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House of COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

TREASURY COMMITTEE

BANKING CRISIS

Tuesday 11 November 2008

MR PAUL CHISNALL, MR RUSSELL PICOT, MR STEPHEN HADDRILL

MS LIZ MURRALL and MR CHARLES CRONIN

SIR DAVID TWEEDIE, MR PAUL BOYLE and MR MICHAEL IZZA

Evidence heard in Public Questions 133 - 239

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 11 November 2008

Members present

John McFall, in the Chair

Mr Graham Brady

Jim Cousins

Mr Michael Fallon

Mr Andrew Love

John Thurso

Sir Peter Viggers

Memoranda submitted by the British Bankers' Association, the Association of British Insurers, the Investment Management Association and the CFA Institute Centre

Examination of Witnesses

Witnesses: **Mr Paul Chisnall**, Executive Director of Financial Policy & Operations, British Bankers' Association (BBA); **Mr Russell Picot**, Member, BBA Financial Reporting Advisory Panel; **Mr Stephen Haddrill**, Director General, Association of British Insurers; **Ms Liz Murrall**, Director, Investment Management Association; and **Mr Charles Cronin**, Head, Chartered Financial Analyst Institute Centre, gave evidence.

Q133 Chairman: Good morning and welcome to the Committee's inquiry into accountancy and the banking crisis. Could you introduce yourselves please and your organisations.

Mr Cronin: Charles Cronin, CFA Institute.

Ms Murrall: Liz Murrall, Investment Management Association.

Mr Chisnall: Paul Chisnall, British Bankers' Association.

Mr Picot: Russell Picot, member of the BBA's Financial Reporting and Accounting Panel.

Mr Haddrill: Stephen Haddrill, Association of British Insurers.

Q134 Chairman: Can I start then, Charles Cronin. The BBA have sent a letter to Sir David Tweedie, saying that they "believe a mixed-measurement model is essential to providing meaningful financial reporting", but, when I value my house, there are four measures I can take: the price I paid; the market price it is worth now, if I were forced to sell it; the price at which I would be happy to sell it at some time in the future; and what I think the house is worth in terms of fundamentals, what I have added on and just how good it is in terms of the number of bedrooms, the condition of it, the postcode, whatever. Could the same not be said for other assets, including financial instruments? What is the most appropriate measurement for financial instruments?

Mr Cronin: Chairman, we are a strong believer in fair value and I think you would much prefer to see or appreciate the value of your house at what it could be sold for today rather than at what you perceive it could be sold at tomorrow or at the price it was several years ago. One of the disadvantages of amortised historical cost accounting is that it is backward-looking, it is subject to judgment from management, whereas, by using fair value accounting, you are using market opinion of what the market is saying. There are issues about measurement, and we can discuss those later, and there are also issues about asymmetries in the use of the mixed-attribute model for historical cost and fair value accounting, but, in the main, we would like to see broader use of fair value accounting; we think that investors would prefer that, we know investors would prefer that.

Q135 Chairman: Did any of you have any quick pithy comments on that before I move on to the next question?

Mr Haddrill: Just to confirm the point that investors do wish to see a fair value approach where judgments are made on the market valuation, providing of course that there is a deep and liquid market there to value it from.

Ms Murrall: Yes, I think there are arguments about the sort of full fair value model and the mixed-attribute model which we currently have. I think the debate needs to be had, but I think any discussion about this needs to follow due process, and I think we have concerns about some of the moves that have happened recently that are taking it outside

that. Although some investors like the full value model, I think I would highlight that there are issues with it. For instance, you fair-value your own liabilities meaning that you fair-value your own debt such that, if your credit rating goes down, so does the value of your debt and you get a credit to the P&L. That seems counter-intuitive to me and I think these things need to be addressed and debated.

Mr Chisnall: Chairman, I would say that I do not think the banking industry would agree that the cost model is backward-looking. I think it is forward-looking and the point is that, unlike fair value, what it is not doing is looking for a need to place a spot price, a today price, on instruments that are being held over the longer term. I think it is important to understand that the IASB has just undertaken a very thorough consultation process on fair value. It received something like 160 comment letters and over half of those comment letters expressed opposition to a move to full fair value, to extending the scope of fair value. Within those organisations that expressed opposition, there was clearly the banking industry, there were also the banking supervisors, there were central banks, there were audit firms, there were national standard-setters and there were some user groups and, therefore, I think it is important to understand that it is not just the banking industry that is saying that extending the scope of fair value would be an inappropriate thing to do.

Mr Picot: In a way, Chairman, just to add to that, I think it is important that the accounting system properly measures the underlying economics and cashflows and, if you have a trading activity, then the use of a market value approach is appropriate, but, where you have got assets and liabilities held for the long term, then it is not actually appropriate to then force short-term fluctuations in values through the balance sheets and profit and loss accounts of companies.

Q136 Chairman: On that point, over the course of the last year several banks have published results and interim statements which show very dramatic write-downs in the value of their assets. To what extent do these reflect reality?

Mr Picot: What they do represent is a fair value basis of accounting. Where you have got active markets, that is going to be a willing buyer/willing seller approach, but what we have seen is very illiquid markets with very thin transactions and, in some cases, complete illiquidity, so what has been happening is that some of the banks have been effectively forced into ever-decreasing values based on very thin transactions or, in some cases, no transactions and then they have used models using the credit spreads, and obviously credit spreads have expanded very significantly over the last year and that has driven down asset prices and that has, in turn, to some extent, contributed to the

downward pressure where there have been more sellers than buyers.

Q137 Chairman: Charles Cronin, is it fair to say that perhaps it does not represent reality that we have seen the banks coming out of their write-downs, drip, drip, and then we open our papers the next month and the same banks have written down again and we do not really know where we are?

Mr Cronin: Chairman, I think the important thing to look at and to stand back from is that the underlying assets, the assets within the assets in these complex structured products, a lot of them are suffering. They are not honouring their obligations, they are not paying the interest rate and there are write-downs in progress. Everybody knows that these are sub-prime assets which have been restructured into a form where you have senior-rated assets, medium-rated and equity assets, but the underlying assets are suffering. Now, you have a situation where you have, if I could describe it as, a head of water filling buckets of assets, which is cashflow water, and the bottom buckets have gone, they have been blown away, and that means that the risk profile of the remaining assets has now greatly increased and, hence, the market is saying that these assets have become more risky and, hence, they are worth less. Also, the current values are reflecting what happened six months ago and the market is looking at what is happening in the future, and I think we would all agree around the table here that the economy is going through some troubled period in the future and the market is reflecting that there is trouble in the value of the underlying assets, hence, the superiority of the fair value model compared to the historical approach, which is saying, "Well, these are the write-downs I've got, therefore, these cashflows I know about and this is how I value this product", and I believe that is wrong.

Q138 Chairman: Stephen, the reality in August is not the reality in September is not the reality in October is not the reality this month and is certainly not the reality at Christmas. Is that the situation? If financial statements are just reflecting reality, why have they become the scapegoats in this debate?

Mr Haddrill: I think that is a strong point, that, to some extent, they have become the scapegoats. I think that they are attempting to provide the best possible estimate that you can provide at any one time, and I would agree with Charles' analysis that he has just set out. I think they are becoming a scapegoat, to some extent, because people are not drawing a distinction between accounting, which is trying to give the markets the best possible view, and regulation, which then, if it just responds to that view in a mechanistic way and does not take account of the fact that markets will turn back and so on, leads to institutions having to do things which are damaging and pro-cyclical, and I

think we need to distinguish between the story we get out of accounting, we have to learn from that and take a view on that, and then make sure that we do not have pro-cyclical regulation just automatically picking it up.

Q139 Chairman: Liz, fair value, is that applied to too many assets or to too few assets?

Ms Murrall: I think there are mixed views on the current mixed-attribute model that we have and, as I have said, I think the debate needs to be had as to whether or not it should be extended. I think overall we feel that the current regime is just about right, but, that said, the current standard is quite complex and there are particular anomalies in it. For instance, you have got instruments classified as fair value through the profit and loss account that are held for trading and yet available for sale is effectively your bucket because it is a default position and they are not the trading assets, so all these things need to be looked at, but I think it is the best position we have got at present and I do not think we could fault recording instruments for trading at fair value.

Q140 Chairman: Before I move on to the next question, would you like to address any of those points, Paul?

Mr Chisnall: Only that I do not think that the BBA have said that we would view accounting as a determining factor. What we do believe is that there are elements of the stance that do need review. We support the role that the IASB has been given by the Financial Stability Forum and G7/G8 leaders to look at its existing standards, to look at whether there are elements that actually do merit review. I think that the IASB has made a positive start to that. It has issued guidance on fair value in illiquid markets, and I think that the guidance that it produced on 31 October is extremely clear, it has produced amendments to IAS39 to permit reclassification in appropriate circumstances at fair value and on a disclosed basis, and it has also announced the establishment of a global advisory panel to look at other issues identified where existing standards perhaps do not help current circumstances. I think there is a point there that, as an industry, we do believe that it is important that the IASB looks at these issues and that we do not have regional groups, including Europe, actually going away and coming up with their own rules.

Q141 Sir Peter Viggers: Looking at the responsibility of those who prepare financial accounts and those to whom they are responsible, in other words, the intended audience of the accounts, Liz Murrall, your submission argued that the primary audience for accounts should be the shareholder.

Ms Murrall: Yes.

Q142 Sir Peter Viggers: Of course it is the shareholder to whom the auditor is responsible through the directors.

Ms Murrall: Exactly.

Q143 Sir Peter Viggers: But is there a possible conflict of interest between the shareholders, who might wish to see their accounts projected in one manner, and other stakeholders, who might wish to have other information made available to them?

Ms Murrall: Well, the shareholders, they put up the capital in the company and they are the bearers of the residual risk, so, when everything goes pear-shaped, they actually have to pick up the tab. We believe that the other stakeholders that may have an interest in the accounts, such as suppliers, customers, employees, et cetera, they are protected by contractual and other rights that are not shared by the shareholders and, thus, by focusing the accounts on the ordinary shareholders, we believe, the interests of others will be addressed as well.

