

Hector Sants

BANKS ON THE BRINK
BBC business editor Robert Peston interview with
Hector Sants, chief executive of the Financial Services Authority

Hector, we have had now you know months and months and months, well over a year of crises in financial markets feeding into a significant downturn in the global economy. How do you think we got here?

SANTS: Well it's certainly been an unprecedented period, I think you would have to say and most commentators I think are now acknowledging that. This is the worst financial crisis in modern times, I think, and certainly without a doubt it's the worst financial crisis anybody currently working in the City would have seen.

How did we get here? Well as people have reflected, it is through a combination of events. It's no one single factor that has brought us here. It's a combination of events. It does reflect undoubtedly to some degree the regulatory system we have, the global regulatory system we have, the approach that has been taken around the world to regulating financial institutions but at the end of the day, that regulatory framework isn't what makes things happen. What makes things happen is the actions of people.

And so you also have to look to the managers of those financial institutions and the wider actions of society as a whole, the political system, the central banks, the wider framework and indeed the way consumers have behaved, the way they have been willing to take on the debt that has been offered to them.

Q: I mean for me there have been a series of triggers but the fund, fundamental cause of our problems was we borrowed too much. Companies, borrowed too much, consumers borrowed too much or to put it the other way round, financial institutions lent far too much.

If you look at the British economy I mean you could put together consumer debt, corporate debt, public sector debt, we're talking about 300% of GDP being accounted for by debt. It's a huge amount. I suppose the question for me is why do you think people didn't understand the risks that were being run in either borrowing these amounts or you know the other way of looking at it, in lending these colossal amounts?

SANTS: I think it is a little more complex than just looking at it as a straightforward economic cycle point. Clearly it is the case that people have borrowed too much and banks have lent too much relative to their ability to absorb losses when those loans go wrong, and that is the case, and of course to a degree people were forecasting that. People were, regulators were saying you know risk was priced too cheaply and there would be a downturn coming.

Hector Sants

What of course has made this particular downturn so unique is not necessarily that straight kind of set of economic facts but the way financial institutions and individuals in financial institutions then behaved. So it is, this repricing of risk has been accompanied by this drying-up of liquidity, and this drying-up of liquidity to a large degree was driven by fear and by concerns and people's behaviour patterns around those concerns.

So I think we also have to think a bit about why did that liquidity dry up, why did people become so fearful? Why was there a liquidity crisis? And I think some of that is also driven by complexity, so I think I would want to say to you yes, people lent too much, people borrowed too much but the way it was done was too complex, was not sufficiently transparent, was not sufficiently understood.

I think the one thing that nobody understood was how the whole system globally fitted together so that when an element went wrong, people lost confidence in the rest of the system.

Q: I mean you worked for many years at a very senior level within investment banks. I mean looking back on your days as an investment banker, why do you think the people running the investment banks failed to appreciate the risks that their employees were taking on?

SANTS: Well I think you've got two elements of risk here. There's the risk to individual institutions and there is the risk to the system, and I think what we can of course observe is that individuals managing individual institutions are not in general going to be looking at risks to the system, and at the end of the day it was the system that has come unstuck and has run into difficulty, not just the individual institution. So one observation is I think you can't rely on individuals and individual institutions to safeguard the system.

But back to your point, I think your more specific point was, was it reasonable for the managers of those banks to have understood the risks in their own institutions? Well I think in a way that's a kind of microcosm of the wider point. I think it is the case that individual traders designing individual products do understand those products but I think you know we have to say looking back over the last fifteen months that many bank management did not understand how those risks would fit together and how, how those risks would impact their own institutions in a downturn of this severity.

It's an interesting question of whether they could have ever done that or whether the problem was they just didn't envisage a downturn of this severity. I suspect it's a mixture of the two, so to some degree the problem was not that they couldn't understand what might happen but had never really thought about a set of circumstances occurring in, of the nature that have occurred.

Hector Sants

Q: I mean if fundamentally which I think is the point you're making it was only possible to assess the risk in a sensible way if you were able to in a sense see the whole world, what does that actually mean then for the kind of business that we should allow institutions to conduct in the future? Since the reality is the nature of many of these products was intrinsically complex.

