Q2152 Mr Fallon: If you do not know what "unobservable profit" is, you are the Chairman of the—

Lord Turner of Ecchinswell: I did not know that that line was there, but I am sure we do understand what is in that line. I have not read that particular line and focused on it.

Q2153 Mr Fallon: It comes just after a paragraph that tells us that, as a result of the most recent stress test, there is potential to increase the fair value of Barclays by up to 2.4 billion or to decrease the fair values by up to 3 billion. So when Barclays tell us they have made 6 billion profit, how can we believe it?

Lord Turner of Ecchinswell: That is a much more straightforward thing to argue. When you do stress tests you are looking at a wide range of scenarios. I think the idea that there is, as it were, a truth as to what losses will be over the next year, and that people are hiding it, is a fundamental intellectual mistake, if I may say, because it fails to realise that what we are trying to do in stress tests is to consider the future, and the future is not determined yet; it depends upon the course of the economy, it depends on the course of financial markets. So, yes, we are deeply involved with running stress tests with Barclays, as they are themselves, and those inevitably have wide degrees of uncertainty. That is inherent, that will always be the case, and that is good supervision, not bad supervision.

Q2154 Chairman: I have given you pages 102 and 103 of Barclays' trading report, and I have highlighted the various sections for you, Lord Turner. The report says that Barclays has assets of almost £45 billion, measured using unobservable inputs almost twice a year before, and they talk about "vanilla" and "exotic" products. This is how they describe vanilla products—it is important for the public record. "Vanilla products are valued using simple models, such as discounted cashflow or Black Scholes models. However, some of the inputs are not observable." They then go on to exotic products and say that they are over-the-counter products that are relatively bespoke, not commonly traded in the markets and their valuation comes from sophisticated, mathematical models though some of the inputs are not observable.

Lord Turner of Ecchinswell: Can I explain what this is? I will explain precisely because I now understand the context of it. Within the valuation of things which are in the trading books of a bank, which are valued on a fair value basis, there is a categorisation of assets which is known as level one, level two and level three, where, at the end of the spectrum which is level one, you are dealing with an instrument—an example might be a traded Treasury bond which is a particular maturity of Treasury bond where there is large and immediate liquidity available every day—where, at five o'clock in the afternoon, you can definitively say: "The value of this is X" because you could, at five o'clock, sell it for X plus or minus a very, very small amount because it is a liquid instrument. There is then a spectrum and there are those called level three. These are assets where there is not, at that point, a liquid market to which you can refer—ie it might be a CDO or a CDO squared, or something like that—where if you called up at that point and asked for a quote you would not get a quote. So you then have to try and work out what the value of that is on the basis of a model. Sometimes you try and do that with other observable instruments, ie by cross-reference to other markets. I was asked this question and I think I was asked it within the context that this was a trick question which was going to find us out—

Q2155 Chairman: No, the reason you were asked this question, Lord Turner, is very simple. We had Brendan Nelson of KPMG before us, the Chief Auditor, and I asked him quite simply that if he had HSBC's statement of accounts before him and he looked at them, could he understand it? He said he could not understand it.[1] The fact is you, in the sophisticated language, could maybe understand it, but this is not understandable to the ordinary person. At the end of the day, what we have found in this Committee is that there has been a massive failure of corporate governance. I put it to you that the type of non-executives on these boards, the best and the brightest, cannot understand what is happening. It is not because they are of limited intelligence. That is the issue here. If we cannot put things in simple language, then we have had it. That is the reason why you have been asked it.

Lord Turner of Ecchinswell: I accept that point and I accept entirely—and I think it is the case—that there has been the development within the trading books of banks of instruments so complex that they have become very difficult to understand, that they have required these "unobservable inputs to value", which is deeply unsatisfactory, and I think, given the changes which we, with international agreement, are putting into the capital which is required against trading books, it is unlikely that these things will exist in future on anything like the scale that they existed in the past. I have also said, which I said in my letter earlier, that I am not convinced that these instruments added much to the sum total of human welfare, and their disappearance we should not regret.

Chairman: That is a satisfactory answer for us because if we are talking about £45 billion, which is a heck of a lot of money, we have got to understand where that £45 million is, and the question for me is how you prevent bank staff from making over-optimistic judgments for using the faulty pricing models we have seen when valuing these assets. We are on the same lines here, that things need to change, and I am quite happy with that answer.

Q2156 Mr Tyrie: You have given us a pretty clear statement that you think the framework of regulation was mistaken, in retrospect. Are you criticising your predecessors or are you criticising the system?