Q144 Sir Peter Viggers: Mr Picot, you have been gamekeeper-turned-poacher, do you perceive problems in account of these and do you think there is something that needs to be clarified further?

Mr Picot: Where we are at the moment, I think it is clear that the purpose of accounts is primarily for the shareholders and clearly there are a number of other stakeholders, depositors and regulators, indeed the public sector and government and indeed bank counterparties. My personal view is that I think the general quality of financial statements, particularly in the banking industry, has improved and I think it has improved quite considerably in terms of disclosure, particularly over the last 12 months. That has put information out into the public domain which, I think, has been very helpful right across the stakeholder community, so I do not see at the moment particular conflicts which need to be addressed.

Q145 Sir Peter Viggers: Then to Stephen Haddrill: your submission drew a distinction between the purpose of financial statements in the UK law and the focus of the International Accounting Standards Board, and I see that the IASB said, "As investors are the providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy", which is less than a ringing endorsement. Is that how you see

this potential conflict?

Mr Haddrill: Well, as Liz Murrall has said, I think the financial statements are prepared to inform the shareholders, to inform the investors, and that is absolutely right. I think we cannot ignore in this world that other people have a legitimate interest in the issue and I think the IASB must consult the preparers, the business community, the creditors and so on when they form their view, but I think the primary view has got to be that of the people who put up the capital.

Q146 Sir Peter Viggers: I think you have all in your different ways expressed concern in your submissions to us of the threats to fair value coming either from across the Atlantic or indeed from Europe. Would you just like to articulate those thoughts?

Mr Picot: I think it is very important to recognise that markets are very interconnected and that the banking system at large is best served by a single language of accounting, and I think that language should be the language of the International Accounting Standards Board. I think, as you go around the world, increasingly we have seen most of the major economies announce, or indeed move to, the use of IFRSs, so countries like China, India, Korea, Brazil has announced, Canada, and recently the United States has announced an intention to allow their major corporations to use IFRSs, so I think it is very important that in Europe we recognise that a single language of accounting is a very good thing. For multinational businesses, it obviously means that they have a lower cost of compliance, which is helpful. It also means for investors that they can look at a set of accounts in one country and compare it and know that they are looking at a like-for-like comparison with another. I think there is concern that there are those in Europe who would amend or add words to the international accounting standards for adoption in Europe. We would be very concerned by that both in terms of the particular instance where they might choose to carve out or amend, but also I think it is important that Europe needs to understand that, over the next three or four years, there will be a very significant influence exerted by countries like China and the United States on the international accounting standard world, and Europe needs to understand that and to properly and fully endorse IFRSs, otherwise, I think there is a real risk that a European voice will start to get severely weakened and that would damage the interests of British and European companies significantly.

Ms Murrall: Fair value is sometimes blamed for this crisis. We do not believe it is to blame at all. It was basically the practice of the financial institutions in excessive leverage, risk controls and incentive structures that encouraged people to take risks. We do not believe that changing fair value, suspending it or modifying it in the current

crisis would actually facilitate to help the situation, and in actual fact we think it would exacerbate it because fair value provides transparency. It is only when we get the full extent of these losses out into the market can confidence in the markets be restored, trading resume and the markets recover. Basically, accounting serves to count the beans and to present them to the markets, and in the current turmoil it is vital that the markets have confidence in the numbers reported.

Q147 Sir Peter Viggers: I maintain that the nearest parallel to the present situation is the Lloyd's of London situation in the early 1990s when there was a cycle of reinsurance. That more needs to be done, and the accounting profession can play its part, in identifying and isolating the doubtful, less firm, less robust assets, and that this needs to be done to give confidence to the rest of the market, you would agree?

Ms Murrall: Yes.

Q148 John Thurso: Can I ask each of you this question for a reasonably quick answer, if I may: why is fair value a better method of accounting for financial instruments than amortised cost?

Mr Haddrill: Simply because it is the best reflection you can get of the value at the time rather than the value at the point at which the asset was acquired.

Mr Picot: It is if you are trading, but it is not if your intention is to hold them long-term.

Ms Murrall: Historic cost is an arbitrary point in time. If you record assets at historic cost, accounts will not be comparable.

Mr Cronin: An historical cost is a rear-view mirror exercise. It is also subject to the management judgment of when you put a write-down in or not, whereas fair value gives you an instant appraisal of what is going on from the collection of the market and an unbiased market.

Q149 John Thurso: So it would be fair to say that you are all pretty much in favour of the fair value concept, but there are perhaps some areas of it that need to be improved. On that basis, perhaps I can ask Mr Picot, there are concerns that the interaction of fair value with the regulatory capital requirements can lead to a vicious cycle where fair value write-downs require the banks to set aside more capital, thus raising further doubts about the institution. How concerned are you about this aspect, this pro-

cyclicality?

Mr Picot: I think it is an issue. Europe has recently moved to a Basel 2 method of measuring capital for banks, and that is pro-cyclical in that, as the credit quality of loans decreases, so the amount of risk-created assets and, therefore, capital increases. What has not been yet revisited is the definition of 'capital', so you are absolutely right that, as a bank writes down its trading assets, so its profits will diminish and, therefore, the amount of capital it generates will diminish and, if that is at the same time, as it is at the moment, as its risk-created assets are rising because of credit quality falling, you do get that reinforcing, that pro-cyclical effect. I have to say, if we were on a full fair value accounting basis, the consequences for reported numbers would be very, very severe. What it would make you do is, if you had a loan, say, at a historical rate of interest of 5%, we have seen credit spreads, as priced by the market, go up by anything up to 500 or 600 basis points, and what a fair value basis would then require you to do is to re-measure that loan against a current market rate of 10% and, therefore, you would take a very significant loss in your profit and loss account. If actually what your intention and ability to do is to hold that loan and earn interest over time, that forced downward hit to your P&L account, I think, would be very misleading. I also do not believe, and would not support, the comments which say that amortised costs is just a rear-view mirror method of accounting. If you make a loan of, say, £50,000 to an individual and you charge them 5%, that £50,000, recorded at cost, absolutely represents the amount of cash that you have expended and what you stand to lose. It also is the basis on which you charge interest, so I think it has a great deal of relevance where you are actually holding those loans for the long term and it is very important for the financial system that there is a mechanism by which long-term assets can be held on an amortised cost basis and not subject to the vagaries of the current market because we all know markets can overshoot, particularly in times of crisis.

Q150 John Thurso: Part of the problem, it seems to me, is the particular example you gave of a straightforward loan where there are two parties, a borrower and a lender, there is an obvious interest rate and there is a very easy-to-spot principle, and historical cost accounting is probably fairly appropriate. The problem comes with very complex instruments where actually nobody is quite sure who the counterparties are, nobody is entirely certain what the asset is composed of and there is considerable doubt as to whether it is going to go on earning.

Mr Picot: I think the problem is when you have got trading assets, and there is no doubt that some of the assets that are out there are indeed very complex and they are very difficult to value, and they are valued on models and, when you get illiquidity, banks

are having to value some of those products based on their own judgments because there are not active markets. It is not like trying to value a portfolio of UK shares or government gilts, for example, where there is a regular, two-way flow and it is very clear what the prevailing market price is, and some would say to you that the term 'fair value' is quite beguilingly misleading here because it is an exit value approach if there are active markets and, at its most extreme, it is a model which may be mainly based on unobservable factors.

Q151 John Thurso: Ms Murrall, you make a point about the accounts being principally for the shareholders, with which I concur. Is there a conflict between what the FSA is looking to find out about an institution and what the shareholders want to see in the accounts in this regard: that the FSA is actually looking at the underlying capital and the capital requirements, whereas the shareholder is looking for a reasonable value of the business and its ongoing profitability? Should the FSA not actually be using the accounts, but, rather, using the information they can access within the institutions?

Ms Murrall: What the accounts do is they are there to count the beans and present the information to the market and, once that happens, then the information can be used in a variety of ways and what, I think, is very important happens because this is all part of the pro-cyclicality which has arisen, so institutions have to write assets down when they are marking them to market in the current climate and this puts pressure on their capital, they then have to sell assets to raise that capital and, hence, you get this downward spiral. This can be addressed quite simply by decoupling the financial reporting requirements of listed institutions to the market and the prudential requirements or capital requirements of financial institutions as required by the regulator. I think the Bank of Spain was cited in the Bank of England's Financial Stability Review of October quite favourably because it effectively established regulatory buffers in the upturn. Otherwise, what happens is that, by requiring institutions to be capitalised now, they will be over-capitalised once we have an upturn.

Q152 John Thurso: So you would be in favour of counter-cyclical regulation in all of this?

Ms Murrall: Yes, I would.

Q153 John Thurso: It has been suggested to us in a number of the submissions we have had that one of the problems with fair value is that in the good times it possibly overstates the asset values, that people who are working in the institutions, trading in them, can over a couple of good years make themselves extremely wealthy and then leg it before they have to bear the consequences of what they have done; a view which, I have to say, is

shared by a great many members of the public at the moment. How true is that and to what extent should we be concerned about it?

Mr Chisnall: I think it is very clear that remuneration should be linked to risk and the period of that risk and the profile of that risk, and I would think that there are issues that need to be looked at by the industry, and certainly, as an organisation, the BBA has established a working party to look at issues of remuneration, and I think that part of that should be whether the remuneration involved in business is actually tied into the period of risk that that business involves, so I would agree with that.

Q154 John Thurso: I think that you would accept now that one of the things that has happened as a result of the troubled times we are in is that the public have become extremely aware of the way in which certain people within the banking sector are remunerated and the seemingly extraordinarily large amounts of money that can be made in short spaces of time. Is this something that the BBA is going to address and actually consider and advise its members on, or is it going to be left to the individual members to think about it themselves?

Mr Chisnall: Well, I think members are looking at it themselves and I think that is entirely appropriate and, as I have said, we have set up an industry working group which, I think, will look at some of the governance around remuneration structures. When that group meets and when it looks through some of these issues, I am sure that there will be guidance that will be given which, I think, we will need to share publicly.

