

HOUSE OF COMMONS
TREASURY COMMITTEE

BANKING CRISIS - BANKS

Wednesday 11 February 2009

MR ERIC DANIELS, MR JOHN VARLEY, MR STEPHEN HESTER, MR ANTÓNIO HORTA-
OSÓRIO and MR PAUL THURSTON

Oral Evidence

Taken before the Treasury Committee

on Wednesday 11 February 2009

Members present

John McFall, in the Chair

Nick Ainger

Mr Graham Brady

Mr Colin Breed

Jim Cousins

Mr Michael Fallon

Ms Sally Keeble

John Mann

Mr George Mudie

John Thurso

Mr Mark Todd

Mr Andrew Tyrie

Sir Peter Viggers

Witnesses: Mr Eric Daniels, Group Chief Executive, Lloyds Banking Group, Mr John Varley, Group Chief Executive (Board and Executive Committee member), Barclays, Mr Stephen Hester, Group Chief Executive, RBS, Mr António Horta-Osório, Chief Executive, Abbey, and Mr Paul Thurston, UK Managing Director, HSBC, gave evidence.

Q1022 Chairman: Welcome to the Banking Crisis Inquiry that the committee is undertaking. Can you introduce yourselves for the shorthand writer, please, and your organisation?

Mr Horta-Osório: I am António Horta-Osório, representing Abbey, a subsidiary of Santander.

Mr Daniels: Eric Daniels, representing Lloyds Banking Group.

Mr Hester: Stephen Hester representing Royal Bank of Scotland.

Mr Varley: John Varley, representing Barclays.

Mr Thurston: Paul Thurston, Managing Director for the UK for HSBC.

Q1023 Chairman: Welcome. Before I came across, my good friend, the ex-Deputy Prime Minister, John Prescott, presented me with 23,000 signatures regarding bonuses not to be given, and I have had lots of emails over the past week or two, and letters. As institutions why do you think you are hated so much by the public? John Varley, give me your view considering you made a point in January about this.

Mr Varley: Mr McFall, I entirely understand why this is a matter of concern and interest and, in some cases, anger, because if you look at the failure in the banking system over the course of the last two years, it is clear that the banks have contributed to that failure and it is clear that part of that problem has been the issue of compensation, and I think that is what we are hearing and, if I speak for my own organisation, it is important that we listen and that we respond, and one of the things that I hope will come out of your work and the work that we are all individually doing as institutions is a compensation structure for the industry that looks right for the future. It is very clear to me that, not all, but some, aspects of it in the past have not served either the industry or society well.

Q1024 Chairman: Mr Hester, obviously 23,000 against RBS and the bonuses. From your role in the job maybe you can give us a fresh perspective on why you think the public have turned off you so much.

Mr Hester: I think I would agree, in the first case, with everything that John has just said, but there is clearly, at the moment, a difference which we have to get away from between the public's view of banks as institutions (and I think John gave a very good answer and analysis of that) and the public's day-to-day experience of us in terms of our services; and every day each one of the institutions here is serving many, many millions of customers, generally doing it well, of course

with exceptions, and what we need to do as fast as possible is get back to the situation where the public see us for the services we are providing and not for the headlines, and I agree 100% with that.

Q1025 Chairman: Eric, just quick response from you.

Mr Daniels: I think that there is probably a fair amount of misunderstanding on the part of the public about the bonus systems in banks. I think, first of all, we have to distinguish between investment banks and commercial or retail banks. One of the things that is not well understood---

Q1026 Chairman: The letters I am getting in these responses are about retail banks.

Mr Daniels: I do understand, Chairman, but I think that perhaps it is not well understood that about two-thirds of our employees who receive bonuses make about £17,000 a year. The average bonus that we give is about £1,000. This is something where, again, we have seen lots of very high bonuses for very specialised positions. That is not something that Lloyds TSB does.

Q1027 Chairman: I have been on the media in the past week and I have been lauding the fact that workers in branches who get between £15-25,000 a year deserve their bonuses, but we are looking at the traders, and we are looking at investments, and we are looking at the casino aspect. It is in respect of that issue that I am thinking about bonuses, Eric, not the branch members. I want quickly to ask all of you to confirm for the public record how much money from the public purse you have received for the purpose of recapitalisation.

Mr Horta-Osório: We have welcomed the scheme in October too, but we have not used any government money.

Mr Daniels: We have received 13 billion in equity and four in preference shares.

Mr Hester: We have received 15 billion in equity, five billion in preference shares. The preference shares are in the process of being converted to equity and there will be an offering to our shareholders of that amount.

Mr Varley: We have not taken government money.

Mr Mudie: British Government money.

Q1028 Chairman: We will come back to that. Maybe for the sake of Mr Mudie, other governments' money.

Mr Daniels: If you ask are there sovereign wealth funds who have invested in Barclays, Mr McFall, the answer to that is, yes.

Q1029 Chairman: We are coming on to other issues on that. Paul.

Mr Thurston: HSBC has not taken any taxpayer's money in the UK.

Q1030 Chairman: To RBS and Lloyds. For the public record can you, please, confirm what percentage of your organisation is now owned by the taxpayer? Eric.

Mr Daniels: Forty-three per cent.

Mr Hester: It is 58% and would rise to 70% if the shareholders do not take up their rights.

Q1031 Chairman: What does the taxpayer get in return?

Mr Daniels: The taxpayer, hopefully, will get a very good return on their investment, but, as you know, the preference shares have a coupon rate of 12% and the equity will depend on what our shares price is in several years, which hopefully will bring better rates of return.

Mr Hester: I hope that the taxpayers will get a few different things. First, I would echo Eric. It is our job to restore value to the shares of RBS and allow the taxpayer to sell out at a profit, but also we have a huge business here in the UK; we serve many millions of customers. Forty per cent of all payments in the UK go through RBS and the stability of our institution and our ability to lend more into the UK, which we are now doing, is something else that this money enables us to do, and we will do more of it. Finally, from a financial stability standpoint, the financial stability of RBS, I think, is highly in the UK's interest.

Q1032 Chairman: Of the Government schemes - recapitalisation, the Special Liquidity Scheme, the discount window, the Credit Guarantee Scheme, the Guarantee Scheme for Asset-backed Securities and the Asset Protection Scheme, the latter two not running yet - what use have each of you made of the various other initiatives like these by the Treasury?

Mr Thurston: HSBC has not required any form of capital or liquidity support.

Q1033 Chairman: You have never used the Special Liquidity Scheme?

Mr Thurston: We have been, in concert with all of the banks, asked not to make any indication whatsoever of any utilisation of the Special Liquidity Scheme - that was a rule set by the Bank of England - but I can say that we have no requirement for liquidity support or capital support.

Q1034 Chairman: You can understand where we are coming from.

Mr Thurston: Yes, I do.

Q1035 Chairman: Where the taxpayer is giving this money out, it is important from a transparency view.

Mr Thurston: We have required no support from the taxpayer.