They were distributed to hundreds, thousands of different investors all over the world. It's unrealistic isn't it to ever expect there to be the kind of global regulatory system that would allow anybody sitting on the top of that regulatory system to understand the global risk in that sense, so – so in other words are you, it seems to me that the implications, are the implications of what you're saying is there's a whole sort of world of business that was being done that just has to be swept away?

SANTS: I think that's the conundrum, that's the challenge that we now have to address. Is it possible to set up an oversight system that would address the issues which we have seen in the last twelve or fifteen months? Is it possible to have an oversight system that would minimise the risks in a system of the complexity that has been developed? And I think that the point you're making is a very fair one.

In the current world with the current nature of national government and national legal systems and so forth, it probably isn't realistic to envisage a single global regulator having oversight of these risks. It may well be possible now I would say to have better global co-ordination to particularly deal with crises when they emerge, but I think the concept of being able to overlook the whole world with the requisite amount of information, knowledge and expertise and authority to manage, manage that process effectively is certainly not a realistic ambition.

So as we're learning lessons from what has happened, I think we have to look to other types of solutions, and other types of solutions will be seeking to ensure we don't get that level of complexity and lack of transparency developed again, and that we don't allow banks to set up systems which they themselves cannot manage as a group of individuals, as a board of directors. So I think the challenge really is to avoid the development of this level of complexity and this level of lack of transparency, not to try to set up some system that could oversee it.

Q: And I think that what that means is that banks, financial institutions are going to become smaller, simpler organisations aren't they?

SANTS: Well not necessarily smaller because of course one of the other features of the period we've just been through is a number of the larger well-diversified organisations have fared well so we're not necessarily saying that size per se is bad. Diversity is clearly good. But complexity carries considerable risk and complexity

Hector Sants

has to be, has to be overseen to ensure that it doesn't get to a level of complexity that is not manageable.

Q: I think what I meant by smaller was simply that there was quite a lot of economic activity created in you know those bits of the investment banks which were doing all this complicated stuff and I think all I'm saying is, is that being swept away? And it looks as though you know even before we have a new regulatory structure, a lot of it is being swept away. That just means the particular institutions that were engaged in that kind of stuff, they're not going to be doing it any more.

SANTS: No –

Q: They will be smaller.

SANTS: Yeah the historic investment banking model which was primarily developed in the US doesn't look as though it will survive in its historic form going forward.

Q: But that's a big industry, I mean it's a big industry in the City, it's a big industry you know in Wall Street. I mean that looks as though it's gone certainly for years, possibly for ever.

SANTS: Well we need to be careful when we use the words "gone". Those individuals may well find other types of financial activity to carry out and those institutions may morph change into other types of financial institutions, but the concept of a US-style investment bank within the regulatory regime that then existed in the US clearly is now, is now part of the past.

Q: But it also means fewer hedge funds engaged on the other side of those sorts of transactions, I mean it, you know insurers also presumably have to change as well since they also had an involvement in a lot of that. I mean it's not a trivial industry is it?

SANTS: As has been observed earlier, there's been a whole parallel industry built up on the back of the provision of plentiful pretty cheap credit, and built up in a relatively unregulated area often called shadow banking sector which includes hedge funds as you, as you say, and those types of organisations will also have to change partly because that plentiful cheap credit is not going to be available, and partly because clearly the degree of oversight of that shadow banking area has to increase or that shadow banking area has to diminish in size.

Q: Do you think there's also a lesson here in terms of in a sense how we run the world? We've all talked for – we've all talked!

Globalisation has been a reality for some considerable time and it's particularly been a reality in financial markets for many many years, and yet we don't have a, we haven't had a governance

Hector Sants

system that matched the ability of capital to move where it liked and you know effectively to ignore borders.

Your vision is plainly for greater co-ordination between regulators across the world, to in a sense manage these global risks but isn't, how great is the danger that actually there will be a rolling back of globalisation, that people will, governments will attempt to erect barriers so that they do have greater control of what they perceive, well that they erect barriers so that they think they've got greater control over their economic destiny?

SANTS:

Obviously globalisation per se is a wider social phenomenon driven by a number of wider trends so I don't think we're going to see any diminution in the tendency of financial institutions to want to operate on a global scale, and by definition therefore globalisation will, is here to stay.

