that we instinctively favour. However, if the market and, in particular, the investment banks prove unable to address the problem of overly complex products, then regulation will need to be seriously examined in the future. (Paragraph 168)

The Government agrees with the Committee on the vital importance of enhanced transparency in securitisation markets and of improved due diligence by investors in structured products. The steps that market participants, the UK Authorities and their international partners are taking to achieve these objectives are discussed further in paragraphs 2.72 to 2.76 and 2.84 to 2.85 of the July consultation.

Events leading to the closure of the credit markets

10. Looser underwriting standards have played an important role in the problems affecting the sub-prime mortgage market in the USA. We are concerned that these looser standards are linked to the decisive loosening of the link between creditor and debtor under the ‘originate and distribute’ banking model. There are therefore important lessons to be learnt that go far beyond the sub-prime housing market in the USA and which apply to other markets. We discuss the issue of a loosening of underwriting standards under the ‘originate and distribute’ model further later in this Report. (Paragraph 82)

20. The market turbulence since mid-2007 has illuminated a number of serious flaws in the ‘originate and distribute’ business model. In particular, the evidence suggests that originators of loans did not have had sufficiently strong incentives to assess and monitor credit risks as carefully as investors would expect, given that risk would subsequently be dispersed to investors. This incentive problem places greater responsibility on investors to exercise sufficient due diligence over the products in which they invest. However, the fact that end-investors have less information about underlying loans than those at the beginning of investment chains makes it much more difficult for investors to exercise such due diligence. We are concerned that these features of the ‘originate and distribute’ model have led to over-reliance by investors on credit rating agencies. (Paragraph 178)

Off-balance sheet vehicles and the future of the ‘originate and distribute’ banking model

28. The ‘originate and distribute’ banking model has many advantages, which have been discussed earlier in this Report. However, problems in the sub-prime mortgage market in the USA have illuminated many weaknesses in the model. We accept that the move from the traditional ‘originate and hold’ banking model to an ‘originate and distribute’ model will not be reversed. The priority is therefore to ensure that market participants learn the correct lessons from the problems in the sub-prime mortgage market and act accordingly. (Paragraph 211)

As set out in paragraph 2.53 of the January consultation, the Government believes that the ‘originate and distribute’ model of banking has brought many benefits but it has reduced some of the incentives for those originating the loans and constructing the financial instruments to assess and monitor ongoing credit quality. The Government agrees with the Committee that it is vital that market participants learn lessons from recent events and act accordingly. The steps that market participants, the UK Authorities and their international partners are taking in relation to the functioning of the securitisation markets are discussed further in paragraphs 2.72 to 2.76 of the July consultation.

Events leading to the closure of the credit markets

11. We note with concern that the credit rating agencies appear to have been slow to downgrade their ratings for securities backed by sub-prime mortgages. Additionally, the ratings downgrades they made over the summer of 2007 were large scale in nature and appear to have been ‘unexpected’ by many market participants. Large, belated and

unexpected shocks can only serve to exacerbate the problems in credit markets. The very fact that the credit rating agencies began reviewing their methods during this period is an implicit admission that they got it wrong and that they did not have the appropriate models to rate such securities during a time of stress. (Paragraph 90)

21. We are concerned that many investors were overly-reliant on the ratings provided by credit rating agencies and that some investors misunderstood the narrow scope of these ratings. This over-reliance on credit rating agencies by some investors appears to have been compounded by the lack of due diligence on the part of some investors in the products they were purchasing, with many investors taking a triple A score as a 'green light' to invest. It is incumbent upon the credit rating agencies to work together with investors to ensure that investors have adequate information to undertake their own effective due diligence and a clear understanding of the meaning of a rating. (Paragraph 184)

22. We support the principle of improving the information content of credit ratings. To this end we welcome the Bank of England's proposals to improve the information content of ratings. We urge progress on measures to improve the information content of ratings and, to this end, will continue to monitor progress towards greater transparency of credit ratings. However, increased information content should not imply to users that they have any less obligation to pursue due diligence. (Paragraph 188)