Mr Varley: What I would say, Mr McFall, is that, as you refer to, there have been structures put in place both to guarantee wholesale liabilities and to create special liquidity arrangements. Our position is as HSBC's as to utilisation of the Special Liquidity Scheme. On the wholesale guarantee, there, as you know, there is a market price levied for the purchasing of those guarantees, and we have purchased some of those guarantees and we have issued debt as a result of it.

Mr Hester: RBS are significant users of the scheme. I am afraid I am under the same restrictions as to amount.

Mr Daniels: We have used both schemes, and we are under restrictions as to amount.

Mr Horta-Osório: We have a similar position as HSBC.

Q1036 Chairman: On a general point, would you accept that over the last ten years the profits of your industry have been privatised but the risks socialised? Stephen Hester.

Mr Hester: I think that there is an extent to which we are all learning the interrelationships in banking and society, and I think we have learned that in one sense of that word they are socialised, although it would also be the case that banks, of course, have been the biggest taxpayers to the economy over many years until now. Now the reverse is happening and that is a source of enormous sadness and disappointment.

Q1037 Chairman: The reason I asked that is I have looked at Woolworths as an example: 27,000 people unemployed at Christmas. The banks get £336 million of their money back from Woolworths; £100 million given to tier-one creditors; only 140 out of the 815 shops sold; the stock liquidated before Christmas. Twenty-seven thousand people unemployed, and the Government pay their unemployment. I think the banks are going to be in a privileged position compared with other sectors of the economy. Is that correct, Mr Varley?

Mr Varley: What I would ask is that you judge us by reference to the commitment we make to the economy. If I look at all the banks in front of you today, but certainly speaking for Barclays, I know that we take that responsibility with great seriousness. If I look at our own lending activities here in the United Kingdom in 2008 and I judge, for example, in the area of business banking, whether that is small businesses or medium-size enterprises or large business, those balances grew 14% year on year. I think that is an indication of commitment to the economy.

Q1038 Chairman: You have not answered the question I posed. The question I posed was: there are 27,000 unemployed as a result of Woolworths and the banks have been saved by the taxpayer, the taxpayer has stood behind them; so banks are in a privileged position. Given that you have not taken any money from the Government, is that not the case, António?

Mr Horta-Osório: But we have not taken any money.

Q1039 Chairman: No, but given that you have not taken, you are in a position to look maybe more objectively and say, look at how other industries are treated. Look at how the bank was treated. The bank was pretty privileged in that the taxpayer stands behind it and it is standing only as a result of the taxpayer, whereas other industries and individuals have to go to the wall.

Mr Horta-Osório: I would agree with you that banking is a critical industry to the United Kingdom, it is one of the major financial industries in the world, and that is why Santander decided to invest heavily in UK banking.

Q1040 Chairman: And privileged, Eric.

Mr Daniels: I do not necessarily think about it in those terms. What I would tell you is that Lloyds was, in fact, I think well capitalised. I did not think we needed state aid or capital. The facts are that HBOS had no chance of accessing capital, the capital that was required by the FSA in October, and, therefore, had to take the state package. As Lloyds in taking over HBOS, we said that as long as HBOS was going to take the capital that in fact Lloyds would as well. So I do not believe that we are in a privileged position. What we did is we took the state capital in an effort to not only takeover HBOS but to promote public stability.

Q1041 Chairman: If you had not bought HBOS, do you think you would have been in the same position as Paul and António?

Mr Daniels: I believe that we are, indeed, well capitalised today and I believe that the HBOS acquisition was a prudent one. Very clearly, over the next two years, as the economy goes through recession, HBOS and their higher risk portfolios will have some issues.

Q1042 Chairman: Do you think you would still have had to take government money, irrespective of whether you had taken HBOS or not?

Mr Daniels: No, we would not have had to have taken government money had we not bought HBOS.

Q1043 Mr Fallon: Stephen Hester, could you clear up for us who is going to decide RBS bonuses, given that you have the taxpayer as the majority shareholder? Is it ministers telling you what to do, is it their agency, UKFI, which the Chancellor says is working with you on management incentivisation, or in the end is it the RBS Board? Who decides?

Mr Hester: I believe that technically it falls to the RBS Board, but I could not imagine the RBS Board doing something over the violent opposition of the majority of its shareholders. As you say, we have one shareholder who is a majority, and so we are working very closely with UKFI to try to get the right solution.

Q1044 Mr Fallon: So it will be ministers, in the end, who will have to be content with your proposals. Is that right? I thought this relationship was arm's length.

Mr Hester: I cannot characterise it like that. What I would characterise it as saying is that I think all public companies try hard not to do things that their shareholders would oppose, and so in working through the very sensitive issue of pay at the moment, and specifically on the recapitalisation conditions UKFI has, if you like, rights of discussion on pay, we are trying to make sure that UKFI are on board with what we do, but, as I say, I think the decision rests with the Board and, obviously, if there were to be a difference between UKFI's view and our judgment of the views of our other shareholders, then the Board would need to take that into account and, I think, probably make that issue public and up for more debate. We are not at that stage yet.

Q1045 Mr Breed: Mr Varley, talking about the whole issue of bonuses and pay and such, it has been reported that one of your employees has been paid the staggering amount of £40 million in order to devise the best tax avoidance schemes possible so that Barclays can avoid paying legitimate UK corporation tax. Is paying somebody that staggering sort of amount to avoid tax an appropriate way for a UK bank to perform?

Mr Varley: The starting point is that I think we need to be careful in giving credibility to all media reports about pay and banks at the moment. In some cases they are accurate and in some cases they are not accurate.

Q1046 Mr Breed: Are they accurate in this case?

Mr Varley: They are not accurate in this case. I said earlier that it is important for us to be both receptive and sensitive to the spirit of the age as it relates to compensation at the moment. If I go to your question about Barclays as a taxpayer, if I look at the amount of tax that we have paid to the Inland Revenue here in the United Kingdom over the course of the last five years, it totals about

£10 billion, and I think it goes right to the statement made by Stephen Hester a moment ago, which is that I think it is in the interests of this economy here in the United Kingdom for banks to be profitable and for banks to create employment opportunities as a result of that and for banks to pay the taxes that go with those profits, and that is what we do.

Q1047 Mr Breed: If you had not undertaken the tax avoidance schemes, how much more would you have paid in tax?

Mr Varley: I do not recognise the statement that we have undertaken tax avoidance schemes. What we are required to do, as you understand, as a publicly owned company - by that I mean having institutional shareholders - is to manage our tax affairs efficiently, but there are very prescriptive and clear laws governing tax in the United Kingdom and, of course, we take it seriously that we have an obligation to abide by those.

Q1048 Mr Breed: But you will be aware that a number of schemes have emerged in the courts in recent years as to precisely that as exactly what you are doing: implementing complex tax avoidance schemes to lower the amount of tax that you pay to the Exchequer.

Mr Varley: That is not what we do. Indeed, what I have just said to you about the amount of tax that we pay would be irreconcilable with the proposition that we are seeking to avoid payment of tax.

Q1049 Mr Breed: One of the issues that surrounds all this is the fact that the taxpayer is putting moneys into banks, and they would expect them, therefore, to undertake their normal payment of tax. Mr Daniels, now that you are in receipt of taxpayer's money, will you stop implementing tax avoidance schemes?