Q155 Chairman: Mr Cronin, a little while ago I was talking to a major fund, talking about this issue of risk and incentives, and they made the point to me that incentives should be structured on, say, a seven- to ten-year company horizon and they should be subject to clawback. Is there any attraction in that proposal?

Mr Cronin: Yes, I think the situation that has perhaps caused us a lot of trouble is that people, in the creation of these structured products, have earned fees and banked them, and obviously you are dealing with assets with many, many years to maturity. There is an aspect here which I would just like to develop on the prudence standards, which I touched on earlier, about the asymmetry of using fair value versus historical cost in the liabilities and assets of a bank's balance sheet. In our evidence, we included an IMF report which studies the European Bank balance sheets and shows that there is this asymmetry which, in good times, promotes earning and, in bad times, is obviously more pro-cyclical which is part of the argument that is being thrown out against fair value accounting, so I think that one thing that the regulatory regime ought to look at is,

where these asymmetries do occur, that there is some sort of readjustment, recalibration of what capital is required, if that asymmetry does exist, so that there is a buffer developed, but I entirely agree with you and I think there ought to be a more measured way of delivering remuneration that matches the risk and the duration of the asset as opposed to just bagging the fees and running.

Q156 Jim Cousins: Mr Picot, if you water down the fair value rules, what will be the market consequences of that?

Mr Picot: I am not sure I understand what you mean by 'water down'. Do you mean to change the current system or to not go ---

Q157 Jim Cousins: Your answers already this morning clearly point to watering down the fair value rules, and you have set out your stall very clearly on that, but what do you think the market consequences of watering down fair value will be?

Mr Picot: My views are that a current mixed-measurement model is appropriate. What I do not support is a move to extend fair value accounting into effectively a long-term banking book because I think, if you were to take that step, you would see very, very significant losses being written through the profit and loss accounts, not just in the United Kingdom, but right across Europe and right across America, and you would be looking at tens of billions of dollars of write-down simply because the current market credit spread is so high in relation to historical standards, and I think that is a step which would be a very dangerous step for us to take.

Q158 Jim Cousins: Mr Picot, on September 11, the Governor of the Bank of England came here, he sat roughly where you are sitting now and he made a long statement to us. Four days later Lehman Brothers collapsed in a puff of smoke. What the Governor of the Bank of England had said to us did not stand up anymore. Now, if the Governor of the Bank of England cannot read the rumbles, how can some poor woman who is relying on a proper investment of her divorce settlement to see her through the rest of her life, how can she rely on it, but you want to water down those rules?

Mr Picot: To be clear, my view is not that I wish to water down the current system of accounting. What I do not support is to change the current system of accounting to increase the use of fair value where, quite frankly, it does not reflect what management is trying to do, it does not reflect the underlying economics and it does not reflect the actual cashflow which will be earned. I do not think that is an appropriate basis for accounting. At the moment, if you use an amortised cost method of accounting for, say,

your loans, you are required to disclose the current fair value, so that information is there, it is there and it is audited in the notes to the financial statement, so you can see what that fair value number is and in a number of cases it is very significantly below what the amortised cost number is.

Q159 Jim Cousins: Mr Chisnall, the problem you have got is that people just now do not believe you, they do not trust you. They have had the experience of Lehman Brothers, they have seen the consequences, they have seen this tsunami spread through the world's financial system, and you come here today and you say to us, "Well, we want more subjectivity, we want to be able to model, we want to be able to use our own judgments. Trust us". How can you expect people to accept that?

Mr Chisnall: I think that the example of Lehman Brothers is a very interesting one. A large part of Lehman Brothers' balance sheet was at fair value, and I think it shows that fair value is not some kind of magic pill to the answer of all accounting problems, but it shows that fair value itself has very real difficulties. The problem with fair value and the problem with fair value, as it is expressed in current accounting standards, is that it is on the presumption of the existence of deep and liquid markets, and what we are seeing very clearly at present is that market circumstances change. I think I said at the start ----

Q160 Jim Cousins: We did have fair value with Lehman Brothers and we are still waiting for tens of thousands of their deals to be unwound and nobody knows what they are worth. That indicates the credibility problem you have got now, never mind watering it down further.

Mr Chisnall: I do not think that we have been asking to water down rules. I think that we have been asking to look at the existing rules, to think about whether there are elements of the existing rules which, in current market circumstances, mean that losses are exaggerated. I think that we have asked for very specific changes and for those changes to be applied in an open and transparent way very much on a fair value basis, and I think that the important thing here is not to draw inappropriate conclusions. I think that Lehman Brothers probably does provide us with an incredibly important case study in terms of understanding what has gone wrong, but I think it would be wrong to jump to determining what that means for regulation. I certainly do not think that you can look at Lehman Brothers and say that the answer, therefore, has to be that fair value accounting should be applied across the board because I think the fair value accounting has been part of the problem with Lehman Brothers.

Q161 Jim Cousins: But, Mr Chisnall, the problem we have all got, and we have all got it and it is a real problem, not a theoretical one, is that we have a vast secondary market out there in financial instruments and it has already let us down on a number of occasions. Nobody knows what is out there, nobody knows what it is worth, and you come along here today and say, "We want more power of judgment. We want more of our little-box-of-tricks models to let you know what it's all worth". People do not believe you anymore.

Mr Chisnall: Well, I do not think that we are asking for a little box of tricks. I think that we are saying that fair value is relevant and appropriate in certain circumstances and I think that we are saying that it is not relevant in certain circumstances. In the context of the Banking Bill, I think that there are ----

Q162 Jim Cousins: What are audits going to be worth if you take that approach?

Mr Chisnall: In the context of the Banking Bill, I think that there are lessons to be learned from Lehman Brothers in terms of risk mitigation and I think there are issues within that Bill around netting, collateral and security and ensuring that you can limit risk. In terms of audit, if you look at the experience of the US, particularly in the light of Standard 157, I think that part of the problem has been that auditors have not found it possible to verify fair values and it has become far too complex and, therefore, the rules, as we currently have them, and I think it is pretty well-catalogued, cause problems for the audit process in the US, and that is one of the reasons that we have seen changes introduced by the US Financial Accounting Standards Board and the Securities Exchange Commission as recently as last month.

Mr Picot: I think one clear consequence of using more fair values where there are not active markets and not tradeable markets is that you will get more management judgments, so in the example I gave earlier of a loan where there is not a traded market, it would be management judgment in terms of determining the fair value, so it would increase the subjectivity in measurement in the balance sheet.

Mr Haddrill: I think you are absolutely right to highlight this point about how do you change a system and in the moment of crisis because obviously that does risk undermining the confidence of people who may not understand at depth what is going on. I think what we are seeing here is that we are in extraordinary times and we did not write the war-book for dealing with extraordinary times before they appeared, and I think one of the lessons we have got to learn from this, whether it is in relation to regulation or accounting, is that we need to plan for the extreme circumstances and that has got to include a degree of relaxation in some of the rules so that people can see it coming and

then the markets will have confidence, and probably we will never need to get there, but the markets will have confidence that the plan has been written out and things are going according to plan.

Q163 Jim Cousins: But, Mr Haddrill, the problem is that the markets do not have confidence.

Mr Haddrill: Not now.

Q164 Jim Cousins: In your own field, we still have AIG and the difficulties of AIG with possibly spectacular consequences there, but hopefully not. Now, how do you deal with this issue of credibility which is now there on the table by saying, "The present system's too difficult. We want to go back to subjectivity. Just trust us"?

Mr Haddrill: No, I do not think I am saying that. What I am saying is that we need to plan for these circumstances rather than change the rules in the middle of them.

Mr Chisnall: I think it is really important that I have the opportunity to say this, that there have been some organisations that have argued for a suspension of fair value, and I want to be absolutely clear here, that the UK banking industry has not argued for a suspension of fair value. What we have suggested to the IASB, and the Committee have the letter, is that the standards were written in very different market circumstances and, when you look at the current market circumstances, there are rules within those standards that actually do merit review. For example, there are elements of those standards that are pro-cyclical and we are asking that the International Accounting Standards Board looks at some of those rules, determines whether or not some of them should be reviewed and changed, but that that process should be open and transparent and the consequence of applying any changes of enabling, as appropriate, can be seen in the marketplace.

Mr Cronin: I just want to make two points. One is that there has been this discussion of the loan of 5% and now the spreads have risen by another 500 basis points, and the important thing to put out from that is that the risk has increased that you are not going to get your interest or your principal back. A lot of these assets that are lying in these balance sheets are damaged, and they are damaged as we see them today, so what are they are going to look like tomorrow? The whole fair value debate is essentially saying, "The market is taking a forward valuation on these assets". Now, you may hold them to maturity, fantastic, but what are they worth on maturity if you do not get your interest or principal back, so that is one very key point. The second is that, as far as confidence in the market is concerned, we did an overnight survey of our EU members, it

is in our evidence, and we used the term 'suspension of fair value' and that is not on the table, the relaxation, and tempers were extremely high, and 79% of our members said that they would be against it. We then asked the question, "If it did happen, would it increase or decrease your confidence in the banking system?" and 85% said no, so this whole process is actually undermining the confidence that the whole finance industry needs to start again and rebuild up.

Ms Murrall: Our members collectively manage £3 trillion of assets, and we sent a memo round to our Board late last week, asking them whether or not they were going to invest in these bank reconstructions that are currently going on in the UK. To date, I have had three responses and I would just like to read one out to you: "In our view, investors are sceptical about investing in banks because they don't believe the full impact of structured credit losses has been taken in the accounting. We feel it is necessary for the banks to fully write down toxic assets before any investor confidence can be built".

Q165 Chairman: That was a point I made earlier. How can we make progress on this because I was saying that things have changed in August, September and October and, given Paul Chisnall's point that Lehman's is predicated on fair value, then off it goes. Is that a fair assessment? He said it was an incredibly important case study of fair value in Lehman Brothers going on.

Mr Cronin: The fact of the matter is that Lehman's lent money. It was supposed to get interest back, it was supposed to have loans valued to a certain level to balance its books and it did not do that. The assets went septic and it has gone wrong.

