HOUSE OF COMMONS

TREASURY COMMITTEE

BANKING CRISIS - FORMER BANK EXECUTIVES

Tuesday 10 February 2009

SIR FRED GOODWIN, SIR TOM McKILLOP, MR ANDY HORNBY and LORD STEVENSON OF CODDENHAM

Oral Evidence

Taken before the Treasury Committee

on Tuesday 10 February 2009

Members present

Mr John McFall, in the Chair

Nick Ainger

Mr Graham Brady

Mr Colin Breed

Jim Cousins

Mr Michael Fallon

Ms Sally Keeble

Mr Andrew Love

John Mann

Mr George Mudie

John Thurso

Mr Mark Todd

Mr Andrew Tyrie

Sir Peter Viggers

Memorandum submitted by Lord Stevenson of Coddenham and Mr Andy Hornby

Examination of Witnesses

Witnesses: Sir Tom McKillop, former Chairman of RBS Group plc, Sir Fred Goodwin, former Chief Executive of RBS Group plc, Lord Stevenson of Coddenham, a Member of the House of Lords, former Chairman of HBOS plc and Mr Andy Hornby, former Chief Executive of HBOS plc, gave evidence.

Q758 Chairman: Good morning and welcome to the banking inquiry, and thank you for your attendance. Can you introduce yourselves, please, starting with Lord Stevenson.

Lord Stevenson of Coddenham: Dennis Stevenson, former Chairman of HBOS.

Mr Hornby: Andy Hornby, former Chief Executive of HBOS.

Sir Fred Goodwin: Fred Goodwin, former CEO of RBS.

Sir Tom McKillop: Tom McKillop, former Chairman of RBS.

Q759 Chairman: Thank you very much. May I start by saying this is an opportunity for you to provide your side of the story. Maybe my first question has been leaked if we look at the papers this morning; maybe all the questions have been leaked. However, is "sorry", the hardest part, Lord Stevenson?

Lord Stevenson of Coddenham: No, Chairman, and thank you for giving us the opportunity, right upfront, because there has been a lot of talk about the "s" word. You have given me the opportunity to repeat what both Andy and I said to our shareholders when we met them at the EGM, that we are profoundly and, I think I would say, unreservedly sorry at the turn of events. Our shareholders, all of us, have lost a great deal of money, including of course a great number of our colleagues, and we are very sorry for that. There has been huge anxiety and uncertainty caused in particular for our colleagues but also for periods of time for our customers. I would also say, Chairman, we are sorry at the effect it has had on the communities we serve. There is nothing sudden, there is no turn of events; we said it publicly at the EGM and we have felt it throughout.

Sir Tom McKillop: Thank you, Chairman. I would echo Dennis Stevenson's comments. In November of last year I made a full apology, unreserved apology, both personally and on behalf of the Board, and I am very happy to repeat that this morning. We were particularly concerned at the serious impact on shareholders, staff and, indeed, the anxiety it caused to customers. I would very much echo Dennis's comments.

Q760 Chairman: Sir Fred, one of the members of the public said to me this morning, "Do the institutions know what they have done to ordinary people's lives, families and jobs?" Everyone in the room pays some form of tax to the UK Government, and the UK Government has forwarded shed-loads, lots of money, to your institutions. What are we getting? In terms of your approach, some people say you have been hesitant to say "sorry", so I am giving you your opportunity now.

Sir Fred Goodwin: Thank you very much for that, Chairman. I apologised in full, and am happy to do so again, at the public meeting of our shareholders back in November. I too would echo Dennis Stevenson's and Tom's comments that there is a profound and unqualified apology for all of the distress that has been caused and I would not wish there to be any doubt about that whatsoever.

Q761 Chairman: And it has affected ordinary people?

Sir Fred Goodwin: It has affected everyone.

Mr Hornby: I would just like to both repeat what has already been said and to stress, Chairman, that we deliberately started our written submission with a full and frank apology. I am very sorry about what has happened at HBOS; it has affected shareholders, many of whom are colleagues; it has affected the communities in which we live and serve; it has clearly affected taxpayers; and we are extremely sorry for the turn of events that has brought it about.

Q762 Chairman: We have got a range of questions we want to put to you and get on the public record, because the aim of this inquiry is: a) to find out how we arrived at this situation; b) how we get ourselves through this present severe economic recession; and c) what the future of regulation in the financial services will look like. On that point, were you fooled into thinking that the "great moderation", with low interest rates, low inflation and easy access to credit, would be a permanent state for the economy? Ben Bernanke's "great moderation", it is going to last forever?

Lord Stevenson of Coddenham: The question is: did we believe the view which came out not so much of Ben Bernanke but Mr Greenspan and indeed, let us face it, most people throughout the world, that we were in a permanent state of cheap money, and everything was the best in the best of all possible worlds? I have to say, speaking for myself, of course you take note of what the major regulators say and what the opinion leaders say and, yes, that period of a decade, where the supposed Chinese deflation lowered rates of interest et cetera, that was quite a compelling argument. I would not want you to think, however, that we slavishly worshipped that doctrine. If I take you back three years, or thereabouts, for example, we took a decision which was widely criticised at the time on all sides to lower our share of the housing market from 30% to 20% just when the views you have summarised were prevailing, and we took that out of good countercyclical caution; and there have been a number of other decisions of that kind. I think I referred in our memorandum to the fact that about five years we deliberately took a P&L hit so as to lengthen the maturity in wholesale markets: but yes, Chairman, the prevailing view - best exemplified by Mr Greenspan's testimony on the Hill, which I remember watching regularly, is bound to have an influence on us and most other people in the world.

Q763 Chairman: When the tripartite authorities came before us - the Bank of England and the FSA in particular - they said they had sent warnings out to the banks and they cited January 2007 and April 2007. Sir Fred, why do you think that those warnings were not heeded?

Sir Fred Goodwin: I am not sure that they were not heeded. As you can imagine, I have gone over this time and time and time again in my own mind as to what was the point at which we should have seen this differently, and I keep coming back to at the time there was a view, not that things would continue forever, there was a definite mood that the economy in this country and generally was going to slow down, that financial markets were going to slow down; but at no point did anyone get the scale or the speed at which. That is really what has been so damaging about this slowdown. It was not that our business was premised on everything continuing to go upwards forever; but that things could turn as quickly as they did, I do not think anyone saw. I do not think, in fairness even to the Bank of England, that they really saw that it was going to turn this quickly. Everyone I think saw that it was to turn at some point, but for it to turn in the way it has and so profoundly and globally I think is the part which has just caught everyone out, and it was not possible at the time to envisage.

Q764 Chairman: Sir Tom, in my preparation for this I looked up the Oxford English Dictionary definition of a "bank". It says: "an organisation offering financial services, especially the safe keeping of customers' money until required and making loans at interest". Does that definition need updating? Do we need to contact the Oxford English Dictionary again?

Sir Tom McKillop: I think modern banks are a good deal more than that. They offer a wide range of financial services, so I think that is a fairly limited definition.

Q765 Chairman: Does that need updating, Lord Stevenson? Because we ended up with the utilities and the casinos, and the casinos got us into bother.

Lord Stevenson of Coddenham: Could you read it out again, Chairman?

Q766 Chairman: The Oxford English Dictionary definition says: "an organisation offering financial services, especially the safe keeping of customers' money until required and making loans at interest".

Lord Stevenson of Coddenham: I think it is pretty accurate. "Financial services" covers a wide range.

Q767 Chairman: Did your organisation live up to that definition?

Lord Stevenson of Coddenham: We certainly aspired to. As our evidence to you made clear, we got hit by -----

Q768 Chairman: Could I interrupt you. Just a word here: has it lived up to it?

Lord Stevenson of Coddenham: In everything we tried to do, yes, and we hit the first major market failure in wholesale markets, as did virtually every other bank in the world.

Q769 Chairman: Andy Hornby, did it live up to that definition?

Mr Hornby: Clearly, there is a definite need for banks to focus on simplicity going forward, no-one would argue with that. That is the clear message of what has happened.

Q770 Chairman: I am just asking a simple question. Did it live up to the definition of the safe keeping of customers' money?

Mr Hornby: We have worked extremely hard to provide the safe keeping of customers' money. We have already agreed that the loss of liquidity in the market ------

Q771 Chairman: I want to get on with other questions. Did it live up to the definition?

Mr Hornby: I would say we certainly aspired to and we clearly did not foresee with enough clarity ------

Q772 Chairman: But there is a question mark there, is there not?

Mr Hornby: Because of the clarity with which we did not see the complete closure of wholesale markets.

Q773 Chairman: Sir Tom, a straight answer? You come from Irvine, a straight answer.

Sir Tom McKillop: Dreghorn actually but near enough! I think as events have turned out, we required help to fulfil those obligations.

Chairman: So it did not live up to it. That is fine.

Q774 Mr Brady: One of the things we want to establish is how far the remuneration policy of the banks contributed to the crisis by rewarding perhaps the wrong kind of risk-taking. Sir Fred, I think in 2007 your remuneration was £4.1 million or thereabouts, of which about two-thirds was in the form of a bonus. Mr Hornby, I think the figure for you was about £1.9 million, about half of which was bonus. Could you tell us, please, what those figures would be for 2008?

Sir Fred Goodwin: There is no bonus being paid for 2008.

Q775 Mr Brady: And your remuneration?

Sir Fred Goodwin: My salary for 2008 would be £1.46 million.

Mr Hornby: There will be no bonus at all payable for 2008. Clearly my salary was roughly in line with the previous year. What I would stress, can I just be very clear on one thing, you picked up the salary and bonus: last year, in common with every single year for the previous eight years, I invested my entire cash bonus in shares. I have never received a single penny of cash bonus during either the two years I have been Chief Executive of HBOS or in the previous seven years when I was on the board of HBOS. My interests have been entirely aligned with shareholders and I never received one single penny of cash bonuses.

Q776 Mr Brady: Thank you. Looking not just at yourselves but at other senior executives in your banks, how would you respond to the charge that you were rewarded handsomely for current performance, but insufficient regard was paid to the need to secure long-term shareholder value?

Sir Fred Goodwin: I think there are a variety of elements to the remuneration package and there are also share ownership requirements, and there are also share-related schemes which, relinquished as part and parcel of the remuneration policy which is approved by the shareholders each year, link our interests into the longer term performance of the company; and considerable losses for me and my colleagues who have shares in the company and share options in the company over the last year reflecting what has happened to the company over the last year. Like Mr Hornby, I too invested my bonus last year in shares in the company, and so there has been a significant penalty. I have never sold a share in Royal Bank since I joined and have always held a large holding, and that would apply to most of my senior colleagues. I think there was a longer term link there to the performance of the company beyond just the current year.

Mr Hornby: I would go even further than that. There is no doubt that the bonus systems in many banks around the world have been proven to be wrong in the last 24 months, in that if people are rewarded for purely short-term cash form and are paid very substantial short-term cash bonuses without it being clear whether those decisions over the next three to five years have been proven to be correct, that is not rewarding the right type of behaviour. At HBOS I would say, and it is not in any way drawing back the apology we have made earlier about the situation we have found ourselves in, not just myself but all the other executive directors were encouraged to take all of their cash bonuses in shares. To put it in perspective, in the two years that I have been Chief Executive I have lost considerably more money in my shares than I have been paid. I think that is showing I have been aligned with shareholders' interests. I do agree with your broader point that that should be a philosophy generally and that some way of making sure that annual cash bonuses are not paid in isolation but are tied into share ownership over the next three to five years is the right way forward.

Chairman: Could I ask if you could all lean forward because you cannot be heard clearly.

Q777 Mr Brady: I am sure you will be aware of the measures that President Obama is taking in the United States not just to cap salary levels but also the requirement to introduce a clawback provision for bonuses from the top 25 executives and banks that are receiving assistance. Could I ask the two former chairmen of the banks: do you agree that this is a wise route to take?

Lord Stevenson of Coddenham: I am not familiar with the detail of President Obama's suggestions. I of course receive no bonuses, just to be quite clear, so in a sense I can speak reasonably objectively. If you have a system, the one Andy Hornby has described, where short-term bonuses are not short-term bonuses because they are invested straightaway in shares and cannot be realised for three or four years, then I actually do not think I would approve of some system of clawback. I would rather not be drawn - frankly until three weeks ago I have had my head down trying to get the right result for HBOS - and I do not have a perspective certainly on the American situation. If short-term bonuses are paid out short-term in cash I think that is a different matter and I can understand why people are concerned about it.

Sir Tom McKillop: I believe there is a need for a fundamental look at remuneration policies in particular parts of banks. You have to differentiate between retail banking and, let us say, more investment banking type practices where remuneration is very high, largely driven by bonus, almost completely driven by bonus. I believe that these events which have occurred and the situation we are now in should give everyone an opportunity to look fundamentally at remuneration practices going forward: but I do believe it need to happen across the board in a fairly coherent and consistent way, otherwise you will see tremendous arbitrage; you will see people moving around, going to other places, different organisations. I do not think this can be effectively carried out in a piecemeal way - and that is a big challenge.

Q778 Mr Brady: What contribution did remuneration policy make to the failures at both of the banks represented here today?

Sir Fred Goodwin: We have looked back at that very specific issue and obviously we have done a lot of work to try and understand what happened, how it happened and why it happened. One of the features of how this all came about, you go back and look at the positions which have given rise to the losses. The traders were trading within limits that would have been set; there were not any rogue elements to it; they were conducting activities which they were authorised to conduct, which we knew they were conducting and they were conducting them within the limits based on what we believed the risks to be. At the heart of this I think there was an issue not about risk recognition but about how the risk was calibrated. They were holding positions in what we perceived to be triple A securities and they turned out to be worth 5 or 10 cents in the dollar. The risk was recognised but in the risk systems it was quantified as being very small: it turned out to be very large and it was wrong, but at the time people were doing what they were authorised to do and what they thought they were doing. I find it hard, looking at the specifics of the case, to point to remuneration as being a cause of what happened on the ground. I would agree with the thrust of the remarks which have been made around the table that this is something which should be looked at as part and parcel of what to do to prevent this sort of situation arising again.

Mr Hornby: I think there is always room to make sure that remuneration is even more closely tied for the long-term. I have already outlined for myself the two years I have been Chief Executive and for other executive directors they were taking their cash bonuses in shares, which they were holding for several years, in my case, for nine years and never sold a share through that period. I think what you do need to do in all banks is look several layers down the ladder as well and to keep asking the question: are you making sure that annual bonuses are being tied in for the long-term? I do think there is more work to do there in all banks. I personally would think the solution where rewards are paid out over three to five years as opposed to annually is the right overall direction.

Mr Brady: Thank you. Obviously we will be returning to this with the current directors of the banks tomorrow.

Q779 Nick Ainger: Let us start with you, Sir Tom: what banking qualifications have you got?

Sir Tom McKillop: I do not have any formal banking qualifications. I was five years in (?).

Sir Fred Goodwin: Whether you would call them banking qualifications or not, but I have a degree in law; I qualified as a chartered accountant; I was in public practice, including auditing banks for a number of years; I was involved in winding-up banks and then looking at providing advice for banks; I was Chief Executive of Clydesdale Bank; and I was a Chief Executive of Yorkshire Bank before I joined the Royal Bank of Scotland group in 1998 as Deputy Chief Executive.

Mr Hornby: I do not have any formal banking qualifications. I have an MBA from Harvard where I specialised in all the finance courses, including financial services; and before I took over as Chief Executive two years ago I was a Director of HBOS for seven years.

Lord Stevenson of Coddenham: Like Andy, I have no formal banking qualifications. I have of course been Chairman of the Bank for ten years; and before that I was initially, for about 20 years, an entrepreneurial businessman and I have run large businesses since then.

Nick Ainger: I just wanted to get it on the record because one of the recommendations that we made in the run on the Rock was that all senior staff of banks, chief executives, chairmen and so on, should have a banking qualification. I am grateful for the information you have given us. Can I just return to what Graham Brady was saying in relation to the bonus issue. There was a report yesterday saying that the bonus culture is in the DNA of the banking system, and yet you are accepting, all four of you, that there are serious problems relating to the bonus culture. Can you explain to me, and to literally millions of people out there, why you have a system where people are paid what appears to many people to be a decent salary but they can then maybe have ten times that salary as a bonus. People understand "bonus" as being a bit of a top-up on their salary, not ten times their salary. How on earth did the banking system allow this to develop, where people were having these huge mark-ups on their salary and, as a result, it would appear that they were not doing their job of the prudential side of banking; they were taking real risks and it was not their money they were risking?