Mr Daniels: I would tell you that we do not do anything other than adhere to the spirit and the letter of the law, and so I think that this is something---

Q1050 Mr Breed: So you do not undertake tax avoidance schemes?

Mr Daniels: The law is very clear about the amount of tax we have to pay, and we adhere to that strictly.

Q1051 Mr Breed: Mr Hester, lastly, I said yesterday to the witnesses that if RBS had failed and patiently gone into receivership, all the bonus and service contracts would have fallen with them and, therefore, anyone picking it up would have been able to start from afresh. The fact that the taxpayer has come in via the Government in order to prevent that taking place means that many of the bonus contracts and service contracts still exist. Do you believe (a) they should do, bearing in mind they would have fallen if it had failed, and (b) should the Government have actually ensured that before it put taxpayer's money into banks it received a commitment from that bank to ensure that all such bonus contracts would have been null and voided?

Mr Hester: I think this is very, very difficult territory, and I think it is rightfully the subject of public debate. Clearly, simply from my position, what we have to do is obey the law and so we are in the position of having to obey the law as opposed to having to make it.

Q1052 Mr Breed: So, basically, the bank got away with it, with the Government forgetting rather to cancel those service contracts?

Mr Hester: I would just make an additional point, if I may, that while I agree 100% with the public sentiment and share it myself in terms of unjustified rewards where they arise, it is interesting to note that actually, so far, when banks have gone bust (and the most recent example was Lehman's but we could use Bear Stearns before that) the vast majority of the employees quickly got rehired with, indeed, guaranteed bonuses extant at quite high levels.

Q1053 Mr Brady: Yesterday Andy Hornby told us 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, and he particularly highlighted short-term cash bonuses as being part of the problem. Sir Fred Goodwin went on to say that this should be looked at as part and parcel of what to do to prevent this sort of situation arising again, thinking perhaps more of those banks that are not in receipt of public support at the moment. Have you done anything to change your remuneration structures yet in the light of this experience?

Mr Thurston: At HSBC have been going through a period of adjustment on the bonus and incentive arrangements across the whole bank for some period of time. There are three key elements to this, I believe. The first is that you get the measures right, that the measure of success is not just driven by short-term profit but by measures that include quality of the business, the risk management in the business; the second, it is the quantum of bonus that is paid and making sure that is in line with the relative success of the business and the returns to shareholders; and the third is the method in which those bonuses are paid. We are increasingly moving towards deferral of bonus payments so that there is no immediate cash payment but there is a payment over a period of time. That process has been moving along, as suggested by the Chairman of this committee, and our remuneration committee at this moment in time are conducting a critical review of the payment levels.

Mr Brady: Has Barclays done the same?

Q1054 Chairman: Could we see that then? Could you send us that information?

Mr Thurston: Once we publish our results, announcements will be made on the bonus and incentive payments in HSBC.

Mr Varley: The system that we use, Mr Brady, at the moment, is that the more senior the executive the greater the deferral and the greater the component of the bonus opportunity that comes in shares to create alignment with our external shareholders. That system has been in place for some time. If you ask me whether we are reviewing our structures today, the answer is, yes. We have actually been conducting that review for some months now, and our intention is that at our Annual General Meeting we will share with our external shareholders the outcome of that review. The thrust of that review will be to try to ensure that the sort of safeguard that you are referring to is available, because I think it is important that bank boards are in a position where they can have some retrospection of performance. There are many systems in place that facilitate that, but whether they are as extensive as they should be is what we are reviewing at the moment. The one other thing I would say is that, as you know, the Financial Services Authority here has published its own views about best practice in compensation for banks, and there is a dialogue going on between all of us and the FSA at the moment to triangulate their assessment of best practice with how we perform. I am quite reassured by what I have seen so far as we have been through that triangulation exercise.

Q1055 Mr Brady: But you agree there is a problem and you have not yet got it right, you would say. You are changing your procedures again. You have not yet got the system in place that you want.

Mr Varley: I think that it would be, in my view, strange, given what has happened in the world over the last two years, for any bank to make a judgment that all is well in the compensation structure. It is absolutely right, as I said a moment ago, that we should listen, we should understand the views of the world about this subject and we should be prepared to respond and act. We have, under the guidance of our Chairman and a senior independent director in Barclays, a review going on at the moment and that will, I am sure, create change.

Q1056 Mr Brady: You will be getting rid of short-term cash bonuses altogether.

Mr Varley: No, I think it would be wrong to say that we will be getting rid of them, because if I go back to the comments that have been made earlier, for example, about our branch staff, it would be natural for our branch staff to be paid in cash.

Q1057 Mr Brady: I am talking about more senior executives.

Mr Varley: For senior executives, as I say, as they become more senior, as their compensation opportunity grows with that seniority, the ratio of shares rises very significantly.

Q1058 Mr Brady: A quick comment from Abbey.

Mr Horta-Osório: I would agree with what has been said, and especially in investment banking, as you were mentioning, there were clearly, in my opinion, flaws with the bonus system and there are two criteria in my opinion that should be in-house going forward. Number one, as was mentioned, the bonuses do not only refer to one year but have a multi-year process in their concession; number two that a growing proportion of those bonuses are paid in shares so that you align more fully the interests of senior executives with shareholders. Having said that, I think those are decisions that should be pushed forward by shareholders through the remuneration committees.

Q1059 Mr Brady: But again it is work in progress.

Mr Horta-Osório: There are several steps in Santander already taken in that direction.

Q1060 Nick Ainger: Do you all accept that the premise which was put in Hector Sants' letter to all chief executives of 13 October last year, saying basically that a major contributor to the current crisis was, in fact, the bonus driven culture which had led to short-term decision, high risk taking, which got many of you into serious problems where you had to go to the taxpayer? Would anybody demur from that position? You are all happy. Hector Sants believed and other organisations, the Counterparty Risk Management Group and the International Institute of Finance, all said the same thing. So the reason that we are here is certainly at least very much partly driven by the bonus culture, driving high risk investments which then went wrong. Does anybody disagree with that?

Mr Varley: Could I just make one qualification, which is that I think it is not a sort of binary subject, it seems to me. If Mr Sants was suggesting, and I think he was, that this was a contributor to the issue, then I would not demur from that at all, but is it the genesis of the problem? I would demur from that.

Q1061 Nick Ainger: But it was part of the problem.

Mr Varley: Yes.

Mr Thurston: I think I have to endorse that and say that, clearly, as part of the industry, it is not unreasonable to say that was an element of the problem, but I would have to say that not all banks are the same, not all banks were driven to the same forms of behaviour.

Q1062 Nick Ainger: Anybody else?

Mr Horta-Osório: I would endorse the comment.

Q1063 Nick Ainger: We note what HSBC say, and I am sure Standard Charter would say exactly the same thing as well, and perhaps Santander too. However, the Policy Group of the Counterparty Risk Management said that remuneration, they believe, should be based on practices that apply to senior executive management and they should be based heavily on the performance of the firm as a whole. Mr Thurston, how big a fall has there been in the share price of HSBC in the last 12 months?