Q166 Chairman: So fair value is ----

Mr Cronin: This is not the issue. The quality of the assets was the problem. It was the lending policies, it was the whole process that got us where we are and that is the problem, and it is a distraction to focus on fair value.

Q167 Mr Fallon: Coming back to you, Charles Cronin, you suggest that rather than take fair value accounting, there should be some more disclosure of what you would call "inherent uncertainty in the margin of error", in other words, disclosure of risk. How would you see that working?

Mr Cronin: Well, you are aware that there are three levels of valuing through fair value: there is the direct pricing method; there is the similar pricing of products; and there is the model approach. There are a number of assets, I think, probably somewhere between

6 and maybe 8% of bank assets, which are valued on the third level and it is important that the models that are actually used are disclosed to investors and the critical assumptions that go into those models are very, very important. My organisation has done a lot of work in the credit rating agencies and there are two reasons why the credit rating values precipitatively fell. One was the complete re-examination of the models where they found the models were at fault and, hence, the actual products themselves were wrong, and the second thing is that investors were never given insight to the actual underlying assumptions that went into these models, and I will give you an example. Say, I stand here and I say, "House prices are going up by 15% for the next two years and by 7% for the next ten years", that is an opinion. If I am selling you a piece of paper, you ought to know that I am pricing my piece of paper on that opinion. That was denied to the investors in these assets, more fool them, but that disclosure was necessary. Hence, if you are disclosing your models, you need to disclose your models on your balance sheet, what model you are using, ideally have consistency of models between banks, but also the key underlying assumptions need to be known.

Q168 Mr Fallon: So it was the internal modelling which has been too optimistic that needs to be disclosed? Is that your argument?

Mr Cronin: The internal modelling, I will not go into the details of it, but the thing is that there is time-series data that was too short, there was dependency on correlation between assets which was probably spurious, and then the assumptions that went into actually, shall we say, the economic prosperity of these assets was perhaps generous.

Q169 Mr Fallon: Could we turn to the issue of how you amend accounting standards, and again perhaps I could start with you, Mr Cronin. You suggest in your memorandum that, in essence, the Board has caved in to political pressure after the October amendment to IAS39. Have you been concerned before about political interference in the way that standards are set?

Mr Cronin: No. This is the first time, as far as I am aware, of where we have had a direct threat to the independence of the IASB through pressure from the European Union. There is an organisation called EFRAG which reviews, for the European Commission, the standards that are produced, and they have been involved in the carve-out issues that surfaced a few years ago, but there has never been before such a direct challenge to the authority of the organisation.

Q170 Mr Fallon: How damaging do you think it has been to the credibility of the Board?

Mr Cronin: I think the Board put a very brave face on it, but had to cave in to it as a pragmatic situation. I think the jury is out in the sense that, if the Board had to cave in again, then the game may be up in the convergence agenda, which would be terrible.

Ms Murrall: Also, the amendments were made on October 13 and they were effectively to align. There are two sets of main accounting standards, IFRS set by the IASB and US GAAP, and those changes on the 13th, basically the IASB moved to allow for more flexibility in the fair value reclassification as is allowed in US GAAP. The changes that are now being put forward and put forward recently by the EU are a complete mismatch. In one instance, they are converging on US GAAP and, in another instance, they are diverging away from it. I think the IASB has not responded to that and I think that is right because the one thing we do not want is politicisation of this process.

Mr Picot: If I may, there has been one instance so far of European pressure which was to do with the first carve-out, which was some three or four years ago. In that instance, IAS39, which was the relevant accounting standard, was not changed, and I think quite correctly was not changed. It resulted in words being removed from the standard as an option, but the UK banks do not follow that option, they follow full IFRS, and it is very important that we do not have that happen a second time. I think the changes which the IASB made in October were welcome. They did even up the playing field vis-à-vis the US and they did give some relief from unnecessary write-downs. Now, there clearly is another letter having gone in from the European Commission. I think it is very important to understand that the overwhelming consensus of stakeholders involved in that European Commission process did not ask, and are not asking, for a European solution or a carve-out. What they are asking the IASB to do is to look at the two or three issues which have been subject to the letter, to go through proper due process and to come up with an answer, and I think it is very important, where you have an independent standard-setter, that the due process is respected because, quite frankly, not everyone is always going to agree with what the IASB says, but you have to trust their due process and accept what they come out with in the final outcome.

Q171 Mr Fallon: Mr Cronin has warned against further interference. Mr Haddrill, there has been further interference. We have this new letter now of 27 October from a Director General in the Commission, telling the IASB to consider three further issues before end-year publication. That is exactly the kind of interference Mr Cronin says will be very damaging, is it not?

Mr Haddrill: Yes, I think it is lamentable, frankly. I think that, if the European Commission should be doing anything at the moment, it should be considering how to

bolster the independence of a body that is the only global standard-setter we have in this area. Independence, I feel, has got to be based upon legitimacy and there are ways, I think, in which the IASB could reinforce its own legitimacy so that this independence issue could be put to bed. It seems to me that it needs, possibly on the Board, but certainly at trustee level, to be more representative of a wider group of interests, including investors and users and perhaps a business as well. I think there are issues around not so much the way it consults, I think it consults very thoroughly, but I do not think it always, however, in that consultation does a sufficiently good job of indicating what the impact of its proposals is, the economic impact, and I think that, as we move into a new world, there is a big question to be asked about whether the legal standing of the Board needs to be reinforced. After all, the Board is coming up against real democratic, political authorities, but it has kind of grown up as a club, a private organisation, and I think that we need to consider whether it is given some international legal standing that would enable it to be robust and independent and to be questioned through some legitimate judicial process really rather than just people having the option either of accepting what it says or carving out and throwing away what it says. At the moment, the basis of it tends to polarise debate and I think we have got to move on to something rather different.

Q172 Mr Fallon: When you said that the Board is coming up against real democratic accountability, this is a letter from the Commission, from a senior official in the Commission, and he has not got any democratic accountability, has he?

Mr Haddrill: Well, he is accountable to his Commissioner and his Commissioner has some accountability to the European Parliament, so I am not saying that they are right, and I do not think they are right, to do that, as I made clear ----

Q173 Mr Fallon: Well, I want to be clear about this. It is inappropriate, in your view, for the Commission to be bullying the Board in this process? Is that right?

Mr Haddrill: I think it is inappropriate for the Commission to be bullying the Board, but I think that the Board is likely to be exposed to be bullying until it has some really solid international legal standing of its own.

Q174 Mr Fallon: What do you think the Commission's agenda here is?

Mr Haddrill: Well, the Commission itself is under pressure from the French Government, and we have known for many, many years, going back to the point Mr Picot was making about when IAS39 was first reviewed, that there has been a view within the Commission and

within European circles that Europe should control accounting within European boundaries, and we reject that because we believe that this is a matter that should be dealt with in a globalised world on a global basis.

Q175 Mr Fallon: Why is it the French particularly who want fair value accounting fudged?

Mr Haddrill: When this came up before, it came up from the same source, it came up from pressure from the French financial community.

Q176 Mr Fallon: But why?

Mr Haddrill: Why that is, I do not know. At that time I was in government in the Civil Service and we felt at that time that the French were worried about what it would expose about the way in which the French banking community was funded. I do not know whether that remains a legitimate concern or not, but I think it is a question that perhaps should be asked.

Q177 Chairman: How much consultation did IASB provide prior to its announcement after this October amendment to IAS39?

Ms Murrall: The trustees met immediately prior to that, the week before, and agreed to suspend due process, so, when the IASB made those changes on 13 October, it did discuss at its meeting, and I was there as an observer, whether or not it should have a truncated consultation period of eight days, but I think the timing was such and it was under so much pressure from the EU that it agreed to make the changes. What they did do is that they ensured that there were a lot of disclosures so that, whereas the results in the actual accounts can be modified by this flexibility, the disclosures in the notes would enable someone to look at what the position was before.

Q178 Chairman: So, if I can follow that down, they did not have any consultation?

Ms Murrall: No, no consultation.

Q179 Chairman: Professor Stella Fearnley has questioned whether convergence to one global standard is the right way forward, arguing that global monopoly stifles new ideas and hinders progress. Does anyone agree with that?

Mr Haddrill: No.

Mr Picot: No.

Mr Chisnall: No.

Ms Murrall: No.

Mr Cronin: No.

Q180 Chairman: None at all? Okay, I have got bad news for Professor Fearnley then! How can the IASB be sure that the process of convergence ends in high-quality standards rather than a rush to the bottom?

Mr Cronin: I think the process that we have at the moment, which is through extensive consultation, shows that the standards that we are getting are as good or better. The whole process, as I understand it, is to actually come up with one single accounting standard that is better than the current standards that are in operation. As far as the race to the bottom is concerned, I think the big issue for me is that, if we do have outside interference, there is a race to the bottom in the sense that the word 'fudging' of fair value has been used here and what we have got at the moment is the European Commission via the French banking sector essentially altering the rules that are to their own benefit, which is a race to the bottom, as far as I am concerned.

Q181 Chairman: A race to the bottom?

Mr Haddrill: Yes.

Mr Picot: I think it is very important that the IASB is independent and is not subject to political pressure. I think it is good at consulting, I think it is an organisation that you can go and talk to. Later on this week, on Friday, there is the first of its three round tables.

Q182 Chairman: I think two for a race to the bottom are the extremes here. Anyone else for a race to the bottom?

Ms Murrall: No, I think that it is very important that the IASB is seen to be independent and has integrity and that the outputs from its processes have integrity. It needs to set the best standards.

Q183 Chairman: But, given that there was no consultation, there will be a question mark over that integrity for the future.

Ms Murrall: I think it was a pragmatic response to a very difficult situation.

Mr Picot: There needs to be a proper, fast-track process, but with consultation on an accelerated basis.

Q184 Chairman: So they need to do something?

Mr Picot: Yes.

Chairman: Okay. Well, can I thank you all very much. That was a very helpful session for us.

Memoranda submitted by International Accounting Standards Board (ISAB), The UK Financial Reporting Council (FRC) and The Institute of Chartered Accountants

Examination of Witnesses

Witnesses: **Sir David Tweedie**, Chairman, International Accounting Standards Board, **Mr Paul Boyle**, Chief Executive, Financial Reporting Council, and **Mr Michael Izza**, Chief Executive, Institute of Chartered Accounts in England and Wales, gave evidence.