Q780 Chairman: We are doing bonuses tomorrow because you have departed. We are looking at the chief executives and chairmen who are in tomorrow, so give us brief answers on this.

Lord Stevenson of Coddenham: I think there is probably a distinction between investment banks and commercial banks. Andy Hornby, who I am sure you will address that question to, will correct me if I am wrong, but I do not think there is anyone in HBOS who has multiplied their salary by ten times on a bonus. I would go slightly further and - in response to the question asked earlier on as to what part did remuneration play in the problems we faced - while, as Andy has made plain, there is always scope for improving the remuneration system, Andy has put that the further down it goes the better, in HBOS you are dealing with a bank which deliberately some years ago created a system for its most senior executives whereby the bonuses they got (which were nothing like ten times their salaries) were automatically reinvested in shares and held for a period of years. Chairman, the FSA brought out its ideal picture before Christmas, did it not, and it was remarkably close to what we are doing. I am not saying, at all, that we got it right because, as Andy has said, we must improve; but we are not one of the banks that is paying ten times salary in bonus. With bonuses, we are increasingly moving towards a culture of putting them into long-term holdings, so you do not get them straightaway.

Sir Tom McKillop: This is a question I have thought a lot about. Just to put it into context: the average salary in RBS is just over £27,000; the maximum bonus for the vast majority of those people is 10%; and the average payout is about 5%, just so we have a perspective. Not everyone is in this class; we are a long way from that. I have given a lot of thought to: why is it that investment banking has developed this bonus culture? It is seen as a very people-related activity; that specialist knowledge and contacts are very important, that is very transportable; but also I think an important element may be the history of these investment banking-type activities. They were largely not carried out initially in publicly listed companies; so they were partnerships; there was a very high payout history in these kind of partnerships; and they have become public companies but those practices have carried over into these publicly listed companies and, because of the competitive pressures to recruit the key people, they have escalated if anything. I think there is quite a lot of history to be unravelled here if we are going to get to the right end point.

Q781 Nick Ainger: There are reports which we have all seen that RBS is an institution which has just announced it is writing down £20 billion of its assets; it has announced that it is likely to make a loss of up to £8 billion; its shares have fallen by over 90%; and four months ago the taxpayer had to bail it out, and if they had not done there would not be RBS. Yet, this bonus culture indicates that RBS may well have been seriously considering paying out major bonuses in that institution. How on earth could they even agree that there should be any bonus, given those circumstances and the fact that the people out there believe that it is taxpayers' money that will be paying those bonuses? What would you have done in those circumstances, Sir Fred?

Sir Fred Goodwin: I do not know what the Bank is thinking of doing. The dilemma with all of us, as Tom has mentioned, is that it is highly competitive market. Many of the remuneration practices have been imported from the United States. As London has emerged as more and more of a global financial services centre a lot of these practices have come across from the United States. This has been a source of angst within banks if you talk to other bank chief executives who have activities in this area for years and years. It is very difficult for an individual institution to make a change unilaterally.

Q782 Nick Ainger: It is the culture then?

Sir Fred Goodwin: It is absolutely a cultural thing. It is an area where people and teams do move around the market; and if amounts are not paid and people do not feel they are appropriately remunerated they will move. It is very much a cultural issue. I am sure Stephen Hester will explain the position tomorrow but many of the businesses within the group are doing extremely well; many businesses within GBM(?) are doing extremely well. I do not know for a fact, but the rates and currencies businesses, for example, has probably had a record year in 2008. It is buried within all of the figures - I do not demur from your characterisation of where the bank is - and the people sitting there will be expecting to be rewarded based on their performance. That is the dilemma where Stephen and his colleagues in management and the new Board will have to square the loop.

Q783 Chairman: Andy Hornby, just so we have on the public record that we do not take your line completely, but in 2007 your salary was £940,000. You say you had two cash payments of £449,000 and £254,000, which you turned into shares. I would submit to you that that has really insulated you to a large extent. There is a real comfort zone there when people say, "Look, you've got a million pound salary". I want that on the record, we are not accepting your point of view fully. Your million pounds people see as a very generous million pounds.

Mr Hornby: Chairman, I accept, along with all other FTSE companies -----

Chairman: Okay, but it is very important for our inquiry.

Q784 Mr Fallon: Sir Tom McKillop, let us get back to what went wrong. You were chairman of this mess. ABN Amro, how much did you overpay?

Sir Tom McKillop: In retrospect we bought ABN Amro at the top of the market, so anything we paid was an error.

Q785 Mr Fallon: What is the answer to my question? How much did you overpay for ABN Amro?

Sir Tom McKillop: Everything we paid basically has not been worth ----- I am giving you a very straight answer. I could say, "50%", but what difference would it make? In fact, we are sorry we bought ABN Amro.

Q786 Mr Fallon: The statement you gave out on 19 January, and you were still Chairman then, attributed a write-down of £15-20 billion. Was most of that ABN Amro?

Sir Tom McKillop: £15-20 billion in January that was the goodwill write-off, and a significant part of that is ABN Amro.

Q787 Mr Fallon: How much is Amro?

Sir Tom McKillop: I could not tell you. We did not break it down explicitly, I do not think.

Q788 Mr Fallon: You were the Chairman; you must know what the figure is? How much have you lost on Amro?

Sir Tom McKillop: If you read the press announcement it said that is work in progress. The goodwill assessment will be done by the end of the year. That had not been completed. These were estimates. I would basically submit that the bulk of what we paid for ABN Amro will be written off as goodwill. We paid about £10 billion.

Q789 Mr Fallon: Why did you and your Board allow Sir Fred to go ahead with this huge deal without an escape clause when ABN had already pre-sold LaSalle, when the credit crunch had already begun, and when everybody else said you were paying too much?

Sir Tom McKillop: The premise that we allowed Sir Fred to proceed implies that this was driven by Sir Fred, which is not the case. When the announcement of the ABN Amro merger with Barclays was made the Board received a presentation from our strategy group and the executive team, an analysis of the ABN Amro businesses; we looked at that in considerable detail. The Board had 18 meetings between March when we received that first analysis following the announcement by Barclays and ABN, in which ABN Amro was considered at every one of those. There was no proposition to buy ABN Amro at the first meeting; it was an analysis session. At every stage the whole Board considered this and were unanimous in the steps we took. It is wrong to characterise it as a proposition driven by Sir Fred that the Board were unable to stop.

Q790 Mr Fallon: None of the non-executives wanted a re-think. Okay. Did they fully understand the additional pressure that a £50 billion deal like this would put on an already fragile UK inter-bank market?

Sir Tom McKillop: Of course we understood, but it was not £50 billion, it was £10 billion for us. We paid £10 billion for it.

Q791 Mr Fallon: But the total deal was £50 billion?

Sir Tom McKillop: Our part of it was £10 billion. The prospects, the financial returns potentially on the deal, were improved when LaSalle was not available. So far from LaSalle, we are very happy we did not get LaSalle; and the financial numbers actually improved without LaSalle, so we did proceed.

Q792 Mr Fallon: Why were you and your non-executives unconcerned about RBS's funding gap - the gap between your liabilities and assets - which seems to have doubled in three years to over £160 billion, is twice the size of Barclays' funding gap, and was a third of the total of all six British banks' funding gap? Why were you unconcerned about it?

Sir Tom McKillop: We were not unconcerned about it. We had a plan. When we acquired ABN Amro there was a capital plan and a funding plan in place. The problem was, no sooner had we acquired ABN Amro then the world changed dramatically and we were unable to implement that plan, and therefore we ended up with the funding requirements you indicate.

Q793 Mr Fallon: Why did you and your Board not fully understand the risks of your increasing overdependence on the wholesale funding markets?

Sir Tom McKillop: I believe we did understand what we were doing, in the belief that that plan was going to be executed successfully.

Q794 Mr Fallon: Did the regulator, the FSA, warn you or your Board about the size of this deal, or the strain it would put on your funding?

Sir Tom McKillop: No, the deal was approved by the FSA, by the Dutch regulatory authority.

Q795 Mr Fallon: Sir Fred said in October that the jury is out on ABN. Now that it appears to be back, how would you summarise it? Sir Tom, I am asking you. You were in charge of this Board.

You have destroyed a great British bank; you have cost the taxpayer £20 billion; how would you now summarise that deal?

Sir Tom McKillop: The deal was a bad mistake - I have already indicated that.

Q796 Mr Fallon: So you failed?

Sir Tom McKillop: We did in fact make a bad mistake in purchasing ABN Amro. At the time it did not look like that. It is easy in retrospect. I could give you many, many statements, many bits of evidence that support that at the time we bought that, when we made that acquisition, there was widespread support for it. Yes, there were some voices saying it was overpriced, but we received 94.5% shareholder approval; we received regulatory approvals; there was a very good financial case.

Q797 Chairman: Sir Fred, others have said it was hubris on your part. As one person said, "It cost the Royal Bank of Scotland its mighty status". You paid three times market value. Indeed the gossip in the market at the time was that RBS and Barclays were bidding up, but Barclays were putting the price up knowing that you would go the whole hog and at the end of the day they were quite happy to see you going out and there were smiles in Canary Wharf and Barclays' headquarters when you did it, and it was just hubris that brought it down on your part?

Sir Fred Goodwin: I have read those comments as well, Chairman, but they are not true. I think the Chairman has explained the background to the Board's report.

Q798 Chairman: It was a bad mistake, Sir Fred?

Sir Fred Goodwin: I am just explaining the context. At the time it did not seem like a bad mistake. Our shareholders approved the transaction in August of 2007. Barclays' shareholders approved it in the middle of September 2007. After the Barclays shareholders approved it - and Barclays stayed in the fight to get ABN Amro right to the end and revised their bid terms up - our bid stayed the same throughout. We got to 17 September 2007 and ABN Amro reconfirmed their earnings estimates for 2007 and specifically stated that credit market markdowns had not affected them. They specifically stated that their credit portfolio and credit outlook was good. Again, that may seem hard to believe now, but at the time that fitted into the context.

Q799 Chairman: It is a question of due diligence?

Sir Fred Goodwin: There was due diligence done earlier in the year on ABN Amro. These were statements that were made to the public market. We raised funds for the ABN Amro transaction in late September - they were eight times oversubscribed. So the view at the time, and we could only work based on the view at the time-----

Chairman: We are coming back to that with the non-executive directors.

Q800 Ms Keeble: I wanted to ask first, Sir Tom, you mentioned there were some voices of warning raised about this deal. Did any of those come from your own internal risk management people?

Sir Tom McKillop: No, there was an awareness on the funding - the question of the funding plan and the capital plan.

Q801 Ms Keeble: No, internal voices inside the Bank were raised about it?

Sir Tom McKillop: The analysis threw up the issues that would have to be managed in the integration, but this was essentially the same kind of plan that had been very successful on the integration of NatWest so, yes, there was a full analysis by internal.

Q802 Ms Keeble: I wanted to ask some other issues about risk management and compliance in particular for HBOS, because you will be aware of the accusations made by a former employee that the sales culture at HBOS outpaced the risk management in compliance systems. Do you accept that those particular functions were overstretched?

Mr Hornby: No, I do not accept that at all. Indeed, I think the particular accusation you are referring to referred to an internal review conducted by us and using external resource back in 2004. There is a whole series of internal reviews constantly done and reported back to the Board. There is an extremely rigorous analysis done each year under what we call the "three lines of defence", which is I think standard for most major banks.

Q803 Ms Keeble: But they all failed, did they not, at the end of the day, those three lines of defence?

Mr Hornby: To say that they failed is not right; in that, as we have laid out very clearly in our submission, the difficulty that HBOS encountered was significant reduction in availability of wholesale funding from August 2007 onwards, and it got much steeper when we had actually continued to fund ourselves very successfully through a 12 month period because we had previously elongated our wholesale funding; and following the collapse of Lehmans we found those wholesale markets even harder to satisfy.

Q804 Ms Keeble: Looking through the structure which I think comes from your annual report, there seems to be no reporting line from any of the risk committees or from the risk directors to the non-exes?

Mr Hornby: I will allow Dennis to expand in a minute but just to be clear: the group risk director reported direct to the chief executive, and the three lines of defence meant that, first of all, you had divisional risk accountability which reported into group risk that reported into internal audit which reports direct to the audit committee and, therefore, to the senior non-executive.

Q805 Ms Keeble: Do you accept that the risk committees and risk directors might be reporting or might have to whistle-blow around actions taken by the executive and, therefore, a separate reporting line to the non-execs can be a good line of defence and, indeed, was put at a group audit meeting and the person was ticked-off for doing it?

Mr Hornby: Let me be absolutely clear, every single division in our business has its own risk committee which is attended by two non-executive directors; so there is not just a straight line, there is an automatic line whereby non-executive directors are reviewing the risk performance divisions entirely independently through that structure.

Q806 Ms Keeble: A separate independent reporting line from the overall risk director to the non-execs, would that not be a useful separation of responsibilities? Perhaps Lord Stevenson would like to respond?

Lord Stevenson of Coddenham: I agree, and that is actually what happened. It is a very important area you have opened up. I would say HBOS had very elaborate systems of risk management and stress testing, worked out over the years and, it is not too much to say, hand-in-hand with our regulator, who was present all the time. I am very happy to give it in detail or to brief the Committee because I think it is an important issue you raise. We could go back over the record, there would be very few Board meetings where risk was not considered with the risk director present briefly the Board on a major risk issue, and the Board was all over it. As Andy has referred to, there were three levels of risk management below it very carefully structured. I know the Committee is looking to the future - I do think we will not be the only bank in the world which had very elaborate risk management systems, where indeed the Board was involved heavily (which is the thrust of your point), but where in truth we failed to consider some of the extreme scenarios that have actually happened. I think that is one of the questions that came forward.

Q807 Ms Keeble: You appointed a new risk director in 2005 who apparently was a sales manager and had no experience of risk management or compliance. Is that the case, or can you say what the person's qualifications were?

Mr Hornby: This is going back to before I was Chief Executive under the previous Chief Executive James Crosby, but he appointed Jo Dawson who is a very experienced banker and had a career previously at NatWest and then at HBOS; and there was a view taken, which I endorse, that good skills and real broad awareness of banking being brought to that job was going to be helpful.

Q808 Ms Keeble: The qualifications of the current risk director are what?

Lord Stevenson of Coddenham: Peter Hickman, who is the outgoing risk director of HBOS (and I do not quite know at what stage), was a career partner in Ernst & Young who joined us five or ten years ago, who is obviously a trained accountant with huge specialist knowledge of the banking system. The point I would make is, Jo Dawson, the person you are talking about, is a quite outstanding executive, who had total access, to take your point, to the Board, to me and everyone else and was constantly confronting the Board on risk issues.

Q809 Chairman: Sir Tom, before we move on, you say due diligence was done on ABN Amro earlier on, but the deal was completed in October 2007. I remember, along with my colleagues in this Committee, sitting here with the Governor of the Bank of England in September talking about Northern Rock in crisis and here, a month after the earthquake has hit the financial services industry, your organisation signed up to ABN Amro. Can you say to us hand on heart here that the due diligence was done in October and you were still very happy with it?

Sir Tom McKillop: The due diligence was done in May, as Fred said, and then there were a series of meetings with the senior people of ABN Amro to determine if there were any further developments.

Q810 Chairman: But that is six months before, Sir Tom, but here we had an earthquake in the autumn?

Sir Tom McKillop: There were a series of meetings and, as Fred indicated earlier, ABN Amro came out with a statement in September of that year which was very clear about their financial position and, indeed, their views on the status of their business in the middle of all of this which was very reassuring.

Q811 Chairman: It does not sound very convincing, Sir Tom?

Sir Tom McKillop: It was very reassuring, I assure you.

Chairman: We are going to look into that further, particularly the present Board.

Q812 Mr Fallon: A year and four months later you are telling us your £10 billion is worth nothing?

Sir Tom McKillop: I am indeed. I think that is indicative of the scale of dramatic change that has taken place that has affected many banks around the world.

Q813 John Mann: Mr Hornby, are you personally culpable, or is it essentially bad luck that leaves you to be facing the music for your industry today? In other words, are there bankers out there at the moment who are thinking, "There but for the grace of God go I"?