Mr Thurston: In the last two years it has fallen by 40%.

Mr Varley: About 70%.

Mr Hester: Over 90%.

Mr Daniels: About 80%.

Mr Horta-Osório: Around 50%.

Q1064 Nick Ainger: Should you be paying any bonuses based on the recommendation from the policy group of the counter-party risk, who made the suggestion it should be based on the performance of the whole group?

Mr Thurston: Whilst HSBC's share price has fallen (and that, I am sure, is a factor that the Remuneration Committee of the Board will look at in their determination on pay levels within HSBC), I would say that our share price has performed better than most of the peer group in the banking industry, that our market capitalisation, which two years ago was 50% over the combined total of all the other banks, is now 200% of the combined total of the other banks, but we continue to pay dividends to shareholders.

Q1065 Nick Ainger: Why are my constituents that bank with you writing to me to complain about your performance?

Mr Thurston: About HSBC's performance?

Q1066 Nick Ainger: If everything is going so well, Mr Thurston, why are you cutting back on overdrafts, and so on? It would appear that, in fact, you are not doing very well, or else you would carry on in the same way that you were in 2007. 2008 has been a disastrous year for you, has it not?

Mr Thurston: HSBC has continued to increase our support of personal customers and business customers in 2008 over 2007, and we have committed to providing increased support next year as well.

Q1067 Nick Ainger: Mr Varley, again, 2008 was not a good year compared with previous years, and yet you are considering cash bonuses as well as share packages for your staff. Why, bearing in mind the collapse in your share price?

Mr Varley: The first thing I would say is that the executive directors are not receiving a bonus for 2008, and one of the significant contributors to that decision was what had happened to our share price, because our shareholders have had a very difficult time and we should acknowledge that in the way in which the reward structures operate. If I then look at the broader subject, our profits are 14% in 2008 versus 2007 and our variable compensation, or bonuses, have fallen 48%, and that is on average. The way that the system operates is that the more senior the individual, then the greater that reduction. We have a number of responsibilities to a number of stakeholders in this area and, I said before and I say it again, we listen carefully to what we are hearing from you and others on this subject, but I believe that we have behaved responsibly in ensuring that the reduction in the variable compensation of the staff at Barclays very significantly exceeds the reduction in our profits year on year.

Q1068 Nick Ainger: Mr Hester, your share price has fallen by over 90%, you have had to write-off 20 billion of assets, you are predicting an eight billion pound loss, you have announced you are making 2,300 staff redundant and you are now 70% owned by the taxpayer. You are not considering paying anybody, other than your lowest paid staff, any bonus, are you?

Mr Hester: As you know, I have been at the bank for less than three months, and this is one of the topics that I wish I was not having to spend so much time wrestling with, because there are other very important things we have to do to get RBS back to strength again, but, of course, I do have to spend time on it and, as I said earlier on, I empathise 100% with the public mood. It would give me no joy whatsoever to pay any bonuses to anyone, and if that was a responsible thing to do, I would recommend that in a heart beat. I do think that banking pay in some areas of the industry is way too high and needs to come down, and I intend us to lead that process. Having said all that, in RBS, although we have not made decisions, what I am clear about is there are no bonuses at the board level.

Q1069 Nick Ainger: But that was a requirement of the bail out. That was not a decision that the board made.

Mr Hester: I would be very clear about that in any event. There will be no bonuses of any sort to anyone at all associated with the losses we have made, whether high or low, throughout the organisation, and, indeed, many of them have been fired. There will also be in RBS a reduction in bonuses, both in cash, greater than any bank that I know of in the world, and, even when we take account of deferred consideration, greater than any bank I know of in the world. RBS ranks currently tenth in the losses it has announced, and so I do agree that we have to be extremely stringent on this subject, and I believe that RBS should lead the industry and I intend to do that. The difficulty, and I am sorry to give you a long answer but I think it is an important subject, that I have to agonise about and wrestle with is that, for all the very good public policy issues that we all know, we also at RBS have a bank where it is very important that I can engage 177,000 staff in getting us out of this and in rebuilding strength, in serving 40 million customers, and, frankly, protecting the taxpayer against a balance sheet that is more than two trillion pounds in size. So somehow I need to engage our staff to have the best people stay with us and to attract better people to replace the ones we got rid of who got us into the mess. Probably something like 176,500 of our 177,000 staff actually did what they were asked to do last year and made profits, and, therefore, when we consider how to treat them, aside from the issue, if you like, of incentivising them, the issue is how much worse can we treat them relative to any other bank in the world, and that it is what we are

wrestling with in order to balance, on the one hand, the very proper public policy issues and, on the other hand, the need for the taxpayer to have RBS regain its strength.

Q1070 Chairman: We are not finished with the bonuses. We will come back to that, maybe not today but certainly in the weeks ahead. Mr Hester, you say that you have got to obey the law. I think that was in answer to Colin's question. If your shareholders rule that you should not be paying bonuses, would you have to accept that?

Mr Hester: I suppose, in the end, we have to do what our shareholders say. Obviously, as individuals, if we are being asked to break the law, we may not be able to do that.

Q1071 Chairman: You would not be breaking the law in every singly case, surely. You would have to look at the legal requirement.

Mr Hester: We are dealing in hypotheticals. I think you would not want to have---

Q1072 Chairman: I will tell you, Mr Hester, what we do not want. We do not want a blanket statement by you. We want to know on behalf of the taxpayer exactly what the arrangements are. So I would be grateful if you could provide us with information of what your contractual obligations are so that we can get a real understanding if the taxpayer really needs to bear this burden.

Mr Hester: I will do that.

Q1073 Chairman: Eric, you mentioned to me that you would not have had to take government money if you had not taken over HBOS. Is that correct?

Mr Daniels: That is correct.

Q1074 Chairman: Previously you said to me you believed the acquisition of HBOS was a prudent acquisition.

Mr Daniels: Yes.

Q1075 Chairman: How can you square the two statements? How can an acquisition be prudent if it pushes your company towards nationalisation and the brink?

Mr Daniels: We thought that the HBOS acquisition, in the short-term, would be painful. It has turned out, given that the economy has turned down even further, to be a very true statement but we also believe it is strategically a very good acquisition and will prove to be so in a couple of years.

Q1076 Chairman: Stephen, you said about bank bonuses. Would you agree that in future bank bonus scheme contracts should have a clause that states "should the state have to assist your organisation, the scheme is nullified"?

Mr Hester: I do not think that there should be guaranteed bonuses. I think it is something that should be avoided. I do think that substantial amounts of bonuses should be paid in deferred form so that they are vulnerable to claw back if there are future losses, whether in terms of state rescue or any other future losses.

Q1077 Chairman: António, Andy Hornby of HBOS told us yesterday that he took all his bonuses in shares, but he still managed to run HBOS into the ground. So is paying bonuses in shares really a safeguard, as you indicated?

Mr Horta-Osório: I think, as was previously indicated, that the bonus is an important part of correcting the situation but, as was said before, it is not the only part.

Q1078 Chairman: I want to point out to you that the company was run into the ground.