Q185 Chairman: Welcome, Sir David and your colleagues. Can you introduce yourself for the shorthand writer, please?

Mr Izza: Michael Izza from the Institute of Chartered Accountants in England and Wales.

Sir David Tweedie: David Tweedie from the International Accounting Standards Board.

Mr Boyle: Paul Boyle, Financial Reporting Council.

Q186 Chairman: Sir David, "spineless" and "caved in". Answer.

Sir David Tweedie: Can I come across the table here? I think we experienced something that, I hope, firstly, we never see again in standards setting, but I think there was just a blunt threat to blow the organisation away. That came very, very rapidly. We heard a speech by the Commissioner saying that he had legislation prepared to have a "carve out" from part of our standards. They cannot put words in at the moment (though I suspect that might be thought about); they can only remove words, and what that would mean was they would be able to transfer out of things like the trading account into some other account - held for maturity, or whatever else - without any controls whatsoever. So companies could have taken items out of that, not at fair value, as we require, but they could have taken them out at original transaction price, for example. There were no disclosures; you would never know what had happened, and suddenly we would see all these losses flowing back in, if they did not think they had been impaired on a permanent basis. I think accounting in Europe would have been totally out of control if they had used the option to take the "carve out". Our problem was we originally intended to have at least a week to find out whether, in fact, we had managed to get our standards equivalent, as far as reclassification is concerned, with the United States. We did not have a week; we had only a matter of days. What we did is we contacted the American standards sector, the Securities and Exchange Commission in America, and the major accounting firms, and say: "We think we have done it here. Is that right?" However, when we put it through - we put it through on the Monday and, if I remember rightly, the European Commission voted on the Tuesday or Wednesday - we had no time whatsoever for consultation. We explained at that meeting: "If we find we have made a mistake, we are going to come back again". In a way, we have got a mistake on the transition. That is what happens when you do not consult.

Q187 Chairman: What was the trigger for that? The credit crisis did not start until October 2008, and fair value did not start in that month either.

Sir David Tweedie: No, we were rather taken by surprise, to be quite honest. It came very quickly. Certainly, US standards and our standards are not the same in these areas, and the idea is we eventually have a common standard in a year or two's time. This one came very quickly and almost out of nowhere, so it took us by surprise. We were not expecting this at all.

Q188 Chairman: Other witnesses: how damaged is the body as a result of the October decision?

Mr Izza: I think it would be unfortunate if those circumstances were repeated again. We recognise that Sir David had to respond on an exceptional basis. When due process is

suspended that prevents the consultation process potentially avoiding some of the unintended consequences that may flow. So the body has been damaged, but we hope not fatally, and we hope that we can put that behind us now and go forward as we were before towards convergence and towards improving the IASB.

Mr Boyle: I think Sir David has described that he was, really, between a rock and a hard place, and the decision that they made could, in some respects, be criticised. However, the alternative that the Board would have been faced with, as Sir David has also described, would have been even worse. It is really important, from our point of view, that accounting standards are set on an independent basis. I think the parallel that we would draw to your attention is that I think there is a widespread political consensus that interest rate decisions should be made independently by the Central Bank and not made by politicians. Of course, it is appropriate that the interest rate decisions are made by an organisation which is properly accountable and properly constituted, and can be held to account to explain why the decisions it made are consistent with the political framework that was established. There is an interesting parallel there to be thought about, as to whether or not accounting standards should be treated on the same basis, because it is extremely damaging if accounting standards are made, in effect, by politicians for political reasons. I say that with the greatest respect to a committee of politicians, but I think the parallel with the setting of interest rates is quite an interesting one to be considered.

Q189 Chairman: Sir David, why should not politicians have a say in the fact that there should be public accountability? The point has been made that the Governor and his colleagues are coming here in two weeks and he has probably been here half-a-dozen times. There are some mornings, probably, when he is putting his jacket on and coming here when he wishes he was going elsewhere. However, he does realise that that is the vibrant, necessary part of the debate. Why should we not have a more robust mechanism for your body?

Sir David Tweedie: I am delighted to appear before you, Mr Chairman.

Q190 Chairman: I know; you are very good.

Sir David Tweedie: And the Senate Committees in the United States as well, and I think that is appropriate. The interesting thing about our organisation is the way it grew, and there is a legitimate flaw in it, at the moment. When we were started we were based on the American model which was having an independent standards board with trustees; eminent public figures who would then appoint the board and make sure that we did the due process

appropriately. They do not get involved in technicalities; we do not get involved in funding, and so on. The bit that was missing from the United States model was the fact they had the Securities and Exchange Commission sitting over the trustees, so if something went wrong the Securities and Exchange Commission would intervene. Of course, they are appointed by democratically elected politicians. The problem we then had was when we started who would be the SEC? There is not an international SEC. At the beginning the only people that really were taking our standards were the Europeans. Did that mean that the European Commission would be sitting over our trustees? That would be unacceptable to the rest of the world. As countries have started to take our standards, and 113 are doing so at the moment (we estimate there might be 150 if we do not get blown away in the interim in a few years' time), what has been proposed now is that we actually try and create a linkage to the securities regulators in the way that the Americans have it, and the trustees have proposed a monitoring group that consists of the Chairman of the SEC, the appropriate EC Commissioner, the Chairman of the Japanese Financial Services Authority, the Chairman of the International Securities Regulatory Emerging Issues Committee and the Technical Committee - plus the IMF and the World Bank - so that we do have far more political legitimacy and people, obviously, can then exert influence.

Q191 Chairman: I understand, Sir David, and the governance of the IASB is not your remit, but I think it is of interest to us. So I think we would be seeking written evidence from the body and, perhaps, oral evidence at some stage.

Mr Boyle: Thank you, Chairman. If I can just amplify my comments, it is clearly the case that the way in which accounting standards operate is a matter of legitimate political concern, just as the way in which interest rates are set is a matter of legitimate political concern. My point is that the very considerable debates which take place about what are the appropriate accounting standards are best settled by the independent board of experts following due process that can then be held to account and explain why it made the decisions it made and how those decisions are consistent with the objective that it has been set, and that will be a proper basis for holding it to account but making its decisions, technically, independently.

Q192 Mr Brady: Just picking up on some of those points, I was going to ask, Sir David, where you feel the IASB derives its legitimacy or its moral authority from. It is a private organisation, it is funded by the industry, but I think, from your previous remarks, you were suggesting that this is a work in progress; that perhaps there is no real source of legitimacy at the moment but you see it, ultimately, deriving from the various international monitoring bodies.

Sir David Tweedie: Yes. The trustees put out a proposal a few months back suggesting this monitoring group, and they hoped they could have that up and running in a few weeks, to be honest. So we always knew that was a flaw, but there was not a lot we could do about it until we had a broader international spread, otherwise we would have been a regional organisation. That was the problem.

Q193 Mr Brady: Does that give political legitimacy? Does it give democratic accountability?

Sir David Tweedie: There is going to be a memorandum of understanding between the trustees and this monitoring group, but, broadly speaking, the monitoring group would approve the trustees' appointment. As a trustee retires and a new one is appointed they are recommended by the existing trustees but they can be rejected by this group. That group obviously has the power to nominate as well, but their nominations do not have to be accepted by the trustees either, so there will be mutual veto. They would check that the trustees made sure that we had observed due process, and so on, and gone through all the procedures that we should go through. Clearly, if there were concerns they would ask the trustees to address them. So that would give the entree into our processes.

Mr Boyle: It is worth saying that the proposals to reform the IASB governance, which the trustees have put forward, were initiated approximately 12 months ago. Since then, of course, the financial crisis has become a lot more serious and there are discussions to take place later this week at the G20 meeting about reforming the overall financial architecture. It might just be worth considering whether any of the conclusions which the G20 governments come to about wider reforms to the international financial architecture have any relevance to what we constitute as an appropriate accountability mechanism for the IASB. We will wait to see what emerges from the discussions.

Q194 Mr Brady: What is your view on it?

Mr Boyle: I do not know what the governments of the G20 are going to decide, but I think - and Sir David and the trustees have recognised this - it is important for the IASB to have a properly legitimate status. That is the only way that we can prevent it being picked off on an ad hoc basis on ad hoc issues by people who might have motivations which are not entirely consistent with the organisation's proper objective.

Q195 Mr Brady: Mr Izza, do you agree that is the right kind of balance of political involvement, and the right structure?

Mr Izza: Yes, I think it would be sensible. We support the establishment of a high-level oversight body for the IASB. We would support the direction of travel. Specifically on your question, Mr Brady, about where does the IASB get its legitimacy, when the standards have actually been adopted by 113 countries. and there is the potential it will be adopted by 150, I think that is the legitimacy. This actually started as a market-driven group, and it has been accepted by national governments.

Q196 Mr Brady: I understand this is something that, Sir David, you might not be able to comment on, but if I could ask the other witnesses: do you have concerns about the funding model of the IASB?

Mr Boyle: The funding model is also a work in progress. The original basis on which the IASB was funded was, frankly, unsatisfactory. It involved the Chairman of the Trustees going round to major corporates and asking for donations. Some of the donations were individually quite substantial amounts and this did lead to accusations - fairly or unfairly but led to accusations - that people were, in effect, buying influence. The trustees are part-way through putting in place what I think is an altogether much more satisfactory funding arrangement, which is sustainable, adequate and free from undue influence. We at the Financial Reporting Council have been one of the leaders in adopting this. The way it broadly works now is that each country in the world pays a proportion of the IASB's costs which are broadly proportionate to its share of global GDP. In the case of the UK, it is about £700,000. We at the FRC raise that amount through the levy we charge to listed companies such that no one company in the UK pays more than about £2,000 towards the IASB which, frankly, is not a level at which you can say you are buying any influence. As it is done indirectly, through us at the FRC, there is no link between the fact that people pay for it and their ability to influence the standards through that mechanism; they have to influence through putting their views in as part of the due process. I think that arrangement is gradually being extended around the world. The trustees should press for it to be completed.