Mr Hornby: I have already said on behalf of the Board we accept full responsibility and have apologised for the events that have taken place, so please do not in any way suggest that I am trying to avoid personal responsibility. I have been CEO for just over two years and it is clear in that time within eight to nine months of taking over as Chief Executive I was then faced with the collapse of wholesale markets, followed by the events on Northern Rock; so it has been an extremely stressful time and we have spent, with huge support from Dennis and the Board, that entire two years trying to make sure of three things: first of all, we cut -----

Q814 John Mann: I am interested in the question of whether if events had gone slightly differently if there could have been others here rather than you facing the music, or whether you are particularly personally culpable?

Mr Hornby: No, I do not feel I am particularly personally culpable.

Q815 John Mann: Sir Fred Goodwin, how much worse could it have been at RBS if you had not been in charge?

Sir Fred Goodwin: I fully accept my responsibility in the matter we are talking about. I would imagine that there are others out there who think, "There but for the grace of God". It was a fact, and all the more numbing, that after a rights issue, right through until the middle of September, we were moving forward positively. It was post-Lehman's that the collapse in confidence, the collapse in markets, just came round and hit us and we were caught at that point. It was very sudden and very sharp. It could have happened to others.

Q816 John Mann: I keep hearing about the requirement for brilliance. People keep on telling us, and telling me all the time, "We need to attract the most brilliance". Are there people out there who are more brilliant who could have done a better job than you with RBS?

Sir Fred Goodwin: There may well be. It would seem unreasonable for me to conclude that there were not. At the time we felt that the rights issue had got the group back on track; it had dealt with the capital issue; we were moving forward; we had published our interim results; and the funding markets came to a complete halt post-Lehman's and it was a crisis of confidence that brought this about.

Q817 John Mann: What it seems to lots of people is when things go into a downward spiral then this extra brilliance, for which huge amounts of money has to be paid, seems to have less relevance;

therefore, why has it got relevance in terms of how things go forward in terms of remuneration? Let me be precise, is your pension linked to the share value of the Bank?

Sir Fred Goodwin: No, my share schemes are linked to the share price of the bank; and my shareholding is linked.

Q818 John Mann: Is your pension? Many pensioners in this country have seen their pension go down because share values have gone down. Is your pension going down because it is linked to the share value of the Bank?

Sir Fred Goodwin: No, because I am in a defined benefit pension scheme.

Q819 John Mann: It is a good job because the share value has gone down from, what, 550 to around 20p. Should it not be linked? Should not your pension be linked to the share value of the business you ran? Would that not be fair?

Sir Fred Goodwin: No, because pension schemes are not generally allowed to invest in the company which is providing them.

Q820 John Mann: As a principle, would it not be fair that your pension, which is quoted as being rather a high pension - over eight million I have seen quoted - would it not be fair to other pensioners in Britain that your pension was linked to the share value of the bank that you ran?

Sir Fred Goodwin: No, my pension is the same as everyone else in the Bank who is in a defined benefit pension scheme. It is determined in the same way as anyone else, and anywhere else, in a defined benefit pension scheme. I am not seeking to not be linked to the share price performance of the Bank; that was achieved through the shareholding in which I have lost a lot of money; it was achieved through the medium and long-term incentive plan, in which I have lost a lot of money. Between the end of 2007 and now I would estimate I have lost somewhere in the region of over £5 million in the decline in value on shares that I have put into the company. I bought shares on the day we completed the ABN Amro transaction - more than a year's salary. So the decline in share price in RBS has affected me. I am not complaining but it is highly germane to this conversation, but my pension is not linked.

Q821 John Mann: No, but you do not appear to have done too badly out of the last eight years. I would be tempted, considering that your bank originated in Tudor times, to ask what Henry VIII would have done to you, but instead I want to ask Mr Hornby: what is the average ago of HBOS staff?

Mr Hornby: The average age I believe would be in the low 40s.

Q822 John Mann: What is the average number of years' service of HBOS staff?

Mr Hornby: That is changing according to the different divisions, the different mergers, but the average service level has been around ten years.

Q823 John Mann: How much is JSA for an adult of, say, age 42?

Mr Hornby: I beg your pardon?

Q824 John Mann: Job Seekers Allowance?

Mr Hornby: I do not know the precise amount but it is a very low quantity of money.

Q825 John Mann: Because that would be the profile of the bank staff and I think it is your age as well. I do not know whether you are going to be relying on £60.50 of Job Seekers Allowance?

Mr Hornby: I accept the fact I am a similar age to the average age.

Q826 John Mann: What is the mood of the staff in the Bank at the moment?

Mr Hornby: Mr Mann, I have already said at the start I have apologised profusely -----

Q827 John Mann: I know, but what is the mood at the moment?

Mr Hornby: I think there is obviously considerable concern. They are going through a very major merger. There is considerable concern about long-term job security. I believe we have handled a very difficult situation to try and deliver the best result for 80,000 colleagues.

Q828 John Mann: What is a COA2 form?

Mr Hornby: I have never used that precise form.

Q829 John Mann: A COA2 form is the form that your Bank sent me in your last week in charge. It sent me it. I am a customer of 40 years, and it sent me it, a change of address, but I have not changed my address. It then sent me the bank account of a Mr and Mrs John Mann; but it was not my bank account it was somebody else's bank account. I put it to you that there is a bit of a meltdown in terms of the morale of the staff.

Mr Hornby: I apologise for that mistake.

Q830 John Mann: Is it not true that yesterday, in an internal staff review, over half the staff speaking to their own management said they were de-motivated, and that 82% of the staff said they were worried for their jobs?

Mr Hornby: Mr Mann, it would be extraordinary, which is why we have laid it out in our submission, if this had not caused de-motivation. It has been an extremely difficult 12 months for us. They have gone through extreme concern; they have gone through a major merger; they are waiting to see how their job situation pans out over the course of the next two years. All I would say is, I believe profoundly that the deal with Lloyds TSB provides the best solution possible in very difficult circumstances. I hope, and I believe it to be the case, that that morale will improve over the course of the next two years. If you look at the history of HBOS, good staff morale has been very strong.

Q831 John Mann: What staff tell me you told them in the two years you were in charge, "We are a safe bank". That is what my mother told me 40 years ago. "Join the Halifax - it's a safe building society". That is what you said. You said repeatedly in the last two years to staff, "We are a safe bank". What staff are writing and saying now is: "I have felt so ashamed to work for the Halifax. It has now hit home that many of us will lose our jobs and that the name of the Halifax, which me and you grew up with, will be erased from the high street and many, many, many more". It is not surprising that they cannot manage to get the bank accounts of someone like me right in that situation, is it not?

Mr Hornby: I agree entirely. I think colleagues have been through a horribly stressful period.

Q832 John Mann: Is not the thing that really annoys them - I know from letters I have seen - that you are still being paid, are you not? Is it £60,000 a month?

Mr Hornby: Mr Mann, I have a short-term consultancy arrangement with Lloyds TSB which, can I just stress, Lloyds TSB asked me to do.

Q833 John Mann: £60,000 a month -----

Mr Hornby: That is correct.

Q834 John Mann: ---- which would be 36 of the lower paid staff jobs in the Bank. 36 of them could be paid each year out of that money. The question they are asking is: considering the failure, why is failure being rewarded? Why are you still getting this money? Is it to cut their jobs?

Mr Hornby: Can I just say three things: firstly, I have already agreed with Lloyds TSB this arrangement will not last for more than three months. If Lloyds TSB still want me to help them after the three month period I will certainly carry on for as long as required and will do it for free and provide Eric Daniels with all the assistance that he looks for; secondly, can I just please reiterate in terms of your impression about rewards for failure what I outlined earlier; that I have invested early single penny of my bonuses in my time with HBOS into shares; I have lost considerably more money over the last two years for the period I have been Chief Executive than I have earned; and I share all your concerns for staff morale; and I really do hope and believe that the future under Lloyds TSB will allow that morale to get back to where it was 18 months ago. It will take time and I accept there is job insecurity.

Q835 John Mann: In your final year one of your branches handed out a cabbage to staff who were not deemed to be performing well. Is that a super epitaph on your time in charge?

Mr Hornby: I think you are referring to an incident a couple of years ago. I thought that was a very unfortunate incident that we followed up internally.

Q836 John Mann: Sir Fred, in the public eye, in the media, you are perhaps taking a much harder hit than anyone on this. This is not actually to get to you - I am interested in the culture. Is it that you are an aberration? Is it that you are someone with a different moral compass in terms of what motivates you; or, in your view, are your integrity and ethics representative of the trade and profession of bankers?

Sir Fred Goodwin: I think, reflecting on everything that has happened, there is certainly cause to question some of the judgements that we have made, and that is reflected in how things have turned out. I am not aware of a basis for questioning my integrity as a result of it all. I could not be more sorry about what has happened. I am not going to go back through all of that again; but I have invested a lot in RBS, and I do not mean financially, over a very long period of time and it is of great distress to me to see what particularly my colleagues are going through and I do not diminish customers and shareholders as well.

Q837 Chairman: Could I just pick up a point Andy Hornby made to John Mann. You said, "I don't feel I am particularly personally culpable. What exactly are you apologising for? We have been told that you have coached extensively, meticulously by PR people and lots of money has been spent.

The papers tell us that, Sir Tom. Are you expressing sympathy because your PR advisers advise you to do so?

Mr Hornby: No, let me just stress, I have already apologised several times on behalf of myself and the whole Board for what has happened. The precise question I was asked of whether I felt purely personally culpable, I think we all take responsibility for what has happened in the two years I have been running the company. I fully accept my own role within all of that and I repeat the apology.

Q838 Chairman: Sir Tom, I want to nail down ABN Amro before we move on. Let us say ABN Amro had an incentive to talk-up the deal with you. I would suggest to you that the due diligence you did in May, followed by meetings, and signing it at the height of the crisis meant that you fell for their line hook, line and sinker?

Sir Tom McKillop: I do not believe that is the case. Banks in particular have very, very public disclosures to make. There are lots of filings made in country of origin, obviously, but also for a bank like RBS or ABN Amro in the United States - very full disclosures of the nature of their business, any issues that are in those banks, the litigation and so on. All of those public disclosures were gone through in enormous detail. We had 15 work streams looking at the due diligence. 15 different sets of activities; all of those reported to the Board on the due diligence.

Q839 Chairman: It is mighty mystifying when we have got an impairment in your trading update of £15-20 billion. We will come back to that with the present lot.

Sir Tom McKillop: That is an estimate of goodwill; it does not mean that the businesses in ABN Amro are worthless.

Q840 Sir Peter Viggers: Of the first Government rescue package in October 2008, Sir Fred, you memorably remarked: "This isn't a negotiation, it's a drive-by shooting". To what extent were you able to negotiate with the Government over the terms of the support offered to RBS, to start with?

Sir Fred Goodwin: That was a comment I made after the negotiations and it was intended as a private comment to one of the other participants but it has obviously got out. It really was neither a criticism nor a complaint. I think of necessity this was all happening at an extremely rapid rate. The rate of deterioration which took place - and you will have heard from many other witnesses about the impact of Lehmans on 15 September and the catalogue of failures which came after that - by the time we got through into that week, Monday 6 October, the 6th and 7th saw a collapse in bank share price, a collapse in our price, a collapse in the FTSE, and a real collapse in confidence. Leading up to that over the preceding three weeks or so there has been an increasingly frequent interaction between the banks generally and the tripartite authorities, and the banks collectively and the tripartite authorities as people were becoming more concerned about how the market was developing, and in that week it just tipped over the edge. I think in a perfect world the tripartite authority would have liked a little bit longer to pull the plan together, but it was very clear to everyone that it had to happen there and then and there was an enormous amount of effort put into it. There was not a lot of negotiation. There simply was not the opportunity for a lot of negotiation. My comments were absolutely not a criticism or a complaint.

Q841 Sir Peter Viggers: Your comments, Lord Stevenson, on the negotiations, insofar as there were negotiations?

Lord Stevenson of Coddenham: The question is: were we able to negotiate? My recollection is that we had two meetings, I think. At the first meeting it was made clear to us that if we wished to have access to government liquidity schemes they wished us to have more capital; that was the trade. They did ask us what we thought was the necessary amount of capital, and they sent us away and we worked it out. There had been prior notice of that and we had (you could call it a "negotiation") a "discussion" about the amount of capital. I think the amount of capital that eventually we ended up with was somewhat different but not very different from the original amount. So to that extent you could say there was a negotiation. But, the commonsense of the matter was that post-Lehmans, with the liquidity frozen, there was not much negotiation.

Q842 Sir Peter Viggers: Returning to RBS, having assured Legal and General in the spring of 2008 that there were no circumstances under which you would need to do a capital raising, and then six weeks later you did a capital raising leading to them asking for both the Chairman and the Chief Executive to stand down, as we have heard, the FSA, the regulator, must have been over you like a rash. How well did the regulator know you by October?

Sir Fred Goodwin: The regulator knew us very well long before October. Because of the size of RBS we are monitored under a close and continuous regime so there is an ongoing and close relationship with the RSA. There is no evidence to me to suggest that the FSA lacked any understanding of the organisation.

Q843 Sir Peter Viggers: What I am trying to reconcile is a statement made by the Chancellor of the Exchequer in the House of Commons on 13 October where he says: "The FSA has taken what it regards as a cautious view, having regard to the difficulties faced in the economy now, as to what the liabilities of the banks might be. That is one of the reasons why the sums in relation to those two banks are higher than might have been anticipated". How on earth could they get that so completely wrong?

Sir Fred Goodwin: I think what they were doing on 13 September was trying to estimate what losses going forward would be. They were not trying to put in place what the provision should be as at October. They put in place, as Lord Turner described it, their assessment of what that extreme stress scenario would look like, and put in place what they thought was sufficient capital in the Bank to allow the Bank to endure that. The capital ratios that were created in October by the investment by the Government would come down if those stresses all flowed through. It was a projection of the future they were uncertain about, rather than anything to do with the past. In terms of what we said to Legal and General, what we said to the whole market when we announced our results at the end of February in 2008 was that we had no plans at that time for a rights issue. That was in response to a question and, in fairness, it is one of these things where you cannot be half doing a rights issue; you either have plans to do one or you do not. We did not have plans to do one. The Board had not sanctioned a rights issue at that time; we did not think we needed a rights issue. We posted trading results in March and the situation changed very rapidly.

Q844 Sir Peter Viggers: I simply do not understand how the FSA, who you say knew you very well, could have made cautious provision in October and, three months later, there is a £28 billion write-down, which is the largest ever. How could it possibly deteriorate at that speed?

Sir Fred Goodwin: I am not privy to all that went on. You can ask Mr Hester and I am sure Mr Hester can explain that tomorrow. At the time there was a trading update given to the market at the beginning of November. That was the last trading update I was involved with, and it was outlined to the market that the Bank expected to incur further credit mark-downs; it expected to incur credit losses; and it expected it was probable there was going to be a goodwill write-off of some scale. All of those things were said at the beginning of November but they were not able to be quantified at that time. It is clear that the credit markets deteriorated very badly again in the latter part of the year. I am sure that has fed through into the numbers. There has been some further deterioration; I know this from what I have read about the public documents about what have happened; there have been credit losses from lending; and goodwill write-off has come through. It was all flagged but not quantified in the announcement that was made at the beginning of November.

Q845 Sir Peter Viggers: How can it be that the FSA made cautious provision and three months later the Prime Minister says he is "angered by reckless loans to foreign customers. A write-off of £2.5billion to Mr Blavatnik a Russian oligarch". How could this possibly happen?

Sir Fred Goodwin: I can see why the confusion perhaps arose, but the FSA did not make any provisions in October. The Bank did not book any further provisions in its books. Capital was put into the Bank, which would enable the Bank to meet those losses as and when they came through in the future. There were no provisions booked in October. It was flagged at the beginning of November that there would be further provisions and they could not be quantified at that time, and it could not be certain whether the Bank was going to make a profit or a loss. It was very clear and very stark what was said. Unlike the time of the rights issue, when we announced the rights issue we said the amount we were raising and we said what we thought the provisions would be. At the time the capital was put in in October - and again this is not a complaint, this was moving at flying speed - all that was done was the capital was put in which would allow losses as they came through, based on the FSA's estimates of what might happen, to be met. The provisions were not booked, and there was no discussion as to what the P&L effect would be. The announcement that was made to the market was very clear. If you go through that announcement it is remarkably prescient in terms of what it said might happen.

Q846 Sir Peter Viggers: So taxpayers' money was invested in banks known to contain toxic assets without provision for future down rating?

Sir Fred Goodwin: No, I would not characterise it in that way. The 13 October was not an accounting period end. There was not a provision to be booked. The bank was not publishing financial statements. What the training update at the beginning of November said was what was likely to happen for the rest of the year, it was giving an outlook. What the announcement the bank made on 19 January did was alert people to the fact that when the results come out some time later this month the number will be different from what some of the analysts had pencilled in. There is no double-counting. There is nothing happening that was not envisaged in October. I am sure the quantum of it is different from what was envisaged.