I think when you talk about the way that regulators and the authorities and governments will react, you're right in saying of course as long as it remains the fact that as a last resort it's taxpayers' money at risk, then national governments are going to want to retain appropriate levels of control which means, to enable them to be accountable to their voters and their taxpayers.

But when it comes to the regulatory system, I do think there are ways forward here. One of the problems is people tend to talk about the regulators and the regulatory system, but actually when you talk about regulation, there are elements, there are different elements in regulation. There are the rules, there are the way that you apply those rules and there are also the way that the regulatory system interacts with government and central banks and fiscal policy. Those are the three elements of the regulatory framework.

And I think going forward we need to have more effective global rule-making processes. Of course the rules we use here with our banks here in the United Kingdom are global rules. They derive from the Basel process, they are not rules that we, the FSA, have made. They are rules that we apply. That process to generate those rules has been a very long and cumbersome process. It's taken us over ten years to develop reforms for the Basel system, otherwise known as Basel 2.

It's clear that Basel 2 to some degree is already out of date before it's been globally implemented. We need to improve the global policy-making framework but I think supervision needs to remain local while the lessons you learn from the crisis is if you want to manage a problem bank, you have to understand it, you have to understand its business model, you have to understand its management. That's a local job.

So I think I see a continued thrust towards global delivery of the policy framework but a re-emphasis of the importance of effective

Hector Sants

on the ground supervision, and of course fiscal policy, there is an argument that says not only do people need to be conscious about macro prudential issues, financial stability issues and the delivery of, of fiscal policy but also that does have to be globally co-ordinated and we have of course in the last twelve or fifteen months seen various global, globally co-ordinated actions in that area.

Q: Now if I could take us back to September, and the weekend where Lehman was negotiating with the US treasury about effectively whether it was going to be propped up or not, how – I mean how significant at the time did you feel you know after Hank Paulson decided that no there wasn't going to be a state bail-out of, a government bail-out of Lehman, how big a deal did you feel that was back then as it were?

SANTS: I think we did know even then, even at that weekend, that if Lehman went under it would have very very significant consequences both globally and indeed in Europe as indeed the facts have shown, so that was one of the, one of the key inflection points of the last fifteen months.

Q: But did you, did you anticipate that it would have the impact that it did? I think most people would say that in terms of the extraordinary crisis that then followed with money managers in particular withdrawing liquidity from more or less every institution that was even perceived as faintly risky, it was the collapse of Lehman that set in chain, set in train a series of events that led to you know the worst banking crisis any of us can ever remember. Did – I mean how, when it went down, did you think crikey this is going to be a nightmare?

SANTS: We knew it would be very very serious but I think you always have to recognise the point I made earlier, that much of what has happened here in the last twelve to fifteen months have behavioural elements. It's the way people have reacted to the crises, to the facts and you can never in all, nobody can say in all honesty they know exactly how people are going to behave so yes we knew it would be very very serious.

Did we know exactly what the consequences are that would have flowed from that? No, we just knew it would be very serious. We couldn't have foreseen precisely what would happen next but we knew it was very serious.

Q: Were you surprised that Hank Paulson let it go down?

SANTS: I think that when we went into that weekend, given what had happened with Bear Stearns, there was a widespread expectation around the City that they would provide the necessary support. So in that sense, we would be, we, we were surprised.

Q: And was it, was it a terrible mistake do you think, to let it go down?

Hector Sants

SANTS: Well I try very hard not to comment on fellow regulators around the world. I think you know history is already saying and commentators are observing that clearly led to the crisis changing shape quite significantly.

Q: Could you just characterise for me how the crisis changed shape? You were at the sharp end. Plainly financial markets were not in the best of shape before Lehman went down but what, in the days that followed, what went wrong?

SANTS: Well what you could say I think in the period prior to that, certainly here in the UK, that what was happening was primarily at least with retrospect understandable and rational, namely we'd had a series of problems here in the UK primarily around a set of mortgage banks. These were the demutualised building societies and as now apparent, they went into the crisis with the wrong business model, in many cases with inadequate management and they had then subsequently got themselves into serious trouble.