Q197 Mr Brady: Are there still areas of concern where that model has not been extended?

Mr Boyle: We are fortunate in the UK that we had an existing model which could conveniently be adapted to extend to cover IASB funding. Different countries have different institutional arrangements, and I think one of the attractions of the IASB's reform of funding is that it allows some flexibility for each country to decide the most appropriate, local basis for raising its proportion of GDP-based share of funding.

Q198 Mr Brady: Are some of them still raising worryingly disproportionate amounts of

money from individual companies?

Mr Boyle: The process is not complete yet.

Q199 Mr Brady: Finally, can I just ask how the FRC is funded?

There followed two minutes' silence

Mr Boyle: Currently, one-third is paid by way of a grant from BERR, although ministers have announced to Parliament that they are going to withdraw that grant, so we are in the process of finding ways of replacing that. One-third comes from the accountancy profession - a charge to the six professional bodies - and one-third is raised by way of a levy on companies which have to prepare accounts. That is, at the moment, limited to companies on the main market and on AIM and on plus markets. So we have got a balanced funding arrangement such that no one exercises disproportionate control. The Government's one-third is being withdrawn, and we have already consulted on ways of replacing the one-third government funding.

Q200 Mr Brady: What is the likely outcome?

Mr Boyle: The likely outcome is that we will make two changes: one is to bring within the scope of our levy public sector organisations because they will now have to produce accounts under IFRS and we are linked in, as I have described already, to the International Accounting Standards Board, and we will also extend the levy to large, private companies, including companies owned by private equity funds, because even privately-held companies still have to prepare proper audited financial statements. Therefore, it is appropriate that they pay for the system.

Mr Izza: If I could also answer your question. There are three principles which, I think, are important to apply to how the IASB is funded going forward. First of all, it does have to be adequately resourced - penny-pinching will not get us to the global set of standards that we all want to see. Secondly, whatever funds are determined have to be sustainable, because if the IASB was faced with potentially those funding sources running out that would distract them from their core purpose and message. When those funds are identified they have to be free from interference and influence. I think those three principles are very important.

Mr Brady: Just picking up on that, Mr Izza, are you concerned, at the moment, as to whether the third of those criteria, regarding the exercise of influence, is a problem?

Q201 Chairman: Can you give us a quick answer?

Mr Izza: No.

Q202 Jim Cousins: Sir David, you have already told us that if you had not agreed to the watering down of the accounting standards on foreign financial products something far worse, in your view, in terms of watering down, would have happened. Did you have a specific threat that that would be the case, in those terms?

Sir David Tweedie: We knew what the "carve out" was going to be; we knew the words that were going to be removed. The words were the restriction on being able to take financial instruments out of the trading categories, and so on. So it would have given you the ability to start moving these things out without any restriction whatsoever. Under the present regulation there is no means by which the Commission or anyone else can put forward a proposal to bring in certain disclosures or anything like that; it is a case of: "There's the standard. You can take bits out and you can't put bits in". That was the real problem, Jim, that, basically, you would have a standard that gave a free-for-all in that area. That was our problem. The other aspect of it was that, quite bluntly, if Europe had yet another "carve out" I think you would have found the United States saying: "This is impossible; we're not going to have global standards after all". The whole idea of the US moving towards IFRS has been based on the fact that you have got Europe doing it, Japan's agreement to 2011, China did it last year and you have got India and Korea coming in, and then suddenly Europe moves out. That would have crippled the whole global process. That was the position we were facing.

Q203 Jim Cousins: Did you have a specific threat that that would be the case?

Sir David Tweedie: It was told that the Commissioner actually made a speech saying he had the legislation already to go, and we knew that Parliament was ready to take it.

Q204 Jim Cousins: The representative of the Institute of Chartered Accountants has already told us that it would be "unfortunate" if something like this were to happen again. Have you got any specific assurance that something like this will not happen again?

Sir David Tweedie: No.

Q205 Jim Cousins: You have not got such an assurance? Have you asked for such an assurance?

Sir David Tweedie: I do not think I would get it if I asked. We have not asked but I do not think I would get it. That is the power that the Commissioner has - to propose a "carve out".

Q206 Jim Cousins: It does seem to me that if that is the case we can only defend the integrity of our financial system in ways other than simply recasting how the International Accounting Standards Board works. Something more would be required in terms of the powers of the Commission and how it proposes to use those powers. Have I drawn a logical conclusion?

Sir David Tweedie: I would think so.

Q207 Mr Fallon: Are you really still an International Accounting Standards Board if the Commission can keep carving out bits it does not like?

Sir David Tweedie: That is the big question that is put to us. Others were asked: "Have we been damaged?" I think the answer is yes we have been by what happened a few weeks ago. I was in the United States a fortnight ago and there were questions of: "Why did you do this? This is European influence. Are you a European body?" Other countries that were completely taken by surprise - because all of this happened very, very quickly - have to put it through their legislature sometime; the standards lie on the table in parliament for so many days, or something, and suddenly they were given something they had no knowledge was coming. That was a major problem for us. It upset a great deal of people. So it did damage the whole exercise.

Q208 Mr Fallon: Did you not consider resigning?

Sir David Tweedie: Yes.

Q209 Mr Fallon: Why did you not?

Sir David Tweedie: We want to make sure we win this project. We are almost on the verge of winning an international project, and that I think is exactly what we have to do. The argument that came about our standards being inconsistent with those of the United States (which they were) was a legitimate argument up to a point. The standards are not even yet compatible because there are different impairment rules and so on. You would have to bring in pages and pages of American standards into international standards. We did the minimum we could do, and that is all we did. We could not survive another one. I think

the whole exercise would disappear if we got more "carve outs".

Q210 Mr Fallon: You have got another one.

Sir David Tweedie: Not yet.

Q211 Mr Fallon: We have referred already to the letter from the Director General of 27 October telling you to address three other issues before the publication of year-end results. Why are you being ordered around by the Commission on behalf of the French?

Sir David Tweedie: We respond to any sort of request. What we have done with that situation is we have said that given that the ECOFIN and the leaders of the major European countries asked for a level playing field, to do something independently of the Americans would create an unlevel playing field. So we have, with them, organised round tables here in London, in America and in Tokyo and we will discuss them, and we will go through due process. We cannot do what happened before. If we agree - and we have not said we are going to agree - to change that will done jointly with the United States and ourselves to make sure that we do keep some form of level playing field. We will have due process and the Board will not do what happened again.

Q212 Mr Fallon: This is not a request; the Director General says: "We consider that these three issues should be addressed", and you have just told the Committee that they have power to require that.

Sir David Tweedie: No, we agreed to address it because others have raised the same issues, but that is all we are going to do. We will address them and then we will see what happens. It may be the Board will vote for no change.

Q213 Mr Fallon: If that happens the Commission can have its way anyway. That is what you are telling us.

Sir David Tweedie: It might. It has not said it will but it might.

Q214 Mr Fallon: At what point is the Board really going to stand up to the Commission and the French?

Sir David Tweedie: I think you should just watch.

Q215 Mr Fallon: You mean you are now going to do that?

Sir David Tweedie: If there is a legitimate reason we should change we will change. If there is not a legitimate reason we will not.

Q216 Mr Fallon: Okay. I want to come on to this issue of the alignment between the European and the American systems. Professor Fearnley has submitted evidence to us suggesting that a global monopoly of standards may not be desirable (I quote): "as it stifles new ideas and hinders progress. There should be room for more than one set of standards in the world". Do you have any sympathy with that?

Sir David Tweedie: None. Basically, you have just had a classic example of what happens when you do have a difference. There you have American standards allowing reclassification - ours did not - and what happened? They want reclassification. I do not think that was a better method than we had, frankly. I can understand the argument of a level playing field, and, to be fair, the Americans have tougher impairment standards if you transfer than we have. So it is not quite level but, nonetheless, that is a classic example of what happens. People will look at the weaker standard and say they would prefer that, and they do not want the tougher bits of the weaker standard, like the impairment rules; they would not want those but they will pick the bits that suit them. We will just get picked off against each other. That is the race to the bottom I think you will get.

Q217 Mr Fallon: Absolutely, but you do not see any merit in her argument that, also, if you have one international standard you do stifle innovation in standards?

Sir David Tweedie: I would cheerfully stifle some of the innovation from some of my Board members, but basically I think you find that you get plenty of arguments, and they come from all over. You do not stifle it. One of the aspects that we have done is to insist that we have a very good national standards area; we have got the Accounting Standards Board here, we have got the American standard setter, the German, French, Australian and New Zealand. They are full of ideas and they do a lot of the preparatory work for us too. So there are plenty of ideas flying around. We have regular meetings with them. So there are not just 14 people thinking great thoughts.

Mr Boyle: If I may, I strongly support this proposition. There is no shortage of people who are putting forward suggestions for ways in which accounting standards can be improved. We have 23 national standards-setting bodies still in operation around the world. They meet together on a regular basis, currently chaired by my colleague Ian

McIntosh in the UK Accounting Standards Board. So there is no shortage of ideas. However, what you cannot have is a multiplicity of different ideas in operation simultaneously. I think there would be no shortage of proposals for new ideas, but you need to have one authoritative body to say: "Okay, having heard all the debates this is the way that we think, on balance, is the right way to proceed".

Q218 Mr Love: Sir David, how concerned are you about the pro-cyclicality of the accounting and regulatory framework?

Sir David Tweedie: That is a major issue. What has happened up to the past is the regulatory capital requirement is moving in step with the accounting, and clearly that does lead to problems. As banks have needed more collateral they are being forced to sell, and the more banks that sell the market price drops, and so on. We were discussing with the Basle Committee just last week various proposals to try and ameliorate this situation. One of the banking supervisor's proposals has been that we should increase the amount of provisions that people make when they lend. We are totally opposed to that on the grounds that if you want transparent accounting you show losses on loans when you have losses on loans, not because sometime you might get one. On the other hand, we understand that their concern is to preserve some form of capital in excess of what perhaps might be lost with the loans. There is a way they can do that and we have suggested to them that the way they should do it is just require certain reserves of these banks to be undistributable.