Q847 Sir Peter Viggers: Do you think the investment of taxpayers' money was made after due diligence?

Sir Fred Goodwin: It was not made after due diligence in the form of an exercise. The FSA knew a lot about the group, so there was knowledge. The FSA ran their model. It was the FSA which determined how much capital they wanted to put into the business. I would consider that to be diligence. In the ordinary sense of a team of people going in to do an exercise called due diligence, there simply was not time.

Q848 Sir Peter Viggers: It does not reconcile with the statement by the Chancellor of the Exchequer, "... having regard to the difficulties faced in the economy as to what the liabilities of the banks might be. That is why it took what was regarded as a cautious view."

Sir Fred Goodwin: I am sorry, I think the Chancellor's statements reconcile exactly with what happened.

Q849 Mr Breed: Sir Tom, you said earlier that you do not personally have any banking qualifications. How many members of your board have banking qualifications?

Sir Tom McKillop: I do not have any banking qualifications, but I was on the board of Lloyds TSB for nearly six years and obviously have been in positions as chief executive ---

Q850 Mr Breed: How many members of your board have?

Sir Tom McKillop: The board of RBS had over 300 man or women years of financial services experience and over 160 of those years of experience were with the non-executive directors.

Q851 Mr Breed: How many members of the board had banking qualifications?

Sir Tom McKillop: I would need to go through them, a number: Joe MacHale, Colin Buchan, Bob Scott, Peter Sutherland ---

Q852 Mr Breed: And they would have participated in core decisions?

Sir Tom McKillop: --- Larry Fish, so quite a number had formal banking experience.

Q853 Mr Breed: When you became chairman of the bank were you approved by the FSA at all? Were you interviewed? Was the FSA in any way involved in your appointment as chairman of the bank?

Sir Tom McKillop: The FSA has to approve any director of a bank, yes.

Q854 Mr Breed: Did they interview you?

Sir Tom McKillop: No, they did not interview me.

Q855 Mr Breed: So it was just a paper exercise that they signed off?

Sir Tom McKillop: They saw the full account of my history. They had approved me being on the board of Lloyds TSB.

Q856 Mr Breed: Looking at the risk management side, did you undertake yourself any training or go through any sort of educational experience to enable you to participate fully in any of the risk management decisions?

Sir Tom McKillop: Every director joining RBS goes through a very full induction programme involving exposure to each of the businesses and sessions with risk, finance and so on and I went through that process. In fact, I committed a very significant amount of my time ahead of becoming chairman to getting to know the bank as well as I could and that included detailed discussions with risk. Indeed, before I joined the board I carried out due diligence, including talking to outside directors, reviewing the high level control documents and reviewing the Arrow reports from the FSA of the bank.

Q857 Mr Breed: So you felt that, in terms of the risk management aspects of the bank, you were qualified through experience, knowledge and everything else to enable you to participate fully when you were talking about complex financial instruments and anything which might involve the risk management of the business?

Sir Tom McKillop: I would not describe myself as an investment banker with knowledge of every complex financial instrument, but, yes, I think I had a pretty good understanding.

Q858 Mr Breed: Lord Stevenson, you did not have any personal banking qualifications. How many members of your board had banking qualifications?

Lord Stevenson of Coddenham: The majority of our executive directors were career bankers. I suspect all of them had banking qualifications. I know of two who definitely did because I just happen to have talked to them about it or remember it from their CVs. In terms of the independent directors, we had the former treasurer of Bank of America, which is highly relevant to the thing we have been through, we had the person who had been head of all legal matters in compliance and risk for Standard Charter, and we had Tony Hobson who had been the long serving finance director of Legal & General.

Q859 Mr Breed: So overall you had a good breadth of experience on the board to be handling that?

Lord Stevenson of Coddenham: Yes. We set it and planned it that way.

Q860 Mr Breed: You may well have become chairman before the FSA or at about the same time. Did the FSA formally approve your appointment?

Lord Stevenson of Coddenham: I believe they did. I think there is a fit and proper person regime.

Q861 Mr Breed: So they did not interview you?

Lord Stevenson of Coddenham: I do remember going and having conversations with Howard Davies. I do not know if that was part of the fit and proper person regime. It was round about the time that I became chairman. They went through a formal process of agreeing me.

Q862 Mr Breed: Mr Hornby, you have explained the three levels of defence as such. Is it not the truth, however, that the siren voices, particularly from your group risk manager, were warning you that things were going in the wrong direction for quite some while? Is it not true that you overrode that and ignored those voices which were saying to you and the board that there was real risk in the business model of the bank?

Mr Hornby: No, I would not agree with that. I took over as CEO in September 2006. Let us look at the set of actions that were taken in the next 18 months to minimise our risk position. The first move we took was to stop share buyback programmes in order to preserve capital. It was recognised that the economy was going to get an awful lot more difficult and therefore I was extremely keen to make sure that we tried to pull back on handing capital back to shareholders. The second thing, which I think perhaps is more important, is we pulled back further on our mortgage market shares, which fell to 14% net lending in 2007 and down to 8% in 2008, which was considerably below the historical average. If we go back to 2002/03, HBOS was operating at around a 25% share of net lending. The third thing is we recognised the fact that the wholesale markets were getting an awful lot more difficult. We had already considerably extended the longevity of our wholesale funding. If I look back and say what could have been done differently, there is no doubt that if we could have gone even further on that over the previous five years that would have been a beneficial situation.

Q863 Mr Breed: So you are saying you responded to the concerns raised by group regulated risk?

Mr Hornby: Yes. There was a constant dialogue.

Q864 Mr Breed: Did you actually change the model of the business in response to the concerns raised by group regulatory risk?

Mr Hornby: Every month when we are looking at asset growth we would be having a dialogue both with the finance function and with the risk function in order to try and get to what we consider to be appropriate levels of investment.

Q865 Mr Breed: With the exact science of hindsight, did you perhaps recognise that those siren voices warning you of the problems lying ahead were a lot more relevant than you gave them cause to be and, in fact, that any changes you made were relatively insignificant, which then ultimately led to the demise of the bank?

Mr Hornby: I really do believe we listened to siren voices very carefully. It is clear with the benefit of hindsight that, over many years of reliance on wholesale funding, that left us in a vulnerable position. I do believe, though, particularly when you got to 2006-2007, that we recognised the lines. We tried to increase deposit growth and grew deposits faster.

Q866 Mr Breed: But that was all too late. If you had taken notice of what was being said to you a couple of years earlier you might not have got into that position.

Mr Hornby: I think if you look hard at the facts from 2006 and 2007 when I took over as CEO, we did try and preserve capital, we stopped the buyback programme, we reduced asset growth and we pulled back on mortgage market share. Of course, looking back, I would have liked to have done even more and I concur with the views that other people have said on the panel. We did not fully prophesize the complete closure of wholesale markets post-Lehman's when wholesale markets were operating on an overnight basis. We did prophesize reductions in liquidity. I believe there are very few people in the world who foresaw the complete clay and I regret that because clearly I would have tried to pull back even more.

Q867 Mr Breed: As an ex-retail agent, do you believe you are fully qualified to run a bank?

Mr Hornby: I actually had been on the board of HBOS for seven years previously. I believe I had acquired a lot of banking knowledge during that seven year period. When you look at the balance of the team, I had a finance director with over 30 years banking experience, a head of corporate banking with over 30 years experience, a head of treasury and international with over 30 years banking experience and a head of retail who was a lifelong banker. When you look at the executive team, those five key people had over 150 years of banking experience.

Q868 Mr Breed: Sir Fred, you were involved in banks in the past and looking at their regulatory systems and risk management systems. Did you ever override any recommendations from your risk management team or the Risk Management Committee in terms of pursuit of the expansion of the bank?

Sir Fred Goodwin: No. I would find this easier to reconcile in my mind if there had been a siren call that had been overlooked or overturned. As we go back through - and we have had occasion to do this more than once - the siren call is not there. It is easier now to go back and see things, but we did not see it.

Q869 Mr Breed: The acquisition of ABN Amro was one of about 26 or 27 acquisitions that you made in a relatively short period of time. It has been suggested that the vast majority of those acquisitions were perhaps not as bad as ABN Amro, but they were not considered great value for money when looked at in the cold light of day subsequently. How do you respond to that?

Sir Fred Goodwin: It is difficult to respond. I think, of the 24, most of them would be extremely small. Some would be better than others. As to the generality of it, they were all acquisitions that we were happy to undertake. They all went through the appropriate governance process. A number of them would have been approved by our shareholders, as the ABN Amro transaction was, and they were all done for the best of motives. It is a reality in business that you have to make judgments, you have to try and predict the future and you do not always get it right. As to our previous acquisitions, I cannot think of one offhand that was a glaring mis-step in the way that ABN Amro clearly was.

Q870 Mr Breed: But they were not startling successes either.

Sir Fred Goodwin: I do not think they need to be startling successes; just successes is fine.

Q871 Mr Breed: Sir Tom, is it your understanding that if RBS had been allowed to fail rather than to be bailed out then all bonus contractual arrangements would have ceased with them, so there would have been no contractual future bonus systems?

Sir Tom McKillop: I could not answer that from a legal point of view, I just do not know the legal details of all the contractual arrangements.

Q872 Mr Breed: If the bank failed and went into liquidation then surely all those contracts which were then entered into by the bank would have failed as well.

Sir Tom McKillop: That may be the case.

Q873 Mr Breed: Is that your understanding, Sir Fred?

Sir Fred Goodwin: I could not be sure, but employee related contracts usually have preference in liquidation. I do not know is the answer.

Q874 Mr Breed: Lord Stevenson? If they had failed then there would be no contractual arrangements in terms of service agreements.

Lord Stevenson of Coddenham: I imagine they would have a legal claim on the assets.

Q875 Mr Breed: It would be the same as a creditor, which would be nothing.

Lord Stevenson of Coddenham: I cannot see where they would be in the queue.

Q876 Chairman: Andy, you said in answer to Colin Breed that, in terms of the creation of the reliance in the wholesale market, you did something about it as chief executive, but you were a Board member before that, from 2001. Was there any time on the board when you voted against it?

Mr Hornby: No. In the period before I was chief executive - and Denis was chairman through this period - as reliance on wholesale funding was growing so we tried to increase the longevity of the wholesale funding. From memory the amount that was maturing within one year fell from 60% to about 47% of the wholesale funding as we tried to reduce the longevity. I accept the fact that with the benefit of hindsight we could have done even more.

Q877 Mr Tyrie: Mr Hornby, you have said that you listened very carefully to siren voices. Lord Stevenson, you have said that you exercised good countercyclical caution. You have also said, Mr Hornby, that HBOS had very elaborate risk testing systems in place, or perhaps it was Lord Stevenson. Your ex-Head of Group Regulatory Risk tried to use those very systems to protect the bank and when he tried he says that he was subject to "threatening behaviours". Is that true?

Mr Hornby: Absolutely not.

Q878 Mr Tyrie: He has made it up, has he, when he says, "My team and I experienced threatening behaviours by executives when carrying out our legitimate role ..."?

Mr Hornby: I have absolutely no recognition of what he might be referring to. I assume you are referring to the period way before I was chief executive. I really do not know what is being referred to. All I can say is that in my experience of watching HBOS executives interacting with risk professionals both before and after I was CEO, I saw people in a constant dialogue and really trying to face head on into issues. I do not recognise that behaviour.

Q879 Mr Tyrie: He says that board minutes failed to record his expressions of concern that the bank was going too fast. Is this true, Lord Stevenson?

Lord Stevenson of Coddenham: No, it is not true.

Q880 Mr Tyrie: He has made that up as well, has he?

Lord Stevenson of Coddenham: I think that is using an emotive phrase. People say things. I am familiar with the episode and the issue. I think I am right in saying that as a result of the allegations we commissioned a very extensive independent study of everything together with the FSA which clarified this, which is the basis on which you are getting such a robust response from us. If I am right about that, I think it would be absolutely in order, though I shall check, for that to be made available to you.

Q881 Mr Tyrie: So all these completely unsubstantiated allegations the FSA themselves would not recognise, is that what you are saying?

Lord Stevenson of Coddenham: The allegations were made.

Mr Hornby: If you go back to 2005, there were a whole series of reviews that we were constantly doing internally often with external help and always in conjunction with the FSA. The FSA personally reviewed the sales culture you are referring to and we made sure that we implemented all the recommendations with very close co-ordination with the regulator. It is as simple as that. That would be the case with all the various risk management reviews that have been done over the last eight years.

Q882 Mr Tyrie: Did the FSA uphold your repudiation of all his allegations?

Mr Hornby: The FSA - this is before I was chief executive so I cannot speak for every point of detail here - were very clear that our action plans that we put in place on the back of all the various risk reviews that had been done were logical and they monitored our performance against them.

Q883 Mr Tyrie: Is it not the case that the FSA in their report wrote, "There is a risk that the balance of experience among senior management could lead to a culture which is overly sales focussed and gives inadequate priority to risk"?

Mr Hornby: That clearly is in the report. We went through everything with them in huge detail. If you look at the balance of the senior team, we had colossal banking experience, an average of 35 years.

Q884 Mr Tyrie: I am not challenging that there are experienced people there; I am challenging that they used it effectively. I am not suggesting that your bank could have possibly escaped the crisis, all banks have been hit; I am challenging the view that you did not take reasonable steps in light of very clear warnings that were being made from within your bank.

Mr Hornby: As we outlined in our submission, we did try and make radical changes. We have all accepted the fact that the balance sheet growth that had been built up over many, many years meant that we did end up over-reliant on wholesale funding. We would have liked to have predicted an even greater contraction in wholesale funding markets. I think it would be difficult. I accept the fact we did not fully prophesize it. I do not believe that was because we were not listening to the risk function.

Lord Stevenson of Coddenham: We are talking here about our retail business. At any point in time, of course, we are reviewing our risk management and the balance between sales and caution at any point in time. Just to be absolutely clear and we would be happy to supply backup on it, we did a clear review of it, at the end of which the FSA regarded the matter as closed. We are very happy to give you all the information you need to back that up.

Q885 Mr Tyrie: So it is the FSA that also got it wrong, is that the suggestion? I hope you do not disagree with the view that the statements of caution he was making on the points of substance were wrong, that you should have gone hell for leather with all these sales and that the balance of risk that you took at the time was right. You began with an apology today.

Lord Stevenson of Coddenham: I do not disagree with that at all. It is the right frame of mind for any banking. It is a balance.

Q886 Mr Tyrie: So you got it wrong but in your defence you are saying the FSA got it wrong as well, is that right?

Lord Stevenson of Coddenham: No. What you have referred to were some allegations that were made which were independently investigated and the FSA were satisfied with them. I am very happy to provide you with all the backup to that.

Q887 Mr Tyrie: I will just ask the same question again. You agreed that you got it wrong, that you did not correctly assess the risk. Everyone is agreed that banks did not do that. You are therefore presumably agreeing that Mr Moore correctly identified one of these risks to which due attention was not paid. Is that correct?

Lord Stevenson of Coddenham: I would say it is not correct. I understand the thrust of your question. The fundamental mistake, if that is the word, that HBOS along with many other banks in the world made was failure to predict the wholesale collapse of wholesale markets. Mr Moore's allegations were nothing to do with that. They concerned a perfectly reasonable area for concern which I and my colleagues have been constantly concerned about, which is the balance between the sales culture on the one hand and caution and integrity on the other. The area, as we have said in our submission, which has caused HBOS problems has been the collapse of wholesale markets.

Q888 Mr Tyrie: You are saying that even with the advantage of hindsight you got the balance between that sales culture and the risks that it might generate correct. You are unrepentant about the judgments you made even with the advantage of hindsight. Is that correct?

Lord Stevenson of Coddenham: You are forcing me into a corner. The truth is that there is no absolutely correct balance in any part of our business or any other bank's business. I think if you were to examine our retail business over the last few years you would find that we had not got it very wrong, particularly the thing you are talking about. Just to be absolutely clear, going right back to what both Andy Hornby and I said at the beginning, we fully accept that we failed to predict what happened in wholesale markets.

Q889 Mr Tyrie: You said that you had not got it very wrong which must mean that you got it roughly right. Is that right?

Lord Stevenson of Coddenham: Right. The other side of which is ---

Q890 Mr Tyrie: Why are you apologising if you got it roughly right? I am left bewildered now.