So in that sense and up to that point, one could at least look at the landscape and say what was happening was a series of specific types of firms, specific business models were running into severe difficulty as a result of the liquidity crisis. The consequence of the Lehman crisis however was to turn it into a genuine global crisis and to really inject serious fear into investors which then therefore put pressure on business models and on banks and financial institutions which in theory should be robust and successful financial institutions.

So the level of concern spread across the whole of the system as opposed to a specific set of fairly understandable, or of understandable business models.

Q: And if you had to look at in a sense the chain of events, was it as far as you could tell the initial decision by US money managers to withdraw effectively from funding banks that was the first event that started to really post-Lehman, that really started to sort of destabilise –

SANTS: Well I think you also have to look at the recognition by all that there were then going to be a considerable number of assets, the Lehman assets, dumped as the investor saw it onto the market and that there was going to be a very significant force seller of a set of very complex and difficult-to-understand assets which would be being forced through a system which had never before had to absorb that amount of assets, that amount of paper in what investors saw as likely to be a very short period of time.

So I think it's not just the behaviour of the money managers. It was the impact of a significant player genuinely, generally disrupting the system.

Hector Sants

Q: And this is its holdings and mortgage-backed securities or CDOs just being basically dumped on the market, driving down the price of you know, of assets being held by other banks and what that meant for the strength of those banks?

SANTS: Yes there's that but there's also the recognition that a major investment bank had failed and that put at risk that business model, and that business model on the mainstream US investment bank has been at the core of the financial system in developed markets for decades, so the recognition that a mainstream player using a business model which would seem historically as indeed the growth type of business model, the type of model that people if anything aspired to, was at risk, was going to be a major factor in undermining confidence.

And of course following on from that we've then seen effectively the disappearance of that business model as the other investment banks have either done deals or turned themselves into banks.

Q: Absolutely. Now if we then go through the subsequent days and weeks, in the UK after Lehman we had the HBOS rescue takeover announced by Lloyds TSB. We had Bradford & Bingley being nationalised, and then we move onto the weekend where the FSA and the treasury and the Bank of England put together a proposal to stabilise the British banking system.

What were you seeing at, in – you know happening at British banks in the days before that comprehensive taxpayer rescue scheme? What was, what was happening at British banks that made it clear to you that it was really urgent to stabilise the banks?

SANTS: Well we were clearly seeing a crisis in confidence, primarily investor, and a liquidity confidence –

Q: The share price is falling.

SANTS: Share price is falling and concerns about their ability to maintain their liquidity, particularly in wholesale markets which is –

Q: This is these money managers again taking their money out basically?

SANTS: And also dealings between banks, so we were having a liquidity crisis and a shareholder confidence crisis, and that was undoubtedly putting at risk some mainstream British banks and I think if those, if those conditions had continued, then there were some British banks which were, could well have failed if those conditions had continued and no action had been taken.

Q: I mean I remember there was a particular Friday – I think I jotted it down because I went back and looked at my notes – it was

Hector Sants

October 3rd, and I had been told that morning that a bank had difficulty that morning in rolling over some of its shorter term debt.

And I just remember at the time thinking this is extraordinary, I mean this is a huge household name and institution and you know my, you know there was no reason at that time to assume that this bank was insolvent and yet it was having difficulty maintaining you know what you would have thought about a few months ago as being just normal lines of credit. Astonishing.

I mean I find that profoundly shocking. I mean here, you must have felt it was, that sort of behaviour was really bizarre?

SANTS: Well I think it was as I said earlier, that after the Lehman, the Lehman event, people's perception of risk changed dramatically and confidence had all but completely drained from the system with regard to a large swathe of the financial industry, not every single institution but large swathes of the financial industry, the consequence of which as you rightly observe, there were banks whose model, business model should be perfectly robust in any reasonably normal conditions and indeed even in any reasonably stressed conditions.

But the complete disappearance of confidence were putting those institutions at risk and that was a highly unusual set of circumstances, as I said before, one we have never seen before certainly in modern financial times and I hope we don't see again.

Q: I mean how many, if you look at one or two of these bigger institutions, how many days' worth of cash, liquidity, did they have left at this stage?

SANTS: Well as you'd expect, as a regulator we did have numbers on that but I think they're so prone to misunderstanding, I'd rather not quote specific problems, specific numbers but what I would say is what I mentioned earlier, that there's no doubt if the conditions which were prevailing at that time and investment attitudes which were prevailing at that time had continued, then there were a number of British banks significantly at risk which were the names that people are now familiar with.