Q219 Mr Love: So it is all the fault of Basle too, then, or does fair value accounting have some responsibility?

Sir David Tweedie: No, it is the two in combination, I think, which is the difficulty. You can actually break the link and still give the banking supervisors what they want and we will not affect the integrity of the accounting. It can be done.

Q220 Mr Love: The question that keeps coming to my mind, as a non-accountant, is: is it possible to get the benefits of fair value in the good times without suffering the consequences of fair value when times are rough? There seems to be a disconnect there. Is that possible?

Sir David Tweedie: No, I understand what you are saying. It is the connection of the exuberance of the markets and "Can you damp it down a bit?" That is what the supervisors are thinking about doing: increasing the capital requirements in exuberant times and then easing them off by some formulaic method in the bad times. The beauty about fair value

accounting, as the Governor of the Bank of France said, is that it brought this crisis very, very quickly into the open, and if it had not then I suspect we might still be having sub-prime lending going on, even now, and the disaster would be even worse.

Mr Boyle: May I comment on this to, hopefully, help the Committee? I think there ought to be a separation of the basis on which accounting operates and the way in which the prudential capital requirements are operated. One example of this which, again, would be a parallel is that the calculation of profits for tax purposes is different from the calculation of profits for the accounts, because governments have decided that certain expenditure shall not be permitted; that there have to be capital allowances, and so on. Everyone understands that there is an appropriate rationale as to why there is a difference. The same rationale can be extended to the financial regulators. The purpose of accounting is to present an unbiased picture of the financial health of an organisation. The purpose of prudential regulation is biased. It is properly biased; it is proper that the Financial Services Authority should be biased in favour of protecting depositors or protecting policy holders. So they have different objectives and, therefore, they can use different numbers. In fact, the FSA already have ----

Q221 Mr Love: Can I interrupt you there because it was said in an earlier session that the problem here with the system is a loss of confidence. Would what you are suggesting give investors the confidence to reinvest in some of these assets? The suggestion has been made by others that it would not.

Mr Boyle: To give investors confidence you need to present an unbiased version of the truth; to give depositors confidence you need to give them some confidence that, to be honest, "rainy day" money is being built up during the good times so that it can be spent in the bad times. I was just about to say that prudential regulators already have, and already use, powers to base their calculation of regulatory capital on different bases than the accounts. They start with the accounts but then they properly make adjustments, and it is up to them, based on their regulatory objectives, to decide what the appropriate adjustments are. That can be done nationally and, also, it can be done internationally by the banking supervisors.

Mr Izza: If I can answer your first question as well, painful though fair value may be, it has got the news out much faster than other methodologies might have done, leading to speedier actions to deal with the situation. It is very important that we do not seek to shoot the messenger, in these circumstances.

Q222 Mr Love: Let me ask you a question following up from that: has fair value gone

wrong? Does it go wrong in an asset bubble and the consequences that follow an asset bubble? In other words, does it over-value things when it is clear that there has been a disconnect with rational decision-making, and when the market falls (and it usually falls further than rational decision-making would suggest) it all goes wrong?

Mr Izza: What I would say is that there is definitely evidence that fair value may exaggerate pro-cyclicality. One of the things that we must be mindful of is that this economic crisis is the first crisis in which we have had to deal with fair value. The way that we should be looking at how to take this forward is considering that, and the IASB should be consulting on that widely with people to see what adjustments, if any, should be made. We should be doing that on the basis of evidence, not on the basis of short-term political response.

Q223 Mr Love: Is not the problem here, Sir David, that we depend on the market and the market is not always rational, but the accounting system needs to be rational?

Sir David Tweedie: The accounting system reflects the position. Take the housing market: Mr McFall made the point earlier about how you value your house. I am sure we would all like to value it at what it was a year or so ago, or hopefully in two or three years' time, but it is not; it is what is there at the minute. That is the real reflection of what goes on. I think we just have to say: "This is it". The markets do overshoot; we know they overshoot. What we always have to look at is what are the alternatives? You have heard of historical cost. If you had historical cost for derivatives you would miss \$4.5 trillion off the balance sheets, and that is what some people have argued. These are gains or losses. Similarly, when you look at the classical example of Japan, you had a situation which was a microcosm of what happened at the moment. You had a situation where the Japanese banks were allowed to freeze the loans and not write them down. Everyone knew their problems, people did not lend to these banks, therefore they could not lend on, and suddenly you found the Japanese economy is stuck for ten years, and absolutely stagnated. Just this summer the Japanese Finance Minister said if it had had fair value and was out and dealt with it would have been brutal but it would have been dealt with quickly. I think, Mr Love, that is the way it has to be. I firmly believe transparency is the way to deal with accounting: get it out in the open.

Q224 Mr Love: Let me just come on to that, finally, in relation to transparency. Your institute has suggested and, I think, has led part of the move towards greater transparency. If you look back to the good times, if I can put it that way, did it suggest any more prudential activity on behalf of the banks and financial institutions? Did they actually take transparency to heart?

Sir David Tweedie: I think everyone has learnt from this, the same way as we are going to have a major committee look at: are there lessons that we can learn from the way we operate fair value? When you look at what exactly has happened with transparency, the dangers of not having transparency are dramatic. The pension problem in the United Kingdom has only really come to light once we started making sure that companies started showing these pension deficits. You can argue about the way they are measured, but they are deficits. Previously they had not been seen. You have a situation where companies lease major bits of capital equipment. I have often said that one of my big ambitions is to fly in an aircraft that is actually on the airline's balance sheet before I die! They are not there because leasing is part of the amount that you pay for it (?), yet you are locked in (if you have an aircraft) for seven years at a fixed payment. There is no way you can get out of it, apart from parking in the Arizona Desert, but you still have to pay. That is a liability and the other side of the right to the aircraft. That is not shown in accounting yet. That is on our programme and we are going to do that too. I firmly believe we have just got to get everything out into the open. Accounting is not rocket science; we have just got to do the accounting the way, frankly, you would do your own - and companies do not do that.

Q225 Mr Love: I understand that and I understand your commitment towards transparency, but there are some who are somewhat cynical that the connect between transparency and prudential operation did not exist during the good times, and people worry that it may not be as effective as we think it is.

Sir David Tweedie: It is going to change; I do not think there is any doubt about it. That was the discussion we were having on the Basle Committee last week. How do we get something to do exactly what you are suggesting: when the markets are exuberant how do we manage to take a bit of the froth off through increased capital requirements, and how can we use that, as Paul said, to feed back in when actually they are going to need that capital? You cannot keep it locked there, you are actually going to have to release it when they need it in the other time - otherwise it will not be countercyclical. That is the way I think it is going to go.

Mr Boyle: If I may, Mr Love, what you need is not just transparency but transparency coupled with intelligent decision making.

Q226 Mr Love: Does one necessarily lead to the other?

Mr Boyle: Self-evidently not, and that is why we are in the current difficulties. The solution to this is not to have opaqueness. So we need transparency plus intelligent

decision making, and intelligent decision making includes recognising that when asset prices are growing very fast that is normally the precursor to them falling very fast. Therefore, we should not be counting on those balance sheet values to remain high forever. It was the fact that asset values were high; the question is how do you intelligently expect what might happen in the future and have some rainy-day money set aside to deal with that, either on a personal basis or on a corporate basis?

Q227 John Thurso: Sir David, I would like to follow up on those questions on fair value but, first, could I follow up very quickly on the answers you gave to Mr Fallon about the European Commission? It is clear you need the robust support of the Government and Ministers. Are you getting it?

Sir David Tweedie: Yes, I gather we have a lot of support from the Treasury and from the Chancellor and Prime Minister.

Q228 John Thurso: On fair value, there seems to be, from some of the evidence we have had this morning, a difference of view. The investment community is very clearly in support of fair value for all the reasons that have been put forward: transparency, speed, getting the worst out of the way quickly, etc. The banking community appears to be somewhat less in favour of that and are more in favour of modified fair value to allow them to take account of the vagaries of a market that may not exist. True value, where there is a willing seller and a willing buyer, is dead simple; the problem we have here is we have got forced sellers and no buyers - and therefore no market and therefore great difficulty. What is your answer to them as to why historical cost accounting for financial instruments is inappropriate?

Sir David Tweedie: One of the problems with the present standard, which we inherited and is based on the American standards, is the amount of intention that you can build into how you are recording the results. I can buy a government bond; I can say I am holding it for trading, I mark-to-market and take gains and losses through the profit and loss account. I can say I am holding it to maturity, so I keep it at the transaction price and do nothing with it until the end. That is the historical cost model. Or I can say I'm not sure which of those two I am going to do; I'll hope and I'll do what they call 'keep it available for sale'. So I mark-to-market and then I bring the gain and loss in when I eventually sell it. Those are three different methods for one single piece of paper. That does not make a lot of sense, and that is part of the issue. When you go more on to the loan book, away from financial instruments, then, again, you have a philosophical question. I have discussed this with several central bankers. One of the arguments they put forward was: "If you had forced us to show fair value at the time of the Sovereign

loan crisis in Latin America, and so on, we could have been bankrupt." Well, yes. The question is: "If, however, you had had to mark those to market as it started to happen, would you have kept lending - which you did do?" There is the moral hazard of all this. If you show items at 100 you do not have to take any action. If you actually see them coming down to 95, to 85 and 75, you think: "Am I going to keep lending to this guy?" I think the answer is going to be no, you are going to stop much quicker, which is why we have not got the sub-prime still being loaned to at the moment; it has stopped because people are going to have to do it. That is one of the great issues, I think, and that is going to be a big debate - whether the loan book should be at fair value. The bankers most certainly do not want that to happen. The danger is the Latin American crisis. What is better: to warn them off or are they automatically doing it? If they are automatically doing it it does not matter so much, if they are aware, but nobody wants to invest in a bank where they are convinced they are showing assets at higher values than they are actually worth.