Lord Stevenson of Coddenham: It is apples and lemons. We are apologising for what happened to our business and we have made it plain that the key factor that affected what happened to our business was the collapse in the wholesale markets. That is not the issue that Mr Moore is raising and you are raising.

Q891 Mr Mudie: There are shades of Adam Applegarth here, ie there was nothing wrong with you, it was the market and the extreme credit crunch, the breakdown of wholesale markets. Is that what you are saying?

Lord Stevenson of Coddenham: No.

Q892 Mr Mudie: What are you saying? We did not bring you here, contrary to what the press think, to cause you public humiliation. We brought you here to find out what happened, to hear how we avoid it happening and what steps we should take. There are two chairmen here. What is causing the anger in the public's mind is that you are in denial. Your group risk manager said you were selling too fast, too much and it was very risky and you sacked him. You come to this Committee and you say to Andrew, "He got it wrong. We got it right." You are the ex-chairman and he is the ex-chief executive officer who got it right. Why are you the ex-chief executive and ex-chairman if you got it right?

Mr Hornby: What our submission clearly says is that the balance sheet growth that had been put on over many years, from the inception of HBOS in 2001, meant that we were overexposed to wholesale funding when the wholesale funding markets closed. That is indisputable.

Q893 Mr Mudie: That is Adam Applegarth.

Mr Hornby: The balance sheet growth that we put on, no one is taking away responsibility for that and we are very clear on that in our submission. I think the point which Denis is making and which I completely comply with is about the complete closure of wholesale markets in the way that they did completely close. We did take a lot of premeditated actions in order to try and reduce our reliance on those markets. Clearly if we had seen the fact that they were going to close entirely coming we would have done even more even earlier and even quicker. We do accept the fact that the building up in the balance sheet over many, many years meant that we were reliant on wholesale funding. The contrary point is that we did try. We would have liked in retrospect to have done even more. We did take action to recognise the risk there.

Q894 Mr Mudie: Nobody is suggesting you did not. You ran a business in a way that got caught out when the market conditions changed. I interrupted you and said Adam Applegarth. He got abused right, left and centre for his extreme model. You ran not exactly the same sequence but a flawed model. You ran something that when the market conditions changed your business is in a very bad way and you are an ex-chief executive officer.

Mr Hornby: Yes. It actually goes back many, many years in that the former Bank of Scotland business was largely reliant on wholesale funding that did not have a retail deposit base in the UK.

Q895 Mr Mudie: I know that. We are all aware of that. Just accept it. Do not try and equivocate, et cetera, et cetera. You did something that was applauded whilst you were making a lot of brass. It turned out to be dodgy when the market conditions changed. We can move on when you say that is it to decide how we can adjust external factors or even internal factors to prevent this sort of thing happening again. Is that not the way forward?

Mr Hornby: I completely agree. We have already said that the building up of reliance on wholesale markets was what has left us vulnerable.

Q896 Mr Mudie: That means risk. What Andrew is questioning is the fact that you sacked a barrister, a fella who had been complimented at various times by various people. A senior figure prevented him from putting something in the board minutes which said you were running a risk here. He says in his memo to us, "When I was Head of Group Regulatory Risk at HBOS, I certainly knew that the bank was going too fast (and told them), had a cultural indisposition to challenge (and told them) and was a serious risk to financial stability ... and consumer protection (and told them)." That is what he is saying. You equivocated when Sally asked you and you further equivocated when Andrew asked you. You sacked this fella. He took you to an industrial tribunal and he won. We are told you paid him undisclosed damages and put a gagging order on him. In fairness to a bank learning lessons, it seems to us in the Committee with this document that you did not want anybody being blunt with you about the risks you were running.

Lord Stevenson of Coddenham: I understand exactly what you are saying. First of all, I remember the incident very well. It was taken very seriously by the Board at the time, with the Chairman of the Audit Committee, Tony Hobson, doing it. We commissioned an independent study into it. I am very happy to provide all the materials to the Committee about it. I do think that in a number of areas it is a fact that very carefully arranged risk management systems developed over the years with our regulator did not spot scenarios coming out that have come up. The stress testing did not stress test adequately. I am being very open. There is nothing in denial about that. I am just being very open about it. How that is changed in future is a hugely important issue.

Q897 Mr Mudie: Not only did you sack him, the person you appointed in his place had never carried out a role as a risk manager of any type before. The individual had primarily been a sales manager and was a personal appointment of the Chief Executive Officer and was against the wishes of other directors. Does that not worry you, if that is true?

Lord Stevenson of Coddenham: It is not true. The board took it very seriously. It was a major preoccupation. The board was briefed on it by the chairman of the audit committee with personal responsibility on it. We delayed the appointment of the person you are talking about, who is an outstanding executive, until the independent review had been carried out and until the FSA and ourselves were happy with it.

Q898 Mr Mudie: Andrew made the point that, at the end of the day, you sacked your group risk fella for the warnings he gave you. Now, four years later, it turns out he was right and you were wrong.

Mr Hornby: This incident you are referring to was with the former chief executive back in 2005.

Q899 Mr Mudie: You were on the board then.

Mr Hornby: I was on the board. When James proposed the appointment, as he did, of Jo Dalton to take on that role, I, along with many others, thought it was a very good appointment. She had huge banking experience built up over many years.

Q900 Mr Mudie: In risk?

Mr Hornby: In many matters very pertinent to risk management.

Q901 Mr Mudie: We are arguing about risk. You sacked this fella and then you appointed someone else who this gentleman is suggesting had no - and I did not mention a girl or her name in fairness to the individual - risk experience of any kind. Your chairman says that the individual who gave us this is telling lies on this point. Can you just confirm that you are saying she had risk experience?

Mr Hornby: No. What I said was she had many years of working in the banking industry, including in risk management.

Q902 Mr Mudie: How come your chairman said she did?

Mr Hornby: She had not had a formal risk title, but she had many years of working in the banking industry within risk. If you talk to the chief executive who took the decision, he made sure he strengthened the risk function alongside in response to the report and in response to all the other actions.

Q903 Mr Tyrie: You have made specific denials on a wide range of issues raised by Mr Moore which taken together appear to challenge all the substantive points that he has made, that the risk culture was out-of-kilter in your bank and you appear to be blaming everything on the collapse of the wholesale markets. You will correct me if you think I have misinterpreted what you have just been saying. His allegations are very specific and detailed. He said at paragraph 2.13, for example, "I told the Board they ought to slow down but was prevented from having this properly minuted by the CFO. I told them their sales culture was significantly out of balance with their systems and controls." Is it true that he was prevented from having his concerns properly minuted?

Lord Stevenson of Coddenham: I am not aware of that communication. We took it very seriously. We had over a nine month exercise investigating it. May I suggest that we make that available to the Committee? You would be free to talk to the FSA about it who were involved in it. The one thing I can assure you, there is no denial, anything to do with risk is taken very seriously by the board.

Q904 Chairman: Paul Moore said that prior to HBOS, from 1995 to 2002, he was a Partner with KPMG's Financial Sector Practice specialising in regulatory services and advised a number of FTSE100 companies. He says in paragraph 3.19 that he was dismissed by the then Chairman, James Crosby, who said, "The decision was mine and mine alone" but refused to explain why. He then goes on to say that what this has led to is "... millions of people in excessive debt, 10,000s who will lose their jobs and many more whose balance sheets have been impacted by the precipitous fall of the HBOS share price ..." That is his accusation which is on the record. To be fair to yourselves, if we engage in this correspondence it will help us because we want to be fair to everyone.

Lord Stevenson of Coddenham: Yes.

Q905 John Thurso: I want to look at the issue of corporate governance and the role of non-executive directors. Before I do that, can I say to you all that my constituents will appreciate the full apology you have given because I have rarely had so much anger expressed to me over the last few days. I did not know that my constituents knew the Treasury Committee existed let alone what was going to be happening today. It is because so many businesses are today in danger of failing, because they cannot get sound businesses and because they cannot get that money. I think that is appreciated. Let me turn to the question of corporate governance. Every time we get bankers from failed banks appearing in front of us we get the refrain - and I have heard it this morning - that we could not see it coming, it was wholly unpredictable and it was this great financial tsunami that arrived out of nowhere. At the base of all this is a failure to calculate, measure and manage risk and we have seen it before. If you look at Salomans in 1992, if you look at long-term capital in 1998 and many other examples, actually the core is there. What I really want to find out is what role the non-executives can and should play and what they did play and whether there are lessons in that. Perhaps I can start with you, Lord Stevenson. What part did your non-executives play in the oversight of risk and the risk management strategy?

Lord Stevenson of Coddenham: I will have to elaborate a little bit to answer your question on the structure that Andy Hornby mentioned to you. Each of our businesses had a risk function. Then there was a separate independent group risk function which had five committees for each category of risk, liquidity risk, asset and liability, market risk, operational risk, et cetera, which met regularly on a monthly basis and has met more often in the last 12-18 months, particularly on liquidity. Then there is the audit committee which operates independently. As we have been referring to so far, there are subsidiary audit committees which we call risk committees for each business and each of those committees was chaired by a non-executive member of the board with at least one other non-executive member of the board on it. At the level of each business, quite aside from what was happening on the Board, which I will come to in a moment, there were at least two members of the board regularly meeting to consider all the risk issues in each of those businesses. Let me come to the board. As I said earlier on in response to the question from Ms Keeble, there was a direct line between the head of risk and the board and, of course, to state the obvious, the chairman of the audit committee was on the board and a very important member of it.

Q906 John Thurso: Was there a direct line from the head of risk straight to the chair of the audit committee?

Lord Stevenson of Coddenham: Yes.

Q907 John Thurso: So he could circumvent the CFO if he chose to?

Lord Stevenson of Coddenham: Yes, as could I, as could he. It would be instructive to just look, if you want to pursue it, at our board meeting agendas in recent years where I think you will find there has hardly been a board meeting without a substantive chunky discussion on risk. I think it is relevant and I understand the frustration, but all issues on risk were fully ventilated at the board. That does not mean to say we got it right, but there was a completely open society, I do assure you. Basically the board, quite rightly, was responsible for setting the risk appetite. Every year it reviewed that formally and it would review the risk appetite for every part of the business anew and, if necessary, do it more often.

Q908 John Thurso: Do you think non-executive directors with an institution as complicated as a bank and dealing in things that we have learned even full-time bank execs did not understand are actually capable of having any relevance in the process?

Lord Stevenson of Coddenham: That is a very leading question which could apply to all complex businesses. We talked earlier on in response to the question from Mr Breed about the composition of the board. I think boards have to be very carefully and thoughtfully composed because you need to have people on them who can really burrow down and understand what is going on. I referred, for example, to John Mack, the former treasurer of the Bank of America who really understands the treasury function. Secondly, and this reflects no more than conversations I have had with prospective directors, you need to have people who are prepared to invest a lot of time in learning. If you take Basel II, that is less on the agenda now than it was, the members of my board had to go through session after session on it; it was like being at school and being educated on it. HBOS is a comparatively simple business in the scheme of things. We did not do investment banking. We did not have a lot of the complexity of other businesses, but it is still a large complex business. For directors to be able to add value (a) it is a good idea to have some directors who have been there done it, which we did, and (b) you should not have any directors who are not prepared to invest a lot of time in going up the learning curve.

Q909 John Thurso: Are there any recommendations out of this experience that you would make for the role of the non-executive future composition of boards?

Lord Stevenson of Coddenham: You are asking a question which I do not think I have got a precise answer to. Perhaps I could go back to the exchange we had with Mr Mudie. I do think that there are real issues about how stress testing is carried out and risk management takes place. I imagine we are not unlike many other large banks, but we stress tested regularly. In answer to your question, I would be very confident that the non-executives really got underneath the stress testing that was carried out. We would have serious debates about it, looking at possible scenarios. The question is why we did not foresee certain scenarios. The question is whether there could be a category of non-executive director who brings that to bear. I do not know.

Q910 John Thurso: Where I think I am going is that I am coming to the realization that a board of part-timers will never actually be able to deal with things that are as complex. Whether that goes to other industries, I do not know, but there is a heck of a difference between a £500 million company in the hotel industry, which is relatively straightforward, and a £100 billion company dealing in complex financial instruments. It may well be that the senior independent has to be a full-timer who is paid to make life difficult and that is his job.

Lord Stevenson of Coddenham: The issue of non-executive pay that you raise is an interesting one. When I became chairman I looked at what was then called the Section 39 FSA Report, which is the equivalent of the Arrow reviews that I am sure you are familiar with, which had some fairly harsh things to say about the audit committee process, et cetera, et cetera. I then looked at actually what was required of the audit committee and I realised it was huge, so we re-specified the job. We had to get someone with hugely relevant experience who was paid to devote a lot of time to it, which we have done and I think that has stood us in very good stead. I am broadly sympathetic to where you are coming from. We put a lot of trouble and time into this. There is a lot of talk about not enough bankers being on boards, but it is very difficult to get non-executives with banking experience on boards. I know because I have been there. We put a lot of time and effort into getting a board with enough experience of having been there and done it.

Q911 John Thurso: I think you need a few who are not bankers. Those have to be prepared to invest a lot of time. Sir Tom, I think you are quoted as saying that the RBS board non-execs were not a group of "patsies". We have evidence here from one of your principal shareholders who told us that they had been putting pressure on you to get rid of the CEO and on the senior independent to get rid of you. How do you square what he told us with what you said?

Sir Tom McKillop: What he said was absolutely accurate. It was one part of a collection of inputs from the major institutional shareholders. There were other institutional shareholders who had quite contrary views. All of those meetings which were held with the institutions were minuted, the summary of all of that was put to the whole board and it was all considered by the board. There were institutions which were very keen to ensure that Fred Goodwin stayed because of his experience in the integration of NatWest. There was some very, very strong lobbying to see that he was not removed. Likewise, there were institutions who wished me to stay. I can assure you that at the time of the April rights issue I spoke with each director, got their views on all of this individually, the non-executive directors met as a group without me and the whole board met. I indicated to the board at that time that I would step down if that was in the best interests of the bank and indeed I have reiterated that on several occasions over the course of the last year. I would always do what is in the best interests of the bank. There was never a question of trying to hold on. The evidence you received was one piece of input and it was not the general view. Indeed, I understand ABI consulted a number of shareholders in a meeting and there was not an agreement that they should seek the removal of the chief executive and myself. We need to see it in that context.

Q912 John Thurso: I want to pick you up on two points that you mentioned earlier, one of which was that you said that at every stage the board were unanimous in their decisions, this was regarding ABN Amro. Obviously when the board makes a public decision, it is a decision and people do not dissent from that. Was the board truly unanimous all the way through? Was nobody saying, "Hang on, guys, this looks a bit odd"? Was anybody dissenting?

Sir Tom McKillop: Thank you for the opportunity to put a bit of colour on this because I think it would help to understand how the board of RBS and indeed, in my experience, a number of other boards would work. In RBS we typically have a dinner the evening before the board meeting and during the course of that whole evening there is extensive discussion of whatever the matters of the day are. So there is lots of air time for ideas, views, what is going on in the economy and so on. I think the input from a whole range of well-informed non-executive directors is very important in setting the framework for a company. Your suggestion of having maybe one full-time independent director risks missing out on that. It will be interesting to see what Sir David Walker's review comes up with. Typically there would be a lot of discussion the evening before and we would deal with all the formal matters of the board during the course of the next day. Doing it that way meant items did not suddenly come on the table proposed by the executive for a decision and a vote was taken. There would be a consensus building, an exchange of views and an enormous amount of challenge went on. In the ABN Amro deal, for instance, everyone wanted to do some part, but there was a spectrum of opinion about which elements of the business we should take or make an offer for. That is an example of the kind of discussion that would take place.

Q913 John Thurso: Do you not think that iterative consensual process leads to "deal-itus" where the desire to end up doing a deal takes over from everything else?

Sir Tom McKillop: No, I do not. I think there is a danger that that could be the case, but that was not my sense of what happened in the RBS board.

Q914 John Thurso: You said something which I thought was remarkably profound at the beginning, which was to draw our attention to the historical difference between the investment merchant banking culture which has come about almost entirely from a partnership background, where the whole point is at the end of the year everybody chops up any money there is and they all get a bit of it, and the commercial retail banking background which is traditionally a joint stock company in which fairly staid and conservative Scotsmen actually end up conserving and guarding the money of ordinary people. I put it to you that one of the problems is that these two cultures actually simply cannot mix, that non-executives have no idea how to get a handle on the swosh-buckling investment types and that the only way we will deal with this is to get some form of glass ceiling.