[1] *Note by KPMG:* Mr Nelson replied "It is not a book you would read cover to cover—it is not a book—but if you have an interest in particular aspects it is quite a good dictionary to look in". (Q 1198)

Lord Turner of Ecchinswell: I think there was a philosophy of regulation which emerged, not just in this country but in other countries, which was based upon too extreme a form of confidence in markets and confidence in the ideas that markets were self-correcting, which therefore believed that the fundamental role of the supervision of financial institutions, in particular banks, was to make sure that processes and procedures and systems were in place, while leaving it to the judgment of individual management to make fundamentally sensible decisions. As Alan Greenspan said, that is the intellectual framework which has received an extraordinary challenge.

Q2157 Mr Tyrie: What I am trying to get at is whether you think this is the specific fault of your predecessors or whether you think this was the fault of the structure and system of regulation.
Lord Turner of Ecchinswell: I am not convinced it was the fault of the structure, if you mean by that the separation of banking supervision from the central bank, because I think there is very good analysis that suggests that the relative success of different authorities around the world at dealing with the financial problems that we face is pretty much totally independent of the way that you organise the structures.

Q2158 Mr Tyrie: So you are saying it was your predecessors?
Lord Turner of Ecchinswell: No, I think there was a philosophy of how regulation was done.

Q2159 Mr Tyrie: Where did this philosophy come from, Lord Turner?
Lord Turner of Ecchinswell: I think it was rooted in particular political assumptions at the time, where all the focus on people like the FSA—

Q2160 Mr Tyrie: So it was just a general idea in the ether?
Lord Turner of Ecchinswell: No, it was expressed in speeches on both sides of the House but which suggested that the key priority in regulation was to keep it light rather than to ask ever more searching questions.

Q2161 Mr Tyrie: While you were listening to those speeches and breathing that air which generated this philosophy, were you also infected? If you had been running the FSA without the advantage of hindsight, would you have made the same mistakes?
Lord Turner of Ecchinswell: I fear I would have, yes. I think hindsight is very valuable and it is a question I have asked myself as to whether I would have. I did have intellectual doubts, which I expressed in a book I wrote in 2001 which has some comments upon the fact that we might have financial market deregulation overdone, but those doubts were not as deep as they should, in retrospect, have been.

Q2162 Mr Tyrie: In which case it sounds as if there was something wrong with the system.
Lord Turner of Ecchinswell: I think there was something wrong with the system but you used the word "structure" and—

Q2163 Mr Tyrie: So did you, actually. I wrote down what you said as you said it; you also came out with the word "structure".
Lord Turner of Ecchinswell: I think that was a misunderstanding. What I said was that there was a philosophy of regulation which when it went into an organisation like HBOS was asking questions about its internal structures and systems rather than about its strategy.

Q2164 Mr Tyrie: We are going to have a new philosophy on the 18th. You said that the FSA is going to be fit for purpose. Do we take it from that that it is not fit for purpose now?
Lord Turner of Ecchinswell: It is a long way through a set of necessary changes. I think it might be helpful if Hector Sants described the very significant changes that have been driven through the supervisory enhancement programme which was already well in place before I became Chairman.
Mr Sants: I will keep it very short but, just to make the point, I do believe that for the last 12 months we have put in place a significant set of changes to our supervisory processes—ie the processes that we as a national regulator can control. As Lord Turner has said, there are many other things in the regulatory architecture structure system that also needed to be changed for that supervision to be effective, not least of which a whole series of the rules which we are not directly responsible for. In terms of changing that supervisory philosophy, so that going forward we look at the business models, we look at the risks, we make judgments about the future, we have the right quality of staff which has a good mix of industry practitioners who understand the sort of issues we have just been talking about but, also, others who take a more dispassionate view with a professional regulatory background, we are well down that track. I believe the FSA is a fundamentally different organisation to that which it was 12 or 18 months ago. We have not quite completed that programme, we are about two-thirds of the way through, but any suggestion the FSA is not currently fit for purpose I would completely reject; we are a fundamentally different business delivering to a different supervisory philosophy to the one that has been described.

Q2165 Chairman: This word "philosophy" has been bandied about, and maybe we can just tie this up, Lord Turner, because is it the philosophy of an independent regulator to roll over under the rubric of political philosophy? If it is, what assurance can you give us in the future that you are going to be independent?
Lord Turner of Ecchinswell: I think that is a good question. All I can say is that I am absolutely determined that as long as I am Chairman it will be independent. I also think that it is the nature of such a huge shock to the world that has occurred that round the world regulators will be able to be more