Mr Horta-Osório: The fact that you align shareholders with the interests of managers is a key point, in my opinion. It is an important thing but not enough. You have to have the right organisation and you especially have to have the right team and the right people in each of the jobs.

Q1079 Sir Peter Viggers: The rescue in October 2008 was projected as a plan to save the banks. Did you expect it to be a definitive and final resolution for the problems?

Mr Thurston: I think the UK Government was one of the quickest to respond and deal with that, but I think the situation has exceeded anybody's expectations over the whole course of events back through 2007 and 2008.

Mr Varley: I think it felt at the time as though it was necessary, but it was unlikely to be sufficient to deal with an economic downturn.

Mr Hester: I would agree with Mr Varley.

Mr Daniels: I agree.

Mr Horta-Osório: Me too.

Q1080 Sir Peter Viggers: The Royal Bank of Scotland and Lloyds signed an agreement with the Government on 13 October. One of the terms was that over the next three years the availability and active marketing of competitively priced lending to home owners and small businesses would be maintained at 2007 levels. What does this mean in practice?

Mr Hester: I can speak for Royal Bank of Scotland. In fact we have exceeded that target. As at the end of 2008 our lending in those categories was more than 10% higher than the 2007 levels, and obviously we announced a range of initiatives in terms of delaying the point of house repossessions, in terms of guarantees on overdrafts to small businesses and a variety of other such initiatives, but the simple fact is that these commitments, while they were commitments that were sensible to make in the context of welcome government support, for which we are grateful, they are also sensible for our business. We have huge businesses here. We want to support our customers and we are very pleased to do so.

Mr Daniels: There are two very explicit commitments and, as you have mentioned, they regard availability of product and then the same level of marketing. Lloyds TSB has complied. In terms of lending to individuals we have lent about 20% up in 2008 versus 2007. That is versus a market increase of about 4%. In lending to companies, we are up about 10% versus the market up about 5%. So the product is clearly available and we are, in fact, exceeding the levels of marketing in 2007.

Q1081 Sir Peter Viggers: Have your risk management systems improved sufficiently for you to be confident that you will not be building up yet another cycle of write-offs? Do you feel confident about that, Mr Heston?

Mr Hester: I think, frankly, the risk management systems at RBS need a lot of change, and I cannot do it all in a couple of weeks, and so we need to keep upgrading and keep improving. We are putting in major changes as we speak, but it will take some time to get those absolutely right. I think there is also a risk of moral hazard as the Government and ourselves balance support of customers, because, obviously, eventually we all need to save more and borrow less, and it is trying to get the balance in allowing the economy to adjust gradually so that borrowing is not withdrawn swiftly, but there is some moral hazard sitting around in there that we all have to watch out for.

Q1082 Sir Peter Viggers: Mr Daniels, are you confident?

Mr Daniels: We are very comfortable with our risk systems. They have stood us well during the last several years and they helped us to avoid the impact, or a great part of the impact, but we are clearly not completely immune. We think that the HBOS acquisition will test our systems. Very clearly, we are going to have to put the Lloyds systems into HBOS, and that will be a challenge for some time to come.

Q1083 Sir Peter Viggers: Members of Parliament are getting a lot of stories about small business finding it difficult to get capital and, indeed, householders finding it difficult to get mortgages. I am surprised by the upturn in your activity. Is the shortfall being borne elsewhere, Mr Thurston?

Mr Thurston: As far as the industry statistics indicate, and this is from the lending panel reports, the major UK banks are, indeed, continuing to lend, but clearly some of the foreign banks, some of the Icelandic banks have pulled out of the market, some of the specialised mortgage providers have pulled out of the market; so it is likely that the overall supply of lending has fallen whilst the major banks are increasing their share of the lending pie.

Q1084 Sir Peter Viggers: You are coming under pressure from government, all of you, to strengthen your capital ratios, strengthen your balance sheets generally. How do you square this with the wish of government that you should be more open in your lending?

Mr Horta-Osório: In our case, as you know, we announced our results last week and we are supporting the UK economy along with the objectives that we have. We increased our lending to small and medium size businesses last year by 30% and we have had a net lending market share in mortgages of 30% as well. Our capital ratio at Santander level is one of the highest of the industry. It is above 7% in quarter year one, and therefore, in our specific case, the continuing lending to the UK economy is perfectly compatible with our capital position on the one hand and with the level of our profitability on the other hand.

Q1085 Sir Peter Viggers: It is quite an upbeat story coming through so far, but how do you value your untradable toxic debt, to move on to another subject. Mr Varley.

Mr Varley: I think the best test of the reliability of the valuations in a bank's balance sheet is whether, when it liquidates part of the assets that one is talking about, they are liquidated in line with those valuations. So there are a number of techniques that we all have to deploy here and have various layers of assessment to ensure that the assessment is genuinely objective. The ultimate assessment, of course, is by one's external auditors, but I think where the rubber hits the road, if I may put it that way, Sir Peter, is when a bank is seeking to close out positions that it has. In our own

case, we liquidated nine billion pounds of positions in the sort of asset classes that you are referring to during the course of 2008, and we did those in line with the valuations that we had adopted, and I think that is the answer of the market to the question that you raise.

Q1086 Sir Peter Viggers: The reaction of fair value accounting with regulatory capital requirements: can this lead to a vicious circle where you are called upon to set aside more capital and this casts doubt on your own balance sheet?

Mr Varley: What I would say is this. The impact of pro-cyclicality, which comes out of the Basel regulations, is something that is quite difficult for us to wrestle with at the moment because I think that when the Basel authorities put those regulations in place they would not have envisaged that governments and regulators all around the world would have been supporting the banking system in the way that they have and are, and, frankly, I would argue for a change in those regulations through time, because I think we need to revert to the standard which used to operate, which is that in good times banks are building their capital reserves. It seems idiosyncratic, in any event, to have bank reserves being required to be built under the Basel regulations at a time when, as you rightly say, the Government and governments all around the world are urging us to lend more.

Q1087 John Thurso: I want to ask about corporate governance, but before I do that I would like to follow on from a point Sir Peter has just made. Can I come back to HBOS, Mr Daniels. You told us (which is certainly what I had understood) that Lloyds TSB was in a pretty good position. You had acted conservatively, you had good risk management and, had it not been for the HBOS acquisition, you would probably not, almost certainly not have required any public money, you would be in the same boat as HSBC - a rather nice place to be. Are you seriously telling the committee that with all that prudence and avoidance of risk, you actually walked into that purchase without any pressure from anybody?

Mr Daniels: We believe it is a very good purchase. Again, the economy is far worse than we had forecast at the time, and I think anyone had forecast at the time; so we will have a period where it will take a while for us to get HBOS to perform at the level that we would like, but we believe it is a strategically important element for the Lloyds Banking Group.

Q1088 John Thurso: In retrospect, is that actually the best value for Lloyds TSB shareholders to have undertaken that transaction?

Mr Daniels: We believed it was at the time and we continue to believe that.