Sir Tom McKillop: It is a very interesting subject for discussion. There have been lots of discussions taking place on the universal banking model, ie will investment banks survive per se. It looks as though they are all moving away from being pure investment banks unless they are very "boutiquey". There is a really interesting discussion to be had here. Around our board table we did have several non-executive directors with real experience of investment banking and they brought that experience to bear in the audit committee and so on as well as round the general discussion. The larger an organisation becomes and the more complex it becomes then you can argue the more difficult it is to control it. That is a subject that has merited a lot of discussion. I would point out, however, that in this crisis as many, if not an awful lot more, small banks, single line banks, have gone down than big banks or required funding. There are many, many single business line operations that have suffered in this crisis. So it is not just a matter of the size of the banks.

Q915 John Thurso: The really phenomenally economy shaking problems have been the world size institutions with tendrils in every business.

Sir Tom McKillop: I would submit that Lehman's was the trigger for so much damage and Lehman's was not a universal bank.

Q916 John Thurso: I have to say, 99% of my constituents feel that if a great black whole opened up and every merchant banker in the world and arbitraged trader and credit derivative inventor disappeared down it the world would be a better place and could we get back to Captain Mainwaring running a bank we could trust!

Sir Tom McKillop: I recognise that sentiment!

Q917 Chairman: Sir Tom, you mentioned a dinner the night before the board meeting. Was the finest malt served the night before?

Sir Tom McKillop: No. These were working dinners, Chairman.

Q918 Chairman: What do you think your qualifications as a chairman were for this job? The reason I am asking that is not to have a go at you because I respect the distinguished career you have had in the pharmaceutical industry, but there is something deeper here we have got to get to. Why do you think you were qualified to be the chairman?

Sir Tom McKillop: I had a very strong numerate background. I am a mathematician and scientist by background. I carried out post-doctoral research in an applied mathematics institute in Paris, so I am certainly numerate. I had five years on the board of Lloyds TSB. It was not the same bank as RBS became, I accept that. I also have had extensive experience of chairing organisations and being chief executive of one of the world's largest pharmaceutical companies. I was involved in major cross-border mergers and indeed in really complex transactions. I think I had a fairly good understanding of these matters.

Q919 Chairman: When I look at the board of Royal Bank of Scotland, you had the brightest and the best. You had Sir Peter Sutherland, who was chairman of BP and Goldman Sachs and the director general of the World Trade Organisation, you had Bob Scott, the senior independent director, the former group chief executive of Aviva and ex-chairman of the board of the Association of British Insurers, and you had Steve Robson, a former Second Permanent Secretary to the Treasury. He was there with Terry Burns when the tripartite authority was established. I could go on. The best and the brightest were there, Sir Tom. There has to be something more fundamental here. Do you not think that the vulnerability was greater than you realised because of the sheer complexity of the products or inadequate monitoring and that perhaps you did not understand the complexity? We had the auditor from KPMG here and I asked him, if he sat down for a night and looked at HSBC's books for the night, could he fully understand it and he said no. Even the brightest and the best cannot understand that complexity. We could not have better qualified people. There has to be systemic problems here. I put it to you that the expansion of new financial instruments increased the complexity to such an extent that people did not really understand them.

Sir Tom McKillop: I agree with the thrust of your question. I would say the four best things I have read around this crisis are the speech from the Governor of the Bank of England recently in Nottingham, Lord Turner's lecture at the London Economics Group, the Financial Stability Report and also the IFF report.

Q920 Mr Love: Nothing from the Treasury Committee?

Sir Tom McKillop: I have not read anything yet. Maybe the magnum opus is to come! A very common theme comes out from all of these that I would subscribe to.

Q921 Chairman: Lord Stevenson, do you accept the thrust of what I am saying?

Lord Stevenson of Coddenham: I think you are following on from what Mr Thurso said. These are large complex businesses even when, as in our case, they do not do investment banking activities and it is a very challenging question as to who are the right people.

Q922 Chairman: The Governor of the Bank of England has almost said the same thing in his evidence to the Committee. If it is a complex financial product and if we have got the brightest and the best there - and you are one of the brightest and the best, Sir Tom - there is something we need to do to remedy this situation.

Sir Tom McKillop: Can I give you my own view here of what has happened? Securitisation, the originate and distribute model, was seen as a stabilising influence in the financial systems. It has been discussed in many forums that I have participated in. This was distributing risk. This was making the whole system more stable. It has not turned out that way. It has turned out completely the opposite to expectations. Everyone has been surprised about that, the regulators, the companies and the banks involved in it.

Q923 Chairman: For four or five years we have had the best and the brightest before us and when I asked the question, "What is the risk?" they say, "Mr McFall, times are different. When you went into your bank 30 years ago the bank kept most of the risk. It is now sliced and diced and it is parceled off. Mr McFall, with Amaranth, the hedge fund that went down, $7 billion, do you know what happened? There was not a ripple in the financial sector. So you are way behind the times."

Sir Tom McKillop: This is a diagnostic of the underlying thinking. This was stabilising. What happened when Lehman's went down is that people realised they did not know where this distributed risk was and then a freeze took place There was a complete lack of confidence, you did not know who you could deal with and the whole thing cascaded from there.

Q924 Chairman: I put it to you that Peter Sutherland, yourself and others, Steve Robson, did not understand it, not because you did not have the facility, but because of the complexity of it and therefore, as far as the future is concerned, we need to do something about that.

Sir Tom McKillop: We had no idea of the speed and the interconnectedness and how quickly it could all have turned out.

Q925 Mr Todd: I want to explore the HBOS risk control arrangement again because, turning to the memo that Mr Moore has sent us, he draws attention to the process of deciding who would be in charge of the risk control committee for retailing. How did you make that appointment? You have mentioned this committee-based approach to risk led by a non-exec.

Lord Stevenson of Coddenham: The chair of each risk committee must be an independent member of the board.

Q926 Mr Todd: And this one was.

Lord Stevenson of Coddenham: However, there have been situations where we have deliberately recruited people to the board because we saw the need for someone with the relevant experience.

Q927 Mr Todd: The person who was selected for this post was Charles Dunstone, who I think most people would regard as an extraordinarily experienced and high quality entrepreneur.

Lord Stevenson of Coddenham: And a retailer.

Q928 Mr Todd: Would he be the appropriate person to be a challenge to the business in terms of the risk profile in retailing?

Lord Stevenson of Coddenham: Anyone who knows Charles Dunstone knows that he is a serious challenge as a general proposition. The no "patsie" applies to him in spades! Charles would be the first to say he has got a specialist financial background. Charles Dunstone made a huge investment of time in going up the learning curve of the risk management function and yes, he did bring to bear serious challenges at various points. We innovated having risk control committees. We thought the whole thing was too big to have one audit committee, it was too complex and we wanted to disaggregate it. There is a perfectly good argument which says, "In an ideal world wouldn't it be good to have people chairing and leading those committees with a more specialist understanding?"

Q929 Mr Todd: I think one can say he provided challenge in terms of the retail techniques and the approach that might be taken in that sector and normally a very supporting challenge, I would imagine, but perhaps not one which would necessarily look at the area of risk itself in retail banking. That is what I am hinting at. I am going back to the issue of the culture of your bank, as to whether the decision making in making that key appointment suggested, not that we wanted to challenge the senior executive who was at that time Mr Hornby, but instead was a supportive figure who would actually more suggest additional ideas for improving the innovation in retailing, and that is perhaps not what people would have understood as the function of the chair of a risk committee.

Lord Stevenson of Coddenham: As it happens, I think Charles Dunstone fulfilled the role extraordinarily well, but I should have explained earlier on that for some years now, recognising the point that we are discussing, we have tried to recruit - and this is very unconventional - outsiders to risk committees who have specialist risk financial backgrounds. I think I am right in saying that when Oliver Page retired, who was an ex-FSA person, we recruited him to the retail committee.

Q930 Mr Todd: You will forgive us for not being entirely reassured by that reference.

Lord Stevenson of Coddenham: He has a specialist cradle to grave understanding of risk management. Similarly John Ormerod, the former senior partner in one of the accountancy firms, et cetera.

Q931 Mr Todd: I am more making the point that it is the culture that perhaps that particular appointment suggests to me as an outsider. Let me turn to another area of challenge which is the institutional shareholders. Sir Tom, you have made reference to discussions over the specific issue of whether Sir Fred should be persuaded to go. Can I look more at the ongoing relationship with institutional shareholders? How did that work in RBS?

Sir Tom McKillop: As chairman, I made sure I offered to visit and discuss with the top 20 or so institutions every year on all kinds of corporate governance matters, on anything that they wished to feed into the board. During the course of those I invariably invited them to telephone me and let me know any input they had for the board. Some would follow up on that and some would not. On average I would speak with them twice a year.

Q932 Mr Todd: Characterise that relationship.

Sir Tom McKillop: That was my relationship, but then you have the investor relations programme which is led by the chief executive, the finance director and so on.

Q933 Mr Todd: I am more looking for whether at any stage any of these institutional shareholders expressed any concerns as to the business model, the approach to acquisitions of your bank or were they merely challenging you perhaps to deliver higher earnings for their shareholders?

Sir Tom McKillop: There is no doubt - and my experience of my institutional shareholders goes back beyond the bank - it would be a very unusual institution that was not seeking a company to grow and to deliver more earnings or better dividends or whatever. That is a kind of given, that they would always be pushing the organisation to perform better and I do not blame them for that. With that kind of background you would get into very specifics. I had been chairman for just under three years. I would say the drift from the most institutional shareholders was increase the dividend, share buybacks, return capital, do not sit on capital and run a very efficient balance sheet.

Q934 Mr Todd: Raise your leverage.

Sir Tom McKillop: That would be the body of opinion that I was receiving in the early phase. Of course, as it went through, towards the end of 2007 people became much more preoccupied with capital ratios and saying you need to consider raising your capital ratios, which is why in January 2008 I went out on a very deliberate programme across all the major institutions to take their views on, "If we need to increase our capital, what mechanisms would you prefer? Asset disposal, rights issues and so on." I was having those kinds of discussions and feeding all of that into the board so that we could frame options, but even then you would have a very wide diversification of views.

Q935 Mr Todd: Can I explain my theme. This is about challenge, if you like, to the bank. What you are reinforcing is the commonsense view that actually through the good times these guys were not challenging at all, except in the sense of "please give us more", yes?

Sir Tom McKillop: By and large.

Q936 Mr Todd: I would assume that is roughly what your experience was at HBOS?

Lord Stevenson of Coddenham: A simple example, Basel 2. The general view was that Basel 2 would lower the amount of capital required for housing finance organisations and I cannot remember but one of the other mortgage banks announced they had reached agreement on Basel 2 with the FSA and there was going to be less capital employed, which is obviously good for shareholders. Immediately we came under huge pressure to make a similar announcement and you feel it. In fact, Andy Hornby's predecessor, James Crosby, is to be greatly commended because I remember we discussed it as a board and this illustrates other points which have been raised today. We discussed it as a board, and James said to the board that the regulator has his or her view as to what our capital level should be, but we need to work out the level of capital that we think is right for the business and so we refused saying it publicly, but we were definitely under that pressure.

Q937 Mr Todd: You are presenting yourselves gently as victims in this process?

Lord Stevenson of Coddenham: No. What can be quite plain, the denial, absolutely not. What is is what is. The institutions are the shareholders and it is our job to remember ---

Q938 Mr Todd: But remember our job is to look at their role too.

Lord Stevenson of Coddenham: Yes. Broadly I would not disagree with their finding.

Q939 Mr Todd: Can I turn to one of the other challenge areas, which is the FSA relationship. In both institutions I would assume that you had an almost implanted FSA presence, a very regular oversight on a constant basis. Tell us a little bit about that in your experience. Yes, let us start with you, Sir Tom.

Sir Tom McKillop: I met with the FSA perhaps twice in the course of a year as part of the close and continuous. The FSA also met with the non-executive directors as a group and would present to the board as part of their normal process. Beneath that there was this close and continuous process that Fred referred to and that was very regular at all levels through the organisation.

Q940 Mr Todd: Just again for our understanding, do you recall alarm buttons being pressed at some point, the FSA beginning to express concern? When did that happen, if it did?

Sir Tom McKillop: When I joined RBS I was very pleased to read the Arrow Reports. There was clearly an improving relationship, and a good relationship. That was confirmed in the Arrow Reports and the discussions with the board. There was a very full and open relationship. In addition to the meetings I have referred to, when we get in to 2008, when there is concern about capital, on two occasions I had conversations with the Chairman of the FSA about the options that the board were considering on capital. He was certainly encouraging us to raise capital at that point.

Q941 Mr Todd: Yes. I think it is fair to say that after Northern Rock the FSA probably started pressing buttons in all sorts of places because it was fairly obvious they had not been doing much in that business at all. Is it the same sort of experience in HBOS?

Lord Stevenson of Coddenham: I think Andy should pick that up.

Mr Hornby: Just to describe the way the relationship worked, I will keep it brief. The close and continuous arrangements meant that not only would each divisional chief executive meet very regularly with the FSA, certainly that dialogue was constant in every division and you typically had a different part of the FSA looking after different parts of the organisation to make sure there was proper expertise. The second part of it is that the FSA not only had regular meetings with every senior executive director but would meet regularly with Tony Hobson, who chaired our audit committee, and to whom the risk committees - to go back to the earlier discussion - formally had a route up to report. Mr Tyrie that was done, Chairman, you can look through Tony Hobson's diary and I would be very surprised if you do not see him in meeting not only before every set of results but at least a quarterly update in between to go through the trends of the business purely from an independent director standpoint as chairman of the audit committee.

Q942 Mr Todd: It sounds a very comfortable, comforting relationship, not one ---

Lord Stevenson of Coddenham: No.

Mr Hornby: Clearly you mentioned Northern Rock and the vast majority of my time period running the business was post-Northern Rock.

Q943 Mr Todd: Although your executive experience precedes that.

Mr Hornby: Yes, indeed, but even in the executive period before I think there was a good and fair degree of challenge. A lot of store, as Sir Tom has already said, was placed around the Arrow Review process and making sure that everything was properly followed through. Lastly, I think the most important thing is the degree of belief the FSA must have that they are hearing about issues quickly.

Q944 Mr Todd: Okay. The last area of challenge is short selling and hedge fund activity. HBOS was claimed to be subject to rumour mill activity to reinforce short selling. Was that something you complain about or do you instead compliment some of these people on their prescience in understanding your business better than quite a lot of other people did?

Lord Stevenson of Coddenham: I think you have to distinguish between short selling, which is illegal, based on spreading false rumours, and short selling. As I mentioned earlier in this room I have no truck at all with the former and we suffered from that in March. Rumours were circulating that were completely and categorically untrue and were immediately denied. As regards short selling, we are widely quoted as being against it and I have to tell you in all frankness we are agnostic. It is a very difficult issue and I very much hope that the Treasury Select Committee will shed light on it.

Q945 Chairman: Okay. Sir Tom, just a quick point, who are the disembodied people who are expecting risk to be defused by the originate and distribute model? Are you one of them?

Sir Tom McKillop: At the discussions I participated in, for instance at the International Monetary Conference, and IMF type meetings, I would say lots and lots and lots of very well informed people genuinely imagined that was the case.

Q946 Chairman: You thought risk was taken off your books?

Sir Tom McKillop: No, not that risk was taken off your books, you could never assume that, no, no, no, but you had more stability ---

Q947 Chairman: You must be precise. It is originate and distribute, which means it is off your books, so did you think with originate and distribute you still had the risk on your books?

Sir Tom McKillop: Some of it is off balance sheet, not all of it is off balance sheet because it is distributed. There are technical matters here. We are not talking about the balance sheet per se, we are talking about whether or not ---

Chairman: I just want to clear, do you feel that risk was dispersed?

Q948 Mr Mudie: You must let him finish. We are not talking about the balance sheet, tell us what we are talking about.

Sir Tom McKillop: We are talking about a general phenomenon here where you have a whole series of loans or whatever the assets are that are backing the distributed product and by these being distributed rather than held by single institutions it was perceived that would be a stabilising influence on the whole financial system. That you will find in abundance in all of these reports. That was a perception widely held.

Q949 Chairman: Sir Tom, I cannot understand you because the reason is this, if you are the Chairman and you have an originate and distribute model, and they tell you the risk is dispersed, then you can look at your company's books and talk to your staff. Were you quite content that the risk was dispersed and you did not realise it would come back to you? You had a £28 billion loss last year.