Credit rating agencies: methods and conduct

23. It is incumbent upon the credit rating agencies to provide further reassurance that conflicts do not exist between their advisory and rating functions. If the credit rating agencies fail to demonstrate that Chinese walls alone are a sufficient safeguard then it may be necessary to look at alternative approaches to tackling this problem. (Paragraph 201)

24. We are deeply concerned about the conflicts of interest faced by the credit rating agencies and agree with Professor Buiter that the credit rating agencies are subject to multiple potential conflicts of interest. These conflicts of interest have undermined investor as well as public confidence in the rating agencies and must be tackled as a matter of urgency. Without reform the credit rating agencies will be unable to regain public trust and confidence. It is therefore incumbent upon the ratings agencies as a matter of urgency to demonstrate that they can effectively manage and be seen openly and transparently to manage the conflicts of interest in their business model out of the system. To this end, the credit rating agencies must put in place policies and procedures to identify, manage and, where incapable of being managed out, disclose conflicts inherent in their individual business models. If they are unable to do this then new regulation will have to be seriously considered. (Paragraph 204)

25. Professor Buiter and Sir John Gieve both suggested to us that the conflict of interest problem could be tackled if investors paid for ratings. However, this may merely serve to encourage conflicts in the opposite direction. For example, if investors paid for ratings they may have an incentive to bargain down ratings so as to maximise their rate of return. This suggests that it may prove difficult to remove such conflicts of interest simply through moving to an investor pays model and that the priority should be to

ensure that a robust framework for managing conflicts of interest is put in place. (Paragraph 205)

The Government notes the Committee's concerns about the role of credit rating agencies in the markets for structured products, including relating to the quality and content of ratings, conflicts of interest and investor reliance on credit ratings. The Government's views on these issues, and the steps that the UK Authorities are taking in conjunction with their international partners to address them, are set out in paragraphs 2.53 to 2.64 of the January consultation and paragraphs 2.77 to 2.86 of the July consultation. The Government supports the objective of a proportionate, principles- and risk-based approach to strengthening independent external oversight for rating agencies. Given the global nature of CRAs' business there would be considerable benefits to an internationally consistent solution to avoid regional differences in standards.

26. We are not convinced that the credit rating agency market is sufficiently competitive or efficient. At present the market is dominated by the two big US ratings agencies, Moody's and Standard & Poor's plus the European agency, Fitch. We therefore call upon competition authorities to examine what barriers to entry have prevented greater competition in the industry and how competition within the industry could be encouraged. (Paragraph 207)

The Government notes the Committee's comments. It is for the relevant competition authorities to best decide how to use their resources and where to focus their investigations.

Events since August 2007

12. The decision of the Bank of England to take part in coordinated action with other central banks in December 2007 is to be commended. We will continue to monitor the Bank's actions, and consider the effects of continued financial market disturbances on the macroeconomy as part of our regular work scrutinising the Inflation Reports of the Bank of England. (Paragraph 133)

The Government notes the Committee's comments. The Bank of England's open market operations are a matter for the Bank.

13. As the Governor of the Bank of England has said, uncertainty about the scale and location of losses has led to concerns about the adequacy of bank capital and hence the ability of the banking system to finance continued economic expansion. There are now growing signs that developments in financial markets are feeding through to the wider economy in the United Kingdom. The continuing health of the UK economy therefore depends to a significant extent upon the banking sector's ability to re-establish reliable pricing and the restoration of confidence in each others' balance sheets. A prolonged failure to do so by the industry would have implications for economic growth. We recognise that some banks have already taken steps to establish losses and repair balance sheets. Nevertheless, the risk remains that if the banking sector does not put its house in order then the problems in that sector will have a significant adverse macroeconomic effect. (Paragraph 137)

The Government recognises the risk noted by the Committee relating to prospects in the banking sector and the real economy. This, and related risks, were discussed in Box B5 of Chapter B of the 2008 Financial Statement and Budget Report. The Bank of England also covered the issue of bank capital in its April Financial Stability Report.