Q: I mean they could have collapsed basically, that's what we're saying?

SANTS: I think that if the lack of liquidity in the system had persisted, they could have, they could have collapsed yes, or at least you would have got to the point where nationalisation was, complete nationalisation was the only option.

Q: So we go into this weekend and it starts you know this, well actually there are two negotiations. So there were two, there were two incredibly intense you know weekends of negotiation. There was the one on the sort of global bail-out, the framework and then

Hector Sants

there was the other, there was the subsequent one where in a sense the banks then came in and made their applications for certain bits of underwriting from the treasury.

If we go back to the first weekend, did you go into it here knowing more or less what you needed to achieve, or to what extent you know was, was, was there a you know a huge amount of work done in a very short space of time?

SANTS: In terms of designing the recapitalisation proposition, as, as has been reflected, that was a proposition which had been under consideration for some time, a number of weeks.

Q: Two three weeks?

SANTS: And there had been a lot of consecration and discussion and we along with a number of others had made a number of contributions into treasury in terms of the way we thought, thought it was best taken forward. So in terms of designing the scheme, that was something that was done over a period of time, over a number of weeks, not done over a weekend. What obviously was done over a weekend was the execution of the recapitalisation element of that, the thirty-seven billion.

Q: That was, that was as you say the second part, so in terms of the, the, you know the first as you say, the first element as it were, the fact that there was going to be fifty billion of capital made available plus you know the, the guarantees for issues of short-term debt plus the extension of the special liquidity scheme, that was something that, that what, three weeks do you reckon from start to finish?

SANTS: It had been under consideration for some time, certainly a few weeks, two or three weeks, and bear in mind certainly from the FSA's point of view, one of the key contributions we had to make was modelling how much money would be involved here, what would the capital ratios of the banks look like or what should they look like? How much money should they raise?

And that required us obviously to develop a complex model to fully understand the current positions of the banks and model what it would look like after a capital injection, and we, we, that's not something you do overnight. We, we spent some considerable time working through those numbers to make sure we had a good understanding because we were making those calculations without speaking to the banks themselves.

We were basing it obviously on the data we collect from banks as part of our job, but we clearly were seeking to design the scheme without actually speaking directly to the banks.

Q: And the primary aim of the scheme was to save the banking system, that was clearly the main aim of the scheme?

Hector Sants

SANTS: The primary aim of the scheme was to restore confidence in the banking system and to ensure that those banks did not fail. Of course by ensuring that they do not fail, they were then able to play their part in the economy and go forward and lend and so forth but obviously the first objective was to ensure that they didn't fail.

Q: Because there had been, there had been a lot of people talking about how you know the banks were only rescued so that they could lend at the rates that they had been lending at. I mean was that ever in your mind?

SANTS: We, we were clearly looking to restore the banking system to normal functioning and to ensure the banking system can do business. As we've observed in the past, of course we weren't expecting to restore it to the level that was seen at the height of the boom in the early part of 2007 when the economy was clearly overheated because as you and I have just reflected earlier, it was those lending conditions which were a significant contributor to the banks getting into difficulties.

But we were obviously expecting to design a scheme or we were seeking to design a scheme that restores the bank to normal functioning, restores the banks' normal functioning.

Q: I mean the statement that was put out by the treasury does talk about lending you know in line with what happened in 2007. What do you think it means by that?

SANTS: Well I think it's making the point I've just made which is clearly that the banks have been recapitalised to do business. My point is a slightly different one, just to say they were obviously not expecting them to do the type of business that they've done in the past which was the type of business that got them into difficulties.

Q: Or the volume of business.

SANTS: Or the volume of business.

Q: Now if we go then to the weekend where the capital was then requested and then allocated to individual banks, my memory of it because as you probably have observed sort of living and breathing what was going on here over a period of weeks, my memory of it was that it started with Royal Bank of Scotland. Royal Bank of Scotland we've seen subsequently, events proved, you know needed the largest slug of capital. How did it, how did it, how did it work?

It started with, with Royal Bank of Scotland needing the capital pretty urgently. When were the other banks brought in?