Sir Tom McKillop: We never imagined the parts we were holding, a large part of it was triple A or super senior, we never imagined, as Fred said earlier, that could end up as 10 cents in the dollar.

Q950 Mr Fallon: Lord Stevenson, you have put up a lot of smoke about your dependence on the wholesale markets, but can we just look at the other issue in your submission, your exposure to the UK property market. It is a fact, is it not, that your highest paid banker, your head of corporate lending, Peter Cummings, was lending £40 billion of your £100 billion loan book to construction and property companies?

Lord Stevenson of Coddenham: Yes.

Q951 Mr Fallon: He said as recently as February 2008, I quote, "Some people look as if they are losing their nerve, beginning to panic even in today's testing property environment, not us". Did not one of your directors spot in February 2008 that you might be a bit over-exposed to a falling property market?

Lord Stevenson of Coddenham: Yes. We were already by then lowering our growth, as it turned out by not enough. I would say to you absolutely frankly it is quite clear, with the wisdom of hindsight, that we were over-exposed, that we lent too much at the wrong parts in the cycle. Simple as that.

Q952 Mr Fallon: I want to be clear about the governance here. Sir Tom talked us through the dinners they had before every board meeting and so on. What happened on your board? Was Peter Cummings running an empire within an empire?

Lord Stevenson of Coddenham: Absolutely not, and, given the risk management system I have described, it would have been quite impossible for anyone to do it. On the issue of property, the fact is we made some mistakes and that is the bottom line.

Q953 Mr Fallon: How did your board allow him to invest 40% of your loan book in property as late as February 2008 and take equity stakes in all these companies?

Lord Stevenson of Coddenham: He was not doing that in February. You are talking about an historic accumulation. Clearly, given the deterioration in markets and the deterioration in asset values, we lent too much and his division lent too much. That the board was hugely engaged in it, I can assure you. Hardly a board meeting passed without issues, not just about that part of our business but also the housing finance part of our business which I am glad to say we retreated from, we lowered our share much earlier. But there is no question, Mr Fallon, we made mistakes.

Q954 Mr Fallon: At what point did your board realise you were over-exposed in property?

Lord Stevenson of Coddenham: I put it differently. The Bank of Scotland has always been a specialist in commercial property. The exposure as a percentage of the balance sheet to commercial property has not increased dramatically over time, that is not what has happened. Looking back, with the wisdom of hindsight, we did not foresee the deterioration in asset values that took place, it is as simple as that.

Q955 Mr Fallon: What is the answer to my question? At what point did the board realise that your bank was over-exposed to the property market?

Lord Stevenson of Coddenham: We were constantly reviewing it through different systems. The reality is when asset values started to tumble out of bed is the short answer. We had already started to go back in 2006, as Andy Hornby has described, and we continued in 2007, pre-Lehman's, during the summer of 2007 we were reducing growth very sharply and turning away deals and of course post-Lehman's we did virtually nothing.

Q956 Mr Fallon: That is not what Mr Cummings said, he said, "not us", "we were not losing our nerve in February 2008".

Lord Stevenson of Coddenham: I do not know the context of the quotation but my judgment, and I would be nervous about taking it out of context, is what in practice they were doing, and this was the public position of the business, was we were in a situation where we were already rationing capital, I make it quite clear to you we were, our public position - I suspect that is where the quote has come from - was saying if we have to choose between customers we will stay with our existing long-term customers. The answer is read literally it is a mistake.

Q957 Mr Fallon: You have said what they were doing, this was your business, you were the chairman.

Lord Stevenson of Coddenham: No, we were, I am quite happy to put "we".

Q958 Jim Cousins: Sir Fred, your successor at RBS has said, "RBS leveraged itself too much in good times". When did you form that view of RBS?

Sir Fred Goodwin: Relatively recently, Mr Cousins. As Tom mentioned earlier, we had run a tight balance sheet for a very long time. It was something which was openly and regularly discussed with our shareholders. We had been encouraged to keep it that way, to do new share buy-backs and to increase the dividend. We increased the dividend by 25% two years in a row, in 1995 and 1996. 1997 was only 10%. That was the path we were on. When we came up to the ABN Amro transaction we proposed a funding mechanism there again to the market. We were very transparent about how it would be funded and the leverage which would be applied within that. As market conditions started to tighten up, late 2007, early into 2008, we were focused more on the funding side and conditions eased somewhat, not back to where they had been previously but we were funding the bank relatively well. During the course of 2008, the period from May to August, we raised about £20 billion of new funding. We raised £3 billion of new funding in the beginning of September 2008, and then Lehman's happened. The degree of leverage became a material issue quite late on in the piece as the funding started to dry up, but it was something which was very transparent about our model all along and it even predates me.

Q959 Jim Cousins: The Bank of England assessed in October 2008 that the combined losses of British banks were about £123 billion, that was as at last October, much of it, of course, incurred outside the UK. What do you think the position of RBS was at that point when you were still in charge? What was their contribution to that £123 billion of losses and how much of that loss had come from outside the UK?

Sir Fred Goodwin: I do not have a precise figure to hand but a big part of it would have come from the United States. The positions that we held, and the credit market write downs, not all, but would be preponderantly coming out of the Greenwich Capital business which was a business we had in the United States.

Q960 Jim Cousins: Coming to Greenwich Capital directly, of course it is a matter of record that is where the biggest bonuses were paid. The accounts show a loan book of well over $100 billion and virtually no cash. When did you form the view that this was not a well-founded business?

Sir Fred Goodwin: I think the issues at Greenwich started to really come home in March 2008. As we moved through 2007 the problems in the sub-prime market were becoming apparent, but in the first instance they related to people who had made direct loans to people who were sub-prime. We had as a matter of policy never done that within the group so that seemed like an issue which was sitting over here. Insofar as there was sub-prime in our book it was wrapped up in instruments which had an investment grade credit rating and in many cases had monoline insurance with them as well. It was only as we progressed through 2007 that we got to the place where by December 2007 we had in our trading statement announced we were going to be taking provisions of £11/4 billion against the position that we held. We still reported record profits after taking that provision.

We thought at that time that that provision was enough to deal with the issue. It was only as we got through in to March 2008 that the valuations dropped on the back of the Bear Stearns collapse, the valuations fell away and that was what triggered the process which took us into the rights issue to go and raise more capital. That is not to say that £11/4 billion was not seen as a serious matter but we thought that was the end of it, it was only in March 2008 that it really started to look a lot bigger.

Q961 Jim Cousins: It is important to bear in mind, of course, that Greenwich was not an acquisition it was yours, as was Citizens, another United States financial institution, one of the largest providers of car loans in the United States, one of the largest providers of home loans against equity in homes, one of the largest mortgage providers in the United States.

Sir Fred Goodwin: No, not mortgages.

Q962 Jim Cousins: When did you form the view that it would be sensible to have doubts about the way the Citizens business was going?

Sir Fred Goodwin: I think we would adopt a healthy scepticism throughout but the other thing you have not mentioned ---

Q963 Jim Cousins: A healthy scepticism throughout.

Sir Fred Goodwin: One of the features you have not mentioned about Citizens is it was also one of the biggest deposit takers in the United States. Citizens had a very well balanced book of business. Traditionally, in fact, it had a preponderance of deposits and lent a lot of money to the US Government. It came from a background of preponderance and got to a more balanced position a number of years ago, but we maintained a fairly healthy scepticism and credit quality in Citizens for some time. We did not do any sub-prime lending by choice or by policy. Citizens' credit quality has regularly positioned it in the top half a dozen banks in the United States for credit. It has had its issues, but the Citizens' story in that respect is a good one and it is a distinct story from Greenwich Capital insofar as Greenwich is involved in the sort of products we have touched on a number of times this morning. Citizens does not have those, Citizens is a much more straight forward operation.

Q964 Jim Cousins: Because there was leveraging between Citizens and Greenwich Capital.

Sir Fred Goodwin: The positioning of funding and financing around all the group companies was organised from the centre.

Q965 Jim Cousins: What do you think now are the losses on Greenwich and Citizens?

Sir Fred Goodwin: I do not know.

Q966 Jim Cousins: You do not know?

Sir Fred Goodwin: I no longer have access to that information.

Q967 Jim Cousins: What were they when you left?

Sir Fred Goodwin: By the time I left, the announcement that was made on 4 November would capture that, at that point credit market write downs in total were about £9 billion.

Q968 Jim Cousins: What was the figure?

Sir Fred Goodwin: I think £9 billion was put forward in the table that was published on 4 November. It was £11/2 in RBS for 2007, about 900 in ABN for 2007, these do not all relate, some of this relates to leverage finance as well, there was £5.9 billion which we announced at the time of the rights issue in which we booked our results, the interim results for 2008, and it was announced there was another 200 in the third quarter of ---

Q969 Jim Cousins: But you will see, Sir Fred, the British taxpayer is now standing behind these loan books. It is standing behind one of the largest car loan businesses in the United States. Do you not now have a lot of concern about that?

Sir Fred Goodwin: It is a fact that the taxpayer is standing behind a large part of the business. This has always been in the business, this is not a new development. The credit quality in the US has deteriorated as it has deteriorated in the United Kingdom, but we are a bank and we do lend to people to buy cars, we lend to people to buy houses, that is part and parcel of the business that we do. Citizens is a very large bank. The rankings will all have changed now as there has been bank consolidation in the United States but their operations in the United States would have made us about the sixth largest bank in the United States. We have 27,000 people working for us in the United States.

Q970 Jim Cousins: I do not take the view that British debts only are for British taxpayers, I do not take that view. Does it not cause you concern, Sir Fred, that a lot of the support the British Government is making, a lot of the loans the British Government is about to guarantee are not loans inside the United Kingdom, they are to support these activities of yours in the United States?

Sir Fred Goodwin: That has been part and parcel of our business model throughout. We are an international bank, we have operations in Europe, we have operations in Asia, we have operations in the United States of all kinds. We take deposits, we lend money.

Q971 Jim Cousins: The day after Lehman Brothers went down you circulated on your internal networks inside RBS a statement that RBS was in a strong financial position and doing good business in over 50 countries around the world. That was not right, was it?

Sir Fred Goodwin: It was at that moment.

Q972 Jim Cousins: It was at that moment, even after all those events. The day after Lehman's, that was right?

Sir Fred Goodwin: The day after Lehman's not much had happened. What happened after Lehman's was in the ensuing fortnight. Lehman's is now widely accepted, even more widely recognised than it was at the time, as being the trigger. The day after Lehman's there was a need in the business for our people to have reassurance. At that point we had recapitalised the bank, we had published interim results which were well received. The consequences of Lehman's in direct first instance did not look dramatic to us. You have raised a very important point. The issue which brought RBS to the position was a loss of confidence in the bank, it was not specific losses at that point, it was not the capital ratios at that point, it was concern about what was coming down the pipe. The day after Lehman's that crisis of confidence in the bank and in the financial system generally had not matured. It rapidly built up over the next fortnight.

Q973 Jim Cousins: Sir Tom, I wonder if I could ask you, do you recollect any discussion at the board of the enquiries that the Securities and Exchange Commission were making into the mortgage book of RBS in the United States from May 2008?

Sir Tom McKillop: Into the mortgage book?

Q974 Jim Cousins: The enquiries that the Securities and Exchange Commission were making, the investigation they had mounted into your mortgage loan activities in the United States.

Sir Tom McKillop: We were notified that the SEC was investigating a whole series of banks, including us, who were engaged in securitisation of mortgages. Yes, we were aware of that. We had no specific information of what they were after or what their concern was.

Q975 Jim Cousins: Do you recollect any discussion of exchange rate risk?

Sir Tom McKillop: Of exchange rate risk? Exchange rate risk is always there.

Q976 Jim Cousins: You have this vast loan book in the United States - car loans, securitised vehicles, in Greenwich Capital well over $100 billion - was there any discussion of exchange rate risk?

Sir Fred Goodwin: Perhaps I could answer that.

Q977 Jim Cousins: I am sorry, I am asking the Chairman of the board. You will understand why governance issues are primarily for the Chairman.

Sir Tom McKillop: As a specific it was not a major topic at the board but I am sure it would have featured in the audit committee discussions.

Q978 Jim Cousins: You do not recollect anything?

Sir Tom McKillop: I do not recollect any major discussion apart from the normal risk that a bank of our sort has, a major international bank has huge flows of money across all currencies, that is part of your day-to-day business.

Q979 Jim Cousins: Do you recollect any discussion at the board of the difference between the way you record securitisation vehicles in British accounting and in American accounting and in particular the difference about when you can say such a securitisation has taken place and has been solved? Do you recollect anything of that?

Sir Tom McKillop: In the early phases of this through 2007 certainly not. Awareness has grown about these details, they have been in the press and so on. These things have become more aware in the course of 2008.

Q980 Jim Cousins: Do you recollect any discussion of whether and how you should record on your own balance sheets the exposures you were taking on through ABN Amro, through Greenwich, through Citizens and a variety of others?

Sir Tom McKillop: Every time we were reporting results there was extensive discussion of those sorts of matters and that would be preceded by intensive discussion with the audit committee and the external auditors.

Q981 Jim Cousins: Sir Tom, have you either asked for or been given any legal advice on the nature of criminal negligence?

Sir Tom McKillop: I have not asked for any advice on criminal negligence.

Q982 Mr Love: Sir Fred, can I ask you, following on from those questions, how leveraged was RBS at the time of the Lehman's dissolution?

Sir Fred Goodwin: I think there would have been a variety of different ways of looking at the leverage ratio.

Q983 Mr Love: I am just looking for a rough idea, order of magnitude.

Mr Fred Goodwin: Towards the higher end but there would be others higher than us. We would have loans to deposit.

Q984 Mr Love: What was the ratio?

Sir Fred Goodwin: 110% but there would be others similar to that, there would be some higher and some lower. We were to the right of the middle, we were at the higher end of the middle.

Q985 Mr Love: Mr Hornby, can you tell us what it was for HBOS?

Mr Hornby: Yes, our loans and advances were around £450 million, our customer deposits were about £250 million, therefore the percentage of one to the other was around 57%.

Q986 Mr Love: The reason I ask that question is that one of the reasons the hedge funds gave for us not being too worried about their activities - and these are meant to be high risk organisations - was they claimed that their leverage was much lower than the banks. Why would that be? Has the world turned upside down in banking?

Sir Fred Goodwin: There are a variety of different leverage ratios so I would like to make sure that we are comparing like with like. I am not sure that we have just compared like with like. Our loans were 110% of our deposits, that was the position we were in. As to measures of leverage of a hedge fund, I think those would be different. I find it a hard comparison to make. I am not trying to avoid the question.

Q987 Mr Love: Do you accept the point they made that they were not as leveraged as the banking system?

Sir Fred Goodwin: I find it hard to take hedge funds in the generality. There are hedge funds and hedge funds and some of them that I have seen are pretty highly leveraged. I am sure there are some that were less leveraged.

Q988 Mr Love: I do not want to get into a technical discussion of the matter. Let me move on because all of you have made the point that no-one predicted the consequences of Lehman's and the seizing up of the wholesale market, so we all share responsibility in that, yet you were the executives of two of the three banks that have had to access public funds. Why did you have to access them and not the other banks? I do not want you to tell us what the other banks do. Why did you find yourself in the position of having to access money from public sources?

Sir Fred Goodwin: I think it was a combination of events. We were larger, we were by far the largest of the banks that have accessed the support. The business mix, we had business in these areas and I think, by virtue of the ABN Amro transaction, our capital ratios were lower than some of the others', so, coupled together, I think, when it came to that point about loss of confidence, there was a general loss of confidence in the financial system, but the spotlight shone on us for that very key moment at the beginning of December when we saw the share price come down and when rumours did leak about banks being supported in the UK, and our line was that we were going to need to support, the spotlight fell on us and our share price dropped 60% or so in two days.

Q989 Mr Love: Listening earlier on, I got the impression that you accepted that ABN Amro was bad timing. Was it a bad decision?

Sir Fred Goodwin: I think that, as we currently sit here today, I can only say that it was a bad decision. Who knows in years to come, but right here and right now it was certainly mistimed and I think that, if we knew then what we know now, we would not have taken the risk of finding out.

Q990 Mr Love: Well, let me come back to that and let me just ask, Andy Hornby, was it rapid growth that was your downfall?

Mr Hornby: In our case, as we outlined in the submission, it was the combination of being property-based on one side of the balance sheet with a significant reliance on wholesale funding on the other, so it was the total reliance on wholesale funding.