Q1089 John Thurso: You might say that; I am not sure I would go with you. Let me move on to what Sir Peter said. What I am hearing from all the constituents that talk to me who are in small businesses and medium size businesses is: "Where is all this money promised to us that has gone in at the top?" Whenever I speak to bankers at a top level, they tell me they are shovelling it in perfectly happily at the top, and whenever I ask a question of a minister, they say everything is rosy in the garden and everything is working. How do you make sure that what the Government is seeking to achieve by putting money into banks, by the loan guarantee schemes and all the other things, actually results in businesses that would otherwise be in serious difficulty getting the assistance that we think we are promising them? Mr Hester, can I start with you?

Mr Hester: As I have mentioned, in fact we are significantly exceeding the targets that we agreed with the Government in terms of lending and then a whole variety of other support to customers.

Q1090 John Thurso: That is presumably an aggregate target.

Mr Hester: Absolutely; in a sense it has to be.

Q1091 John Thurso: How do you reconcile this. These are not hypocritical stories. These are actual businesses that I know about and do not want to name here because I do not want the suppliers to withdraw.

Mr Hester: I think the point was made by HSBC that in fact there is a gap in the market from the disappearance of other lenders, mostly international banks, foreign banks, probably similar to the gap that RBS will create in other countries when we draw back from certain other countries, and so even though the major banks are expanding, it is possible that they are not expanding by enough to fill that gap. As I understand it, it is for that reason that the Government is seeking to get the major banks to commit even more expansion to fill the gaps. At RBS we committed an extra six billion pounds in connection with the conversion of the preference shares a few weeks ago, and if the Asset Protection Scheme goes ahead, we will commit a further amount. So I think the issue is the big banks will need to expand to fill the gap left by the withdrawal of the foreign banks, and what we are all trying to work out is by how much and through what mechanisms, and that is the process that is going on and the process of engagement with government.

Q1092 John Thurso: Let me, Mr Daniels, come you to. Can I say that in Caithness, Sutherland and Easter Ross there are not that many foreign banks! Most of the lending was done by the RBS, or HBOS, or Clydesdale Bank. I have heard that Lloyds are doing quite well. In your answer to the Chairman in this vein, I was interested that you said Lloyds TSB is lending more and you did not mention HBOS. Specifically, on Monday morning I had a meeting with a company worth approximately four million that has banked with HBOS for 40 odd years. It has positive cash flow; it can meet its interest payments; with a 50% hair cut on its assets it is still twice loan-to-value; so it is precisely the kind of company that ought to be being looked after. On my advice they went to their corporate manager in Inverness, who told them he had no money and he had never heard of any government schemes. On my advice again, he went to the head of that section in Edinburgh and received exactly the same story. They said they would be very interested to know where their funny MP got these notions from that there was some sort of help available. How on earth do I help my constituents when your bankers do not know Tuesday from Wednesday?

Mr Daniels: I apologise if that in fact was the case with that particular customers, and if you would be kind enough to give me the customer's name what I would be happy to do is to look into it personally, but, as you know, HBOS had tremendous amounts of funding difficulty during the last few months of the year. We took over on 19 January. Very clearly one of the things that we have to do is to put in not only our governance that has served us well but our practices across the board. Because of the funding restrictions, or the lack of funding that HBOS had, they had to restrict their lending. Despite that, they actually did increase in 2008 over 2007, but the specific policies, and so on, we very clearly will have to take a look at and I would be very happy to take a look at this specific incident.

Q1093 John Thurso: Thank you very much. Can I turn, finally, to the question of corporate governance, and perhaps, Mr Thurston, since your company, as it were, has not had to go for any help, yesterday we were told by Sir Tom McKillop and by Lord Stephenson of the amount of hard work that had been put in by the non-executives in their institutions, how much time it took, how much training they had. There is a general view amongst the public that most boards of non-executives are a happy little decoration of the great and the good, like lights on a Christmas tree that do not provide much. Clearly, the truth will be somewhere between the two. Can I put it to you

that the problem is that international banks operating across all the banking disciplines are actually too complex to be governed by a traditional exec/non-exec format?

Mr Thurston: We have, as you well know, an executive chairman, and we do believe that it is very important for a group of our size and geographic reach---

Q1094 John Thurso: Which is to clarify he is in contravention to the model code.

Mr Thurston: There is clear separation of responsibilities between the Chairman and the CEO but he is an executive. With the scope and breadth of our activities, that is important. Our board of non-executive directors at a group level has a number of leading businessmen and women who have run businesses on a multi-national basis. In the UK bank we have a board of senior people, we have an audit committee, which is one of the key committees which oversees the risk management of the board: there are three members of that, they are all non-executive, each of them has 30 years' of experience in either the banking or financial services or accountancy business. So it does require significant experience in those roles.

Q1095 John Thurso: Mr Hester, can I come to you? I look at RBS, a once proud Scottish banking institution, British banking institution, brought to its knees. I look at those names on that non-executive board and say to myself, how come none of them said, "No, this is nuts"? You have come in, new broom, and I am sure are going to do a great job. What would you like to see done to make sure that kind of thing does not happen? What is the lesson in this for corporate governance?

Mr Hester: This is a really, really difficult question. Obviously, I was not there in the past, so I cannot comment on that other than to say that I think that the criticisms being thrown around are, in some cases, harsh but, obviously, the mistakes are there for all to see. I think that all companies struggle with the non-executive balance, and it gets down to humans rather than process, and it is really incumbent that you have an executive that wants strong challenge and that gives information to enable it, and it is equally important that non-executives understand that, because it is their job to help the companies succeed. Helping the company succeed does not always mean saying, yes, to the chief executive, it can mean a challenge, constructive challenge, but I have to tell you, I am not sure this is an issue of process. I think it is, unfortunately, an issue of humans and their behaviour.

Q1096 John Thurso: Mr Varley, one of the things that came out of yesterday's session was the fact that the investment merchant banking side came out of the partnership tradition, which is a wholly different culture, wholly different way of taking risk, wholly different remuneration. Banks came out of stock holding, people owning shares. Is it the case that we ought to really go back to something akin to Glass-Steagall where there is a separation, because the two cultures simply do not mix? Is it that corporate governance just cannot take care of the swash buckling side of the business?

Mr Varley: I saw the comment, and to me it was a very interesting comment. Going back to your question about governance and the composition of boards, I certainly find it very helpful around the Barclays Board table to have three of our non-executive directors who have significant investment banking experience. I am not suggesting for one moment that you want to have on a bank board a non-executive director cadre that is made up of former bankers, but I think it is extremely desirable to have at the board table people who understand the industry and, in particular, the most esoteric parts of it, and that would cover the investment banking world. That would cover the investment banking world. It is no coincidence in our case that we, including our chairman, have an investment banking background. That is a very conscious decision. I certainly find it very helpful as a chief

executive to know that I get that challenge from people who understand intimately the financial services industry and even the more abstruse parts of it.

John Thurso: We are going to write a report. We are going to make recommendations. Would you all like to reflect and give us a measured, written response?