Hector Sants

SANTS: I think what was clear was it would not be a good idea to recapitalise one bank in isolation of the rest of the system. If we did that, there was a risk given the way investors were behaving that the focus would just switch to the next weakest bank, so it was clearly desirable to ensure that we had a solution that encompassed all the major banks which is why we focused on that group of seven in the UK.

So, so we'd made that decision that by Monday morning we want to be able to deliver the message to the market that the UK banking system, or at least all the major players in the UK banking system, had been recapitalised or had a mechanism to access capital which would ensure they would not get into difficulty.

Q: But to what extent was that intensive activity triggered by the fact that it was obvious that the Royal Bank of Scotland needed urgent help and therefore it was important to get all the others in, or was that weekend always going to be the weekend when you did it all?

SANTS: No I think the, the very specific driver was the difficulty, liquidity difficulties being experienced by a number of the banks just in front of that weekend so in that sense, that's why it was very hectic activity because the, the tactical timing was determined by market events.

Q: Were you, for that weekend were you here or did you spend most of your time over at the treasury?

SANTS: Over at the treasury, so we had teams of people here.

Q: So you were at the treasury, and then other people were sort of punching the numbers back here for you?

SANTS: The negotiations with the banks which obviously was led by the treasury, it's taxpayers' money, but which the FSA and the Bank of England were present at, were conducted at the treasury but here were our supervisors which is obviously where we have, have the models of the banks and are able to do the calculations with regard to what was the right amount of money needed and what would the banks look like after the capital injections, that type of analysis was obviously done here in the FSA.

Q: I mean in a way it was the sort of biggest corporate finance deal almost ever conducted in the City as it were. Were all the representatives of the banks in one room or were they in different rooms throughout the treasury?

SANTS: Obviously each individual discussion with a bank was an individual discussion with a bank. I mean they were customised solutions for each of those individual banks. We were seeking to ensure that the individual banks were properly recapitalised at a level that was appropriate to that individual institution.

Hector Sants

Q: And did you, I mean did you personally work through the night? Did you get any sleep that weekend?

SANTS: I did get some sleep, there were certainly many who got no sleep. I got some sleep but as in all negotiations, you go through a period of where you have, have the senior executives of the bank reaching the high level views and then of course there was a considerable amount of activity working through the detail, through the documentation.

And of course treasury had, had appointed advisers. They had investment banks helping them and a lot of, a number of my – those investment banks of course were the ones doing the detailed documentation.

Q: And if it starts on Friday night, when did you feel over the weekend that you had a breakthrough, you knew broadly what was – that it had, that it had succeeded?

SANTS: I think that given we, we knew what the plan looked like because as you observed that had already been worked through previously, going into that weekend, once we'd made the decision that we were going to seek to address issues of all the major banks at one go, the issue to me was always could we get through the volume of work, not did we need to design what we were trying to do.

I think it was always clear to me what we were trying to do. The question was could we get through that work in the time, and in that sense you're never sure you've got through all the work until you've done it and that obviously wasn't done until Sunday night.

Q: Yeah absolutely, and has there, I mean do you ever recall in your career anything quite so sort of intense and high stakes?

SANTS: No I mean clearly you have intense periods of negotiation and extremely hard work on individual deals when you are an investment banker but no investment banker would have ever been involved in, in a set of transactions of such historic nature and of such importance to the entire UK economy, and to everybody, everybody, every depositor and every borrower, you know this mattered.

Q: Absolutely. Was there a sort of, I mean because it helps to get, people sort of get a flavour of it, was there ever sort of moments of sort of slight absurdity or humour in the weekend that you can recall?

SANTS: Well there are always odd moments of absurdity and you always have to have a few odd moments of humour or you don't get, or you don't get through the weekend but I have to say generally I thought it, I felt in comparison with a lot of corporate, individual corporate deals, it went remarkably smoothly.

Hector Sants

I think the feature that probably struck me the most is making very very significant decisions in relatively short timescales so it's very, the negotiations which in normal conditions in the commercial world might have taken days or weeks were conducted in a matter of hours. So it was that compression of the timescale which I think will always stick with me and, and rather than necessarily any particular kind of incident in the way people behaved.

Q: Were you around for the famous Indian takeaway or whatever it was?