International action

14. We support the Chancellor's approach to seek to make the IMF the international community's early warning system, identifying global economic and financial risks, acting to identify problems before they occur. In our Report of 2006 on Globalisation: the role of the IMF we supported proposals that "the IMF should focus more on crisis prevention as well as on crisis resolution, and ... there should be a new focus on surveillance". We note, however, that whilst the IMF should play a leading role in identifying global economic and financial risks, it lacks the necessary policy instruments to enforce action by market participants. Yet the international turbulence of since mid-2007 has served to emphasise just how great the challenge facing the global financial community is in improving their response to financial problems. We support a greater role for the Financial Stability Forum sharing information and coordinating the global response to such shocks. (Paragraph 147)

The Government welcomes the Committee's support for the Chancellor's objective of encouraging the FSF and the IMF to enhance their cooperation and provide the international community with an early warning system on the threats to financial stability and the global economy from the international financial system. G7 Finance Ministers in April endorsed these objectives. Paragraphs 2.96 to 2.101 of the July consultation sets out the steps being taken internationally to enhance the role and capability of international financial institutions in maintaining financial stability.

15. We support the Government's efforts to promote a review of the Capital Requirements Directive/Basel II framework, and in particular to ensure that that framework does not provide perverse incentives to banks to reduce capital adequacy. (Paragraph 153)

The Government welcomes the support of the Committee. The steps that the UK Authorities are taking with their international partners to strengthen capital requirements relating to certain securitisation and off-balance sheet activities are set out in paragraphs 2.31 to 2.33 of the July consultation.

27. We expect to continue to monitor the role of monoline insurers and the risks associated with the problems they face. (Paragraph 208)

The Government agrees on the need for continued monitoring of the risks associated with monoline insurers.

29. Ambiguity and confusion regarding the ownership of risks associated with off-balance sheet vehicles have contributed to the financial market volatility since mid-2007. The FSA, working with international partners, must ensure that banks report their exposure to off-balance sheet vehicles appropriately. The FSA should also consider whether banks have been using these off-balance sheet vehicles for genuine economic efficiency reasons or as a smokescreen to hide behind, given that the capital,

reporting and governance requirements on these vehicles are lighter than those incumbent on banks themselves. (Paragraph 216)

As set out in paragraph 2.41 of the January consultation, the ongoing market disruption has highlighted concerns around lack of transparency as to who is ultimately carrying risk in securitisation markets, particularly in relation to the losses suffered by off-balance sheet financing vehicles on asset backed securities. Paragraphs 2.53 to 2.76 of the July consultation sets out the steps that the UK Authorities are taking with their international partners to address these concerns.

Heeding the warnings

30. The Bank of England and FSA both gave warnings of deteriorating market conditions during 2007. It has been reported to us that these warnings were not taken on board by some banks and building societies. We do not believe that public authorities should be prescriptive in how financial institutions must react to such warnings. However, given the strong public interest in avoiding banking crises, there is a strong case for establishing a mechanism by which receipt of warnings from public authorities would be formally acknowledged by financial institutions. We recommend that when issuing warnings of potential problems, the Bank of England and the FSA should highlight the two or three most important risks in a short covering letter to financial institutions, for discussion at Board level. The Bank and FSA should seek confirmation that these warnings have been properly considered, and publish commentaries on the responses received. (Paragraph 222)

The Government notes the comments of the Committee and agrees with the importance of effective communication of warnings to the private sector. The mechanisms for communicating the risks identified by the Bank and FSA, particularly in the Financial Stability Report and Financial Risk Outlook, are a matter for the Bank and FSA respectively.