Chairman: In answer to our question yesterday to Sir Tom McKillop, I put the puzzle that we had Sir Peter Sutherland, a former EU Commissioner, chairman of Goldman Sachs. We had Steve Robson, number two at the Treasury when the tripartite authority was established. We had Jim Currie who works at the EU. We could go on. Either people are stupid or there is something systematic. These people have an excellent track record so there must be some systematic issue and problem here. We have to push at that because I am coming to the view that maybe banks are different from other organisations and what we need in boards. If you can contribute to that for us, it would be very helpful.

Q1097 Mr Tyrie: I wanted to ask one follow up question to Mr Daniels about the HBOS deal. You said that it was a very prudent one. What due diligence did you do before you went ahead with that deal?

Mr Daniels: As a publicly traded company, there is a limited amount of diligence that can be done in an acquisition. That said, we put approximately 5,000 man days into the diligence effort. A great part of that was done by people that we had hired as experts, accounting firms, investment banks and so on, in an effort to value the portfolios properly.

Q1098 Mr Tyrie: If you had had more time, how many man hours would you expect to put in?

Mr Daniels: If we had unlimited access, which is not permitted by the law ----

Q1099 Mr Tyrie: To a similar company but with more time.

Mr Daniels: We probably would have put in somewhere around three to five times as much time as we put in.

Q1100 Mr Tyrie: Since you have only just taken over on 19 January, how can you be so confident that it was a very prudent deal? You must be still doing the due diligence now.

Mr Daniels: We very clearly are learning and assembling a database in order to be able to run the company well.

Q1101 Mr Tyrie: How comfortable are you about the quality of the assets? Is it better, worse or about the same as you thought on the basis of the very incomplete due diligence you did?

Mr Daniels: The outcomes that we have seen thus far are within the ranges that we forecast.

Q1102 Mr Tyrie: You are very confident you are not suddenly going to have to come forward to us and to the public to tell us that there is a whole basket full of toxic assets which you had not foreseen being there?

Mr Daniels: Based on what we have seen thus far, we believe that we are well capitalised as a group.

Q1103 Mr Tyrie: Do you think this was a commercial transaction? Do you think it should be described as such?

Mr Daniels: I believe it should be.

Q1104 Mr Tyrie: You do not think there was a political element to this deal?

Mr Daniels: I believe that it was a good deal for Lloyds TSB.

Q1105 Mr Tyrie: Do you think there was a political element to this deal?

Mr Daniels: Very clearly, there was a clearance by government to help us with the Competition Commission so to that extent, yes, there was involvement by government.

Q1106 Mr Tyrie: I want to ask the others here whether they have any concerns about the fact that there was that political element and therefore competition was being reduced in the industry. Do not all feel obliged to comment but, if you do want to add something, perhaps we can go right to left. Are you concerned by the diminution of competition?

Mr Thurston: I think it is something we have to look out for in the future in terms of the way these businesses are managed to ensure there is no diminution in competition, as we should do in all such cases.

Q1107 Mr Tyrie: You do not think there will be?

Mr Thurston: I think it was the right decision to put aside the competition rules at a time of crisis, to take decisions. I think that is understandable, but we have to make sure that in doing so what results at the end of it is not anti-competitive. We have not had the ability to study the details of what the combined entity will be like and how it will operate.

Q1108 Mr Tyrie: Do you think we are going to be able to unwind it?

Mr Thurston: I am not sure.

Q1109 Mr Tyrie: Mr Varley?

Mr Varley: I think what was done had to be done at the time. I also take some comfort from the fact that the European Union takes an interest in the competitive landscape and will have an overview as to whether there is any distortion. If you are asking whether there will be any distortion, I believe not.

Mr Hester: I agree with my colleagues.

Q1110 Mr Tyrie: Do you want to add anything?

Mr Daniels: No.

Mr Tyrie: I am amazed by those replies. I would have thought you would be very concerned in the long term about competition in your industry. All I can suggest is that you come forward with some other deal which can give you a slug at some market in a disproportionate amount.

Q1111 Chairman: On the issue of due diligence, a very experienced, senior, distinguished individual said to me, in terms of the complexity of some banks as organisations, that it could take a year to go through books and fully understand what is on the books, what are the risks and obligations. Is that way off the wall for you?

Mr Thurston: It would depend on the size of the organisation and the nature of its business.

Q1112 Chairman: You could envisage something like that with the complex organisations we have today?

Mr Thurston: That would be a very large, complex acquisition for that length of time.

Q1113 Mr Fallon: Stephen Hester, your majority shareholder, UKFI, has the objectives of protecting and creating taxpayer value, maintaining financial stability and promoting competition. How can all those objectives be reconciled?

Mr Hester: In my engagement with them so far, which has been significant, I think that they have been behaving like a very engaged institutional shareholder in relation to what I will call the strategic and shareholder value type issues. They do have other mandates that are not about shareholder value but are to do with the lending commitments, pay and those sorts of things, which are a little more political in terms of the engagement we have with them. Nevertheless, I certainly have no fears at the moment in terms of the way UKFI specifically are going about their job.

Q1114 Mr Fallon: Eric Daniels, how can they promote competition at the same time as protecting taxpayer value?

Mr Daniels: What we have seen thus far has been a reasonably even handed treatment. We are early in the relationship. We will watch it unfold but, so far, I have not seen any conflict among the objectives.

Q1115 Mr Fallon: Stephen Hester, what is the strategy to repay the taxpayer? What is the time frame?

Mr Hester: We obviously have a really huge job to do. It is my belief that it will be a three to five year process. Clearly, the length of the process will significantly depend on how long the economic downturn is because that slows things up, but three to five years is the planning horizon that I have for getting RBS back to stand alone health and enabling the taxpayer to be free and hopefully make a profit.

Q1116 Mr Fallon: Does that depend on current lending levels?

Mr Hester: Current lending levels are of course an aspect of that but I think there are many bigger aspects that will determine how fast that process is.

Q1117 Mr Fallon: Eric Daniels, what is your strategy to repay the taxpayer and what is your time frame?

Mr Daniels: It is very hard to signal a time frame. Part of the issue is that repaying the taxpayer really means, in the case of UKFI, when they decide to sell the shares. Our best strategy is to serve our customers extremely well so that they prefer to do business with us. That will allow us to be

profitable and hopefully that will make our share price rise. That will give UKFI the option of deciding when they wish to sell the shares.

Q1118 Mr Fallon: What is the time frame?

Mr Daniels: If I could call the stock market, I would not be doing what I am doing.

Q1119 Mr Fallon: Is it less than the three to five years that Stephen Hester mentioned?

Mr Daniels: I would certainly hope so.

Q1120 Mr Fallon: What impact will the more rapid repayment of taxpayer support, Mr Hester, have on your ability to lend to home owners and small businesses?

Mr Hester: If I am understanding your question correctly, clearly, if we deplete our capital base, we could lend less. If I understood your question correctly, repaying the taxpayer quickly, if that meant depleting our capital base as opposed to finding capital from somewhere else, would have that consequence.

Q1121 Mr Fallon: The three to five year timetable you have given the Committee presumes lending at current levels?

Mr Hester: I am expecting us to follow different strategies in different parts of our business. Overall, the Royal Bank of Scotland has to significantly reduce its balance sheet and that means lend less. However, I believe that we can do that through our international, global operations and yet protect our UK customers and lend more to creditworthy segments in the UK. That is our plan.