SANTS: No I, I didn't participate in the Indian takeaway.

Q: There isn't a particular anecdote that is worth telling about any of this that occurs to you?

SANTS: No, as I said before, I think the feature that struck me was the way that major decisions were made in very short periods of time and quite a few of them in fact were made over the telephone rather than in face to face meetings. Indeed quite a few of them were made over, over mobile phones often people were walking up pavements or going from one building to another.

So there's that slight sense of you've just made a decision over a mobile phone that normally you would have spent a few hours round a table making, but I don't think with hindsight, I feel, I don't feel we would have made any better decisions if we'd spent a few hours round a table.

Q: Sure sure.

Is there anything else material on this because I want to move onto the future?

I mean just – plainly things have not gone swimmingly for the British financial system. A number of banks collapsed. To what extent, there's a lot of anger out there, quite a lot of people do blame the FSA. Are they right to blame the regulator?

SANTS: Well we are the financial regulator and there has clearly been a major crisis in the financial system so we can't absent ourselves from that fact and that is clearly, clearly the case. I do however think, and in a way maybe this isn't the answer people want, but there isn't one person to blame here. People often feel the need to say who is responsible.

As we reflected earlier, actually the, this set of events came about because of a series of events. It came about because of failure to a degree in regulation but as much on a global policy sale as, as at individual supervisory level. It came about because of certain types of monetary policies being adopted around the world. It came about by some attitudes in society towards borrowing and

Hector Sants

credit, and it certainly came about through the behaviour of certain banks' managements and their competencies.

So it was a, a collision of a whole series of factors on a global scale that had generated the issue we have here in the UK. But as the supervisor, you know we have said a number of times already that we could have done a better job with regard to our supervisory process but I don't think the supervisory process was the real genesis of the problem here.

The genesis of the problem was these wider factors and that is the regulatory process as a whole not the national supervisory role.

Q: So to be clear, and for example you've conceded that you got things wrong with Northern Rock, but what you're saying is even if you'd been a completely perfect national regulator, we'd still be in a mess?

SANTS: As a national regulator, you could not control all the factors that have brought us to where we have got to, and it's undoubtedly the case that when we get into the events of the weekend we were just talking about that by then we were seeing a global failure of confidence and a national supervisory authority could not have deflected the world from its course in that respect, I don't think.

Q: But do you think the mess for the UK would have been less if the FSA had done a better job before?

SANTS: Well, we, as I reflected earlier, I think that there were a group of institutions, financial institutions, banks, mainly the demutualised building societies, that went in to the crisis with a business model that couldn't survive the crisis and more, more intensive and obtrusive supervision of those particular group of firms might well have led them to going into the downturn much better equipped, and therefore they may well not have got into the difficulties that they did do.

But the overall financial crisis can not I think be attributed to supervisory issues. It can to some degree be attributed to regulatory policy issues but regulatory policy issues are developed globally and the FSA has a say in that process, but only a say.

Q: Now, the big contributor to the economic slowdown is the shortage of credit. Looking into 2009 and 2010, to what extent do you think we can expect domestically and globally a recovery in the provision of loans by banks and other financial institutions? How optimistic or pessimistic are you about both the outlook for financial markets, and for the wider economy?

SANTS: Well as we've said before, there were, the period prior to the crisis was an exceptional period. It was an overheated marketplace with too much credit being delivered too cheaply, and at the end of

Hector Sants

the day that was probably the biggest single driver in creating the problems we are now in.

So when we go into the correction as we, as we are going into the correction now from that upturn, we clearly shouldn't expect and nor should we want us to go back to the conditions that were prevailing just prior to the crisis. I think what we would expect to see is confidence returning to the market and we would expect the bottoming out of the process, the re-establishment of more normal banking conditions and we would then expect or I would expect that process to become apparent during the course of 2009.

But we do need to draw this distinction between the crisis abating and more normal market conditions prevailing, and a belief that somehow or other we either ought to or will get back to the conditions that were prevailing at the top of the cycle, because it was the conditions at the top of the cycle that created the difficulties we've now got into.

Q: I mean how tough will 2009 be do you think?

SANTS: Well we, we – the FSA as you know doesn't make economic forecasts. There's now consensus forecasts out there of a recession. We're certainly expecting firms and banks to prepare for a recession and as I mentioned before, we would not expect the market structure to generate as much credit as was seen in the first part of, first part of 2007.