Q229 John Thurso: In a way, the classic loan book does not pose so much of a problem because you have a party on either side and there is clarity, and a reasonable judgment can be made by an informed investor as to the quality of that. The problem we have now is we have got instruments which even the Chairmen of the banks selling them do not understand, as they told us in evidence, and which may be inherently toxic from the moment they were conceived - probably invented by a bunch of guys with a Masters in computer games. The point is they have almost no value unless there are a lot of people who want to buy them. If nobody wants to buy them then they have zero value. Is there any way that one can deal with that, or is it just going to be a case that when the market is bubbling away happily these things will have a value in them but when the market crashes they will have to be written off in their entirety? Mr Boyle is dead keen to answer this question.

Mr Boyle: There is a sort of misunderstanding that the banks just lend money to people. That is now becoming a kind of minority sport for some of the banks. If you look at the detail of their balance sheets, a huge proportion of bank assets is in this trading in financial instruments; in some of the banks in excess of 50% of their total assets are these sorts of instruments. The fair value debate only really focuses so far on that side of the bank's balance sheet, and if the facts are, as in the example you have quoted, that there are no buyers for these assets, maybe the real estimate of their value is, indeed, zero. It is like the market now for "Come on Tim Henman" T-shirts; there are no buyers for them now. There is a serious point here: some of these products were designed in such a way that if the underlying asset defaulted the resulting value of the financial derivative was, indeed, zero. That was the way they were designed. Therefore the proper accounting value for that is zero, and people need to face up to that. That is what fair

value is forcing people to do.

Q230 John Thurso: Is this debate, in a way, a mask to the real problem, which is they should not have been created in the first place and, actually, we should not have solid banks, whose job ought to be lending money, getting involved in this stuff in the first place, and that what we need to do is create a regulation a bit like Glasteagle (?) where people who have deposits and look after money and are going to be protected by governments are not allowed to do these things?

Mr Boyle: The question of whether they are not allowed is something for the FSA to think about, but I must say I have been personally surprised to see some of the write-offs on complex financial instruments from organisations that I thought were there to provide mortgage loans into the housing market. It, frankly, came as a surprise that they were dealing in these sorts of things. They may now question whether they had all the necessary skills to do that on an appropriate basis. That is something for the management of the banks to take up.

Q231 John Thurso: Can I move on? Sir David, you were once quoted as having said (I am sure you know what is coming): "If you understand IAS 39 you haven't read it properly." Why is that?

Sir David Tweedie: This is the standard we have on financial instruments, and it is probably about 200-odd pages long. It is not something that you can actually read and then quickly describe; it is something you have to dip into to find out the answer to the particular problem you have. It is coupled with a couple of hundred questions - again we inherited these. Some of them are blindingly obvious in the answers, and the others I recall micro-accounting; I could not care less what the answer was it was just so insignificant. However, that was the style of accounting that was surrounding financial instruments in the US and North America. That is what the problem is. We have to completely simplify this standard, and that is what we hope to do with the Americans by 2011. So this is very firmly on the list. This advisory committee that we are setting up with the US is to get eminent people from around the world to say: "This is what happened in the crisis. This is what the standards do. Can you give us some high-level views?" We do not necessarily have to take them, of course, because we have to make our own minds up, but, clearly if the whole consensus is going in the same direction it would be pretty silly not to pay considerable attention to it. So we really want to rewrite the whole thing.

Q232 John Thurso: One of the major problems, I know, for auditors is: what are

management's intentions? If you take a non-financial company - say, one that owns hotels - if it is owning the hotel to hold it and trade it, it is an EBITDA multiple, which is a valuation. If, on the other hand, you intend to sell it it gets reclassified with sometimes impairments and sometimes improvements to the profit and loss. How do we protect auditors from what managers decide they are going to do to change their numbers?

Sir David Tweedie: I think the answer is to remove intentions from accounting. A gleam in the eye is not actually a good accounting concept, and that is, basically, what I think we have got to get rid of. We have to deal with it in the same way.

Q233 John Thurso: Last question: under what circumstances should banks be allowed to use their own internal models for asset pricing?

Sir David Tweedie: We have rules on that and we issued some guidance at the end of last month. Quite clearly, if there is a market use the market, if they are not allowed to use their models. If there is something that is very similar to what you are trying to value, then okay you take the prices that are in the market for that and you have to make adjustments to come to your model. The third one is when you have a situation where the market is very thin, or it is a rather unusual instrument, and then you have to go back and look at it. What is happening in this present crisis and what they are having to do is look through these instruments and say: "What are the underlying mortgages?" - and there are hundreds of them. "Where are they coming from?" "Are they from California?" "Which particular district in California?" "How many people are actually owning those houses?" "Are these buy-to-let things?" "What are the numbers of failures in that area?" That all has to be built into the models and the statistics. That is difficult in the subjective, and it has to be constantly moved. That is why we have just put out proposals emphasising the need for clear assumptions to be shown. Plus, what alternative assumptions could you have shown, and what would the effect of that be? I think it is the point you made earlier - some of these things are so complicated it is very, very difficult to manage them, and I suspect the market for these is going to disappear in the future because nobody is going to buy them, until the next generation forgets all about this and buys them at that time.

Q234 John Thurso: Thank you. I hope you succeed, by the way, with getting aeroplanes on the balance sheet.

Sir David Tweedie: I think we will.

Q235 Chairman: Sir David, I just want to go back a bit to the trigger for change for this

October decision. You said that it took you by surprise. If the Commission, the EC, has so much power over your body, could that not be seen as an utter failure on your part to understand the mind of the Commission? You consult other bodies; should there not be a built-in anticipation in your organisation which has been missing to date?

Sir David Tweedie: We do consult with the Commission, we see them fairly regularly, but we just did not have an inkling of this coming until, probably, about a fortnight beforehand. That was the first we knew.

Mr Boyle: I think, Chairman, if I may say so, the problem here is there is a structural issue. The Commission would not dream of and has no powers to instruct the ECB to change interest rates or to instruct the Bank of England to change its rates. The reason for that is that a very great deal of thought was given, at the time that independence of the interest-rate-setting power was handed over, to the accountability arrangements. I think, with hindsight, in the enthusiasm for moving towards international accounting standards, there was probably insufficient given at that time to the governance and accountability arrangements. That leaves it open for people to interfere. It was the Commission this time, but the threats could come from a variety of places - they could come from US Congress. So what we need to have is a set of arrangements for which there is broad political support and which make it impossible to interfere and to instruct the Board to do this or that. That is the only way in which we can prevent this from recurring in the future, and that does require a more thorough debate about these arrangements.

Q236 Chairman: Given this is a banking crisis, the points you made are of interest to me when you said that trading in financial instruments can exceed 50% of a bank's balance sheet. It would seem to me what you are saying is that banks have now organised themselves into utilities which do the normal issues but have casinos attached. How far do you agree with that, and what lessons should banks take from this crisis?

Mr Boyle: I would not quite have used those words, but if you look at the areas of significant growth in the profitability of banks in the last few years, it has not been in the traditional lending area; it has been in some of these sexy derivatives and financial dealings, and, of course, the City of London has been a global leader in some of that innovation. So the upside of all this has been the attraction of substantial amounts of business to the City; it is regarded as being a globally significant financial centre and full of innovation and creative people. These are the people who have been making the big money bonuses. It is really not for us in the accounting community to make decisions about what controls should be placed around that; our job in the accounting community is to make sure that the financial consequences of that are fairly reported.

You can tell from looking at the bank balance sheets what proportion of the assets are derived from that sort of activity and which are valued on a fair value basis. That is a big improvement on what we had previously; it is for others to judge whether that has gone too far and where the controls should be.

Q237 Chairman: Sir David, you smiled there. Is there a smidgeon of sympathy for that description? What should banks do in the future?

Sir David Tweedie: I think this has been a massive lesson for the entire financial community worldwide. What has happened previously, derivatives were used to perhaps protect for creditors or credit guarantees. Now we have got what they call "naked" derivatives, which are actually bets. That is where a lot of the problem has arisen. Certainly, there have been a lot of those in some of the failures. They are speculation, pure and simple, and that is what I think has to be looked at by the regulators.

Q238 Chairman: Last week in our evidence session the issue of non-executive directors came up, and it certainly surprised me that some of the non-executive directors knew their way about the City and had a pedigree in financial services, yet missed a lot of this. Are there lessons here for non-executive directors?

Mr Izza: Chairman, I also saw the evidence that was given to you last week, and I thought there are real some lessons that we can take from it. Firstly, the financial institutions are incredibly complex, and I think it was Lord Turner who said that one of the things we must look at going forward is how much time non-executive directors actually do spend understanding these organisations, because they are not things that you can spend a day every two months on; they are very complex animals. The other thing that bodies like mine also have to do is give our non-executive directors as much support as we possibly can because, quite frankly, they need it. With that in mind, we have convened a meeting on 9 December of all the listed Audit Committee Chairmen because this year-end is going to be a year-end like they have not experienced before; there are just so many issues to deal with, and the Audit Committee Chairmen really do have to be on top of their game. So it is incumbent on organisations like mine to support them as best we can.

Q239 Chairman: Finally, Sir David, when you appeared before us last time (I think it was after Enron and we were looking at corporate governance in UK plc) you did mention, if I remember, receiving threats from corporations in America regarding discounting of stock options. You saw your way through that battle. What other threats could emanate, and from where?

Sir David Tweedie: I think the one we are in at the minute is probably the most critical to the organisation, because if we have another "carve out" in Europe people are going to feel that Europe has gone, and suddenly, instead of 100-odd countries using our standards, there is 75, and you then find that others will start thinking: "If we aren't going to have a unified global system, should we, in fact, simply have equivalence? We will deem the European style of accounting equivalent to the US standards equivalent to the Japanese", and so on. That is the big danger. I think in the United States they are incredulous at what has happened. When we are just on the verge of getting the United States signed up, this happens, and that has come as a massive shock and disappointment to the United States, and also everywhere else. There is a danger now that this could be set back for a generation. That is the situation we are in. Michael asked me why I did not resign. It is because I want to win this one, and we are almost there; I would hate to walk away at this stage. We may lose, and that might be the time to go.

Chairman: You won the stock options one, so let us hope that you win this one, Sir David. Can I thank you and your colleagues for attending this morning; it was very helpful.