Q1122 Mr Fallon: Overall, lending in the UK will increase?

Mr Hester: That is our plan.

Q1123 Mr Brady: Stephen Hester, you said earlier I think that you wished you did not have to spend so much of your time on pay and bonus issues. Are you finding your contact with UKFI is disproportionately focused on those issues?

Mr Hester: I do not really feel like casting stones at the moment. I think we should all be very grateful ----

Q1124 Mr Brady: I was only asking for an answer.

Mr Hester: ---- for government support. The price of government support must be to build confidence on behalf of government that we are proper stewards of the support. I do not resent the time spent building confidence either in government or in all the other people who are trusting us to get back. We have to explain ourselves and build and rebuild confidence.

Q1125 Mr Brady: Your answer is that you are not critical of it but that is taking up the greater part of the contact with UKFI?

Mr Hester: We are taking up a significant amount of time with government, which I think is appropriate.

Q1126 Mr Brady: Specifically on pay and bonuses?

Mr Hester: On many issues. As much on strategy as pay and bonuses but certainly most recently on pay and bonuses.

Q1127 Jim Cousins: Mr Hester, you told us a little earlier that your balance sheet was £2 trillion.

Mr Hester: More than, sadly.

Q1128 Jim Cousins: How much of that balance sheet is outside the United Kingdom, bearing in mind that the United Kingdom taxpayer is now your majority shareholder?

Mr Hester: It is not a figure on which it is easy to be precise, because we have very many cross border flows that involve people on two sides of borders, but I think it would be accurate to say that something like two thirds of our loans would be international and a larger amount of our securities and derivative contracts.

Q1129 Jim Cousins: Mr Daniels, what is your position with regard to that issue?

Mr Daniels: We are primarily a UK based bank. Approximately between 80 to 90% of our business is here in the UK.

Q1130 Jim Cousins: Mr Hester, I can tell you can see the immediate difficulty that the British taxpayer is standing behind a set of operations where two thirds of the loan book is outside the United Kingdom. What can you say to British taxpayers, who may well not be able to get car loans themselves, but who find themselves supporting as taxpayers car loans right across the United States?

Mr Hester: I think I would say the following: the only part of our business where we are expanding lending is in the UK. Everywhere else we are reducing it and that process will continue and indeed probably accelerate. Secondly, governments everywhere around the world are supporting the financial system and supporting banks of all nationalities. If I look at just RBS, while of course our greatest support is coming from the UK, we do benefit from support programmes of the Fed in the United States, of the European Central Bank, of the Australian Central Bank, of the Japanese Central Bank. I am sure most of my colleagues at this table have their own dealings with these central banks. It is very important that the world not retreat into a process of isolationism, whether on trade or on financial services, because that will make it worse for everyone. We all have to work together. It is a cliché but it is true. We do.

Q1131 Jim Cousins: Do you have access to the Troubled Assets Relief Programme or to its successor that has been mounted?

Mr Hester: At this juncture we have not had direct access to the Troubled Assets Relief Programme. As to its successor, the details are not fully available yet. We do have significant support from the Fed though, as I believe all international banks do.

Q1132 Jim Cousins: Do you regard yourself as being eligible for the Troubled Assets Relief Programme?

Mr Hester: Phase one we were not eligible for.

Q1133 Jim Cousins: For phase two, the story is still to be read?

Mr Hester: I do not know.

Q1134 Jim Cousins: Are either of you advocates, Mr Daniels or Mr Hester, of a so-called bad bank where your least well performing bits of business would be separated off and would become presumably the complete responsibility of taxpayers?

Mr Hester: The problem, as with many of these issues, is that the same term is often used for different things. If we take the distinction that I would draw, insurance schemes, of which there are a number in the US, proposed here and in Switzerland as an example, may insure a bank against risk with various arrangements around the premiums, but the assets stay on the balance sheet and need to be funded by the bank. More conventionally the term "bad bank", although that is sometimes also used for insurance schemes, would mean that the risk is taken off the balance sheet of the bank and funded. The advantage of that is that one of the problems in this current crisis is banks' inability to fund very large balance sheets when funding markets dried up, so it would alleviate that additional problem of banks which goes beyond the capital ratio. The disadvantage is that it is more complex to agree the pricing than a simple insurance policy and has a more immediate burden on the taxpayer. I do not think there is a right or a wrong answer, but I think those are the issues that have to be weighed.

Q1135 Jim Cousins: Have you started to discuss a structural separation of your least well performing assets with UKFI or with the Treasury?

Mr Hester: We are engaged with the Treasury in exploring the asset protection scheme that they have announced and I am hopeful that we will make use of it and that that will allow us to lend substantially more into the UK. I believe that there are potential provisions of that scheme to fund assets as well as to insure them, although my understanding is the principal thrust is the insurance thrust at this stage.

Q1136 Jim Cousins: Is it your intention to put any of your badly performing assets outside UK jurisdiction into the government's loan guarantee scheme?

Mr Hester: In our case, given how international we are, the assets that we would put forward for the scheme would be from many countries, including the UK but also including non-UK. If we restricted it only to the UK, its use for us would be of limited value. Because in a sense balance sheets are fungible, support that we receive for non-UK assets enables us to do more in the UK and that is something that I hope we will do, I want to do, we are doing and is a very important element to the scheme.

Q1137 Jim Cousins: You will clearly be aware that there is likely to be a very strong reaction by UK taxpayers to the idea that they are helping to fund the loan guarantee scheme which is supporting bits of your balance sheet which may be quite dodgy, which are thousands of miles away from the United Kingdom.

Mr Hester: That is why I think it is very, very important that, if the scheme goes ahead, we and the government can demonstrate that there is something in it for the UK taxpayer over and above financial stability and the investment in us in the form of extra lending.

Q1138 Jim Cousins: In general terms or case by case?

Mr Hester: Both.

Q1139 Jim Cousins: What steps do you think would bring about the nationalisation of either the Lloyds Group or RBS? What steps are you taking to avoid that?

Mr Daniels: Nationalisation would be a result of burning through our very considerable capital which I do not believe we will do. It is impossible in this kind of environment to forecast how bad things can get or how quickly we will recover, so it is hard to make a definitive statement, but from everything that we see today we are well capitalised and we believe we can continue to do business successfully and grow our business.

Q1140 Jim Cousins: I wonder if I could ask you the same question, Mr Hester, which is perhaps a more powerful question in your case.

Mr Hester: Everyone at RBS is working flat out to try to rebuild our strength and repay the support of people who depend on us and repay the people who have supported us. We will do that regardless of our shareholding base. However, I do believe that it is not in the public interest to nationalise us. I think that point of view is taken by governments everywhere around the world in respect of banks everywhere around the world, in all the major countries. I believe that it is taken by the UK Government. The furore that banks are currently in, in the public eye, demonstrates rather eloquently the difficulties of public ownership and bank operations. I think it would not be in people's interest. I hope it does not happen. I hope we can remain strong enough for it not to happen, but whatever our ownership we will try to rebuild the strength of this institution