So conditions will be tough and we expect banks to prepare for tough conditions which is why we recapitalised them and are expecting them to hold the right amount of capital to survive those tough conditions, and we shouldn't forget the FSA has a vital role in ensuring that depositors and borrowers are, are prepared and treated fairly in these difficult conditions.

So you know we would also be warning consumers that they are facing a tough time and they need to, they need to prepare themselves for that. I'm sure they, to be clear of course I'm sure they already appreciate that.

Q: And to what, I mean how confident are you that this extraordinary rescue that we've seen is a once and for all solution, or, I mean how great a risk is there that banks are going to have to raise more capital and that we're going to have to do more as taxpayers to help the banks?

SANTS: Well, it's, it undoubtedly is a solution to the conditions that were prevailing at the time and I do think that we have put behind us that period of the market completely losing confidence and investors believing that any institution could potentially fail. And therefore –

Hector Sants

Q: So Armageddon, that was Armageddon and that's not going to be repeated in your view?

SANTS: I think that, the actions that authorities around the world have taken and I would include in that the US's recent support for Citigroup for example, I think will have reassured investors that they are not facing Armageddon. I think we are however, as we've just discussed, going into a recession. We're going into a very difficult period for the real economy.

A difficult period for the real economy will generate credit losses for banks and at the moment on a reasonable scenario, in general the UK banks have sufficient capital to absorb those losses but we clearly expect their capital to come down. That's why they've been recapitalised, so that they can absorb those losses as they come through, as the economy, as the recession generates them.

So I think at some point of course as you would expect, the banks will come out of that process and then of course you would expect them to take advantage of market conditions, probably to add further capital to pursue more normal business objectives. So what you shouldn't say is that there will be no more capital, no more capital raising in the banking sector but the purpose of it and the conditions under which it's achieved I think will be different.

Q: So, so the risk of a you know nationalisation of our biggest banks, that is much reduced in your view?

SANTS: In so far as nationalisation was the last resort response to a bank potentially failing, that risk is much reduced if not disappeared.

Q: Do you think it has disappeared?

SANTS: I – we would like to think so. That was the objective of the weekend and nothing has happened since that suggests that objective wasn't achieved.

Q: And just looking five years ahead, what kind of City of London do you think we'll have in five years?

SANTS: Well there's the City of London and there's the financial system. I think we've already observed the financial system has to change. It needs to operate in a way that is less complex, more transparent. It will be, it will have greater oversight. I'm not necessarily sure that means more rules in the regulated space but it certainly means more oversight in general of the whole of the financial system.

So the nature of the activity in the City of London will certainly change going forward. The City of London as an international capital market I think will continue to be really a very very important centre in the global context but what it does will change, and the type of firms that operate here will change, and I was

Hector Sants

going to say, I don't think we will see the excesses that we saw at the latter end of the boom for, for a very long period of time to come.

Given human nature, you can never say never but certainly not in the lifetime of current practising practitioners.

Q: So in a sense a simpler place, a more sober place, perhaps slightly smaller?

SANTS: Well I think you are always going to expect the growth of emerging markets and so forth to put pressure on, on London's market share, London's share of the global cake, so, so in that sense it was always possibly going to lose a little bit of market share as we saw the development of the emerging economies, but in so far as it's been at the cutting edge of the development of some of these more complex products, and in so far as simpler banking will tend to be more related directly to the needs of individual customers, then you might well expect somewhat of a reduction in the more complex world of finance and that would obviously impact London.

Q: And sort of finally, you've been, you know been around the City for – what is it thirty years in total, is it thirty years?

SANTS: Thirty years, yeah.

Q: Thirty years. Did you ever in your wildest imaginings think you'd live through what we've lived through the last few weeks?

SANTS: No I think, no, I think there's nobody I know of in the City, none of my friends or acquaintances envisaged we could have had the set of events that we've had over the last fifteen months both in terms of their impact, the fact that it was this convergence of behaviour as well as economics, and the fact that it's gone on for so long.

No I don't believe anybody anticipated everything that has happened over the last, over the period since August '07.

Q: Hector, many thanks.

SANTS: Thank you.