Q991 Mr Love: Okay, let me come back to that. Sir Fred, I read with interest the biography you gave to us which tells us that you were number one in Scotland on Sunday's annual power list for several years in a row, European Banker of the Year in 2004, European Business Leader of the Future as well. Did any of that go to your head?

Sir Fred Goodwin: I would like to think not. I do not know that being number one in the Scotland on Sunday's power list is something you would wish for. I do not think that these are things have gone to my head and, even if they went to my head, they did not go to my Board's head.

Q992 Mr Love: Can I ask you, Mr Hornby, you were a Managing Director in Asda before you were 30 and you were the CEO of HBOS before you were 40. Did your reputation as a wunderkind affect you in any way?

Mr Hornby: I really do not think so, no.

Q993 Mr Love: You do not accept that that evokes any consideration? We have asked the question the other way round, but let me ask it to you. This Committee thinks that a banking qualification is quite important. Do any of you think a banking qualification per se is important? I only want to hear from someone who does because I am assuming that you do not consider it a particularly important consideration. Right, can I then move on and ask, Mr Hornby, were you brought into the bank for your marketing skills rather than for your banking skills? Would you accept that as a rationale for why somebody was plucked out of Asda to take over at HBOS?

Mr Hornby: I was not, to be clear, Mr Love, brought in to take over HBOS, I was brought in to run a division of, what was then, Halifax and then became HBOS, as part of a very well-balanced team where everybody else on that board had 20 to 30 years' banking experience.

Q994 Mr Love: But you said earlier on that aggressive growth was very much at the centre of what HBOS was at during that time. Would you accept that, while things were going well, we were living in benign times, if I can put it like that, that was a sensible strategy and it may well have hit the buffers when things changed?

Mr Hornby: I think that the good performance of the business through the years when it was growing clearly showed that good profit growth was being delivered, as has proven to be the case now. We would have liked, in retrospect, to have delivered less of that growth through wholesale funding.

Q995 Mr Love: Sir Fred, I think your original reputation is of a somewhat aggressive accountant, if I can put it that way, but you soon developed a reputation for takeovers, the National Westminster Bank being a very successful one. Did you become enamoured with your own reputation for takeovers so that a natural consequence of that would be that, when you took over ABN Amro, which I think quite a lot of comment at the time suggested, it was a takeover too far?

Sir Fred Goodwin: I do not think so. I do not think I got overly enamoured with my own reputation. In fact, if you look back over the period of my tenure, by far the bulk of the growth we achieved was organic growth and it did not come from acquisitions, but, you are right, NatWest happening right at the start and being such a long, drawn-out exercise to get the deal completed, it all went extremely well. I and my colleagues were associated with that and a lot of folklore went on around that. Since then, the transactions, and there have been a number, but most of them have been quite small. ABN Amro, as I think Tom explained earlier, the process for ABN Amro, the Board were enthusiastic about ABN Amro, our shareholders voted for ABN Amro by an overwhelming majority, so, if they had concerns, it did not manifest itself when they were given the opportunity to vote on it. Similarly, Barclays' shareholders voted on it in the middle of September, so there was still enthusiasm and, at that time, it seemed like a good thing to do. I bought a lot of shares in it the day it happened and I thought it was a good thing to do and we were excited about the prospects the business brought. The rest, I do not want to go back over it, but I am happy to, if you want me to.

Q996 Mr Love: No, I do not need you to go over it. Can I ask the two former Chairmen the same question and that is that one of the real central concerns about governance issues is whether or not part-time directors, including part-time chairmen, are really up to keeping a proper tab on the work of the full-time directors, in particular the CEOs. How would you respond, Sir Tom, to the concern that Sir Fred's reputation rather overwhelmed the board?

Sir Tom McKillop: I do not think that is the case. As far as my own position was concerned, I had an agreement and my letter of agreement with the bank said I would commit whatever time was necessary to do the job. I can assure you that it has not been part-time in the last many months, but it has been a very full-time commitment which has been made.

Q997 Mr Love: Lord Stevenson, do you accept any implied criticism that perhaps, having brought Mr Hornby in to expand the business, to do the marketing, you maybe took your eye off the ball?

Lord Stevenson of Coddenham: Can I make clear that we brought him in because of his reputation as a manager and a leader and not because of his marketing reputation, just to be absolutely clear on that. In response to the question you asked Sir Tom which you are now asking of me, no, I feel very comfortable that an engaged part-time chairman who develops the right relationship with his board, or her board, and the chief executive can do the job adequately. I think the question that has been raised around this table as to the need for specialist knowledge with increasing specialist business is a highly germane one. I would like to think I have invested the time to go up the learning curve.

Q998 John Mann: Sir Fred, you made the extraordinary statement to Mr Cousins in response to a question in that you defended the strong financial position and good business position of the bank on 16 September and, three weeks later, the Government was having to stick in £20 billion of capital to keep the bank going. I put it to you that you do not like criticism, do you? You like people who bring you the good news and you do not like people who bring you the bad news.

Sir Fred Goodwin: No, that is not correct. I do not think anyone likes bad news, but you have got to be a realist in my job and I have had plenty of bad news to deal with, as you can well imagine, so I cannot live in denial of the facts and I have to accept the good news and the bad news.

Q999 John Mann: But, with respect, you are in denial of the facts. Your own staff say that you brook no criticism and you are still defending the great position of the bank on 16 September and we are listening here, thinking, "Well, hang on a minute, three weeks later the Government's having to put in £20 billion to keep that bank going. Those two things do not add up". Is not part of the problem with your bank and your leadership that the culture created was one whereby you lived for the good times, you wanted the good times, and you did not want any criticism, and you wanted people to give you the solutions, not to identify the problems?

Sir Fred Goodwin: No, I do not agree with that characterisation, Mr Mann, but to go back, I was responding to Mr Cousins' question about the basis for the memo being sent and I was trying to explain the basis for the memo being sent and I make no more or less of it than that. My management style is something that evolves and changes, depending on the circumstances, but I believe I have led the bank in a responsible fashion with my colleagues and I have been equally receptive to bad news and good news. Of course, I wanted solutions rather than problems, but you cannot exist in a job like mine by ignoring problems, and I do not have a track record of ignoring problems or leaving problems undealt with.

Q1000 Mr Mudie: Securitisation has been important to both organisations, and Tom and yourself have referred to it specifically in terms of RBS. You both referred to credit agencies, the fact that they had a good rating. Now, this has puzzled us since this started 18 months ago because we kept being, and have continued to be, told by the credit agencies that banks were too-sophisticated users of ratings and they were not so naïve as to rely on ratings blindly, in other words, they would take the security, they would dissect it and they would decide on the risk themselves. Now, Fred, you said that ratings plus insurance were okay and Tom said just ratings. Now, are you telling us that you were not that sophisticated then and that the ratings agencies are trying to palm some of the blame off on to your good selves?

Sir Fred Goodwin: It may be both, but that goes, I think, to the heart of an important issue. The originate and distribute model started off at a relatively simple level and we were intermediaries in it, so we were bringing things in, packaging them up and selling them to investors. The reason that so much reference is made to the credit ratings is that that was the language, if you like, that we talk to investors in. We had our own ratings systems and assessments for risk, but, because the investors were wanting to buy, if you like, in a currency or language that they understood, that was the rating of the ratings agencies. So we could sit and produce this securitised product until we were blue in the face and attach our own ratings to it, but we would not sell any of it to investors because investors wanted the independent rating and the ratings agencies were paid to rate these ----

Q1001 Mr Mudie: Fred, what did you buy when you bought the stuff? Did you dissect it?

Sir Fred Goodwin: Yes, that was the essence of the business to begin with.

Q1002 Mr Mudie: Well, why did you not pick up the sub-prime stuff contained within those securities?

Sir Fred Goodwin: We did pick up some of the sub-prime stuff in them.

Q1003 Mr Mudie: And you sold it on?

Sir Fred Goodwin: Yes, but what we did was as an intermediary, so there were those people originating sub-prime mortgages who did not have the ability themselves to package them and distribute them, so we packaged them and distributed them, and that business can be conducted largely without incident and, when the music stopped, it cleared, as we would expect it to clear, so we had inventory which flowed either back to the originator or ----

Q1004 Mr Mudie: Fred, you said something very important there and let us clear it up. Were you aware of the sub-prime content of these securities because, if you were, you were part of the problem.

Sir Fred Goodwin: No, it was not sub-prime in our hands. We were doing it as agents for other people.

Q1005 Mr Mudie: Yes so, but I asked you again then, when you got stuff from other people, did you dissect it before you passed it on, and you said yes, so you must have been aware of the sub-prime part.

Sir Fred Goodwin: Absolutely, and I am agreeing with that, but that is what ----

Q1006 Mr Mudie: But then, as a banker, a sophisticated banker, could you pass these on with triple A, knowing the content, knowing that the houses that were being sold were being built and mortgaged in America, all over America?

Sir Fred Goodwin: These were knowingly being originated by professionals and sold on to professional investors and rated by their agents. The content was known and, when I say "dissect" it, what I mean is that that was the essence of what we were doing. We were taking a pile of sub-prime loans and packaging them up to different ----

Q1007 Mr Mudie: Yes, but you cannot pass them on as triple A.

Sir Fred Goodwin: Some of it you can.

Q1008 Mr Mudie: Then Tom said he bought them as triple A.

Sir Fred Goodwin: You can pass some of them on as triple A and the others are more junior. The interesting thing in all of this is that there was actually latterly a bigger appetite for the junior tranches than the seniors because the junior tranches, because of higher risk, had higher yield. This business went on for a long time and many other people were doing it. They were, so-called, "sliced and diced" and, if that was all that happened, we would not be sitting having this conversation today, I do not think, about this subject. As the industry went on, there became more and more demand from investors for more and more, so we started to get into doing the exercise with synthetics and other products related to sub-prime. One of the consequences of this was that it magnified the effect and individual loans were being referenced more than once. That is where you got a big multiplication that went on and that is where, when the music stopped, some of these were still held. It was thought that the junior tranches had been sold, that the most risky piece had been sold and was out there somewhere with someone else, and at least we were holding the super-senior and, in many cases, with insurance gone up and an investment-rate monoline against it one of the first shoes to drop in relation to this was that the monolines' credit rating started to come down because then you get too much exposure to this one thing and that began a process which had now led us to a place where the monolines have had to be written down and we have had to write down the underlying ----

Q1009 Sir Peter Viggers: Can I ask each of you, did you personally understand the full complexity of these vehicles that your clever young men were creating?

Lord Stevenson of Coddenham: The short answer is yes. We did not have many.

Q1010 Sir Peter Viggers: And you could dialogue with these brilliant young gentlemen making up these vehicles and you ----

Lord Stevenson of Coddenham: We did not have lots of brilliant young chaps making them up, Sir Peter.

Mr Hornby: We were not major players in this kind of market, Sir Peter.

Sir Fred Goodwin: No, I would not. That is part of the secret of how you risk-manage it.

Sir Tom McKillop: You said "full complexity" and I would say no.

Q1011 Nick Ainger: Just following on from that, from what Sir Fred was telling us, are you not culpable in some way. The excuse that we have had constantly is pointing the finger at the credit rating agencies, that they give the CDOs and so on triple-A ratings, but you are saying that you actually did really deep due diligence, knew that there was a substantial element of sub-prime and yet you still carried on dealing with them and ended up with them on your books. Are you not culpable for that?

Sir Fred Goodwin: We did not end up with those on our books. That is what I said.

Q1012 Mr Mudie: But you said that as ----

Sir Fred Goodwin: The willing buyer and willing seller. This was a business which was conducted and there was no secret about it and there was no subterfuge involved. Again, just to be absolutely clear, I am not pointing the finger at the ratings agencies, and I go right back to the opening statement made ----

Q1013 Nick Ainger: Well, you are the only one who is not.

Sir Fred Goodwin: Well, what I am concerned about actually, and I think it was referenced by a number of other members here, is that it is just too simple if you want to blame it all on me. If you want to blame it all on me and close the book, that will get the job done very quickly, but it does not go anywhere close to the cause of all of this.

Q1014 Nick Ainger: I appreciate that, but, as one final question, you appear to have lost £400 million in the Madoff scandal. Who did the due diligence on that of putting £400 million into what turned out to be a pyramid scam?

Sir Tom McKillop: That was an investment made by ABN Amro and it went through all the ABN Amro risk assessment processes, but it was completed before we were involved.

Q1015 John Thurso: Mr Hornby, one quick question regarding the merger: last autumn, before we became aware that there was a general problem throughout the banking system, Lloyds made an offer for you or you asked Lloyds to make an offer or whatever, but it was reported widely that this was the Government pushing that ahead as a solution to the then-perceived crisis. Fast forward five or six weeks and it becomes utterly clear that we have got a wholly different set of circumstances, namely that every bank is in trouble. Did you at any point consider going it alone and just being 100% nationalised, thereby leaving Lloyds without the problems you have and yourselves just being dealt with?

Mr Hornby: I think it is fair to say that, when we looked at the options we had, we looked at the benefits of pushing ahead with the Lloyds merger which, we felt, provided three benefits: first of all, vastly improved funding; secondly, greater security for colleagues over time, although clearly, when the integration comes together, there would be job losses, but we believed it would be, in the long term, a much stronger business; and, thirdly, benefits for shareholders. That was appraised against the pros and cons of going it alone, as you would call it, which we perceived to be of higher risk and, more importantly, not in the benefit of long-term stakeholders.

Q1016 John Thurso: After the problems had generally become known, did you have any discussions with the Chancellor or the Treasury as to that option because he testified to us that the decision was an entirely commercial one?

Mr Hornby: Yes, it was an entirely commercial one and we looked at the options we had. We were very aware that we now had, post the announcement of the Lloyds deal, security in terms of capital agreed, we had funding agreed, and I think anything that endangered that by our sort of reappraising would have been the wrong thing to do. Dennis, though, is on public record of equally saying that, had anyone chosen to come in with another offer, with another proposition for the board, we would have of course considered it.

Q1017 Chairman: You have all said that the banks were victims of an unprecedented event, the collapse of wholesale funding, and, as the bosses, you did not foresee that. Now, in future, therefore, when these financial tsunamis come along, the same excuses could be made, but, because of the unique nature of banking, and the future crisis may well happen again, which one of these three propositions are you more aligned with: first of all, if it happens again, the taxpayer accepts the risk and takes it on the chin, as happened here; secondly, relying on regulators to spot where the risks are when the banks do not see and to clamp down accordingly to prevent bank failure; or, thirdly, the Government taking action to separate risky investment banking from traditional retail banking?

Lord Stevenson of Coddenham: I cannot say to you that any one of them convinces me in the long term. If you want, the nearest I can get to it is that, in the event that there is another major market failure in the wholesale markets, I very much hope that the central banks of the world have a clear position on their attitude to banks using wholesale finance and a clear position as to what they will do in the event there is a market failure.

Q1018 Chairman: You have not answered my question, Lord Stevenson.

Lord Stevenson of Coddenham: I am afraid I cannot because you asked me to choose one of the three.

Q1019 Chairman: Because I want the banks to be safe places for their customers and it is the same question I asked at the very beginning: how can we ensure that banks are safe places for customers to put their money and that they feel confident in? That is what the public at the moment are feeling angry about.

Lord Stevenson of Coddenham: I understand that very well, and rightly so, and I am trying to respond to your question, Chairman, but I am telling you very straight that neither of the three I find a convincing, reassuring part about the future, but I would think number two with a clear definition of what the central bank and the Government's view is when markets fail.

Q1020 Chairman: Okay, it is not your fault then.

Lord Stevenson of Coddenham: No, just to be quite plain, I am not saying that at all.

Q1021 Chairman: Andy?

Mr Hornby: Chairman, I very much agree with something that Lord Turner said in one of his recent initiatives, that the challenge now is for banks and regulators to make sure that, through the good times, both enough capital and enough liquidity is maintained in the system. That means that banks in the future will have to keep too much capital and liquidity through the good times in order to make sure that there is more for the bad times.

Sir Fred Goodwin: Picking one from those three, I would pick number two, but I would not believe it was sufficient on its own to address this.

Sir Tom McKillop: I would say the same, but I think there are some things which do need to be addressed, do need to be done which we perhaps have not discussed today, but which I am sure that you and your Committee will discuss.

Chairman: Can I thank you for your time. It has perhaps not assuaged the public's anger, but we are hoping to have a fundamental look at this and your answers on the record this morning will be helpful to us, so can I thank you for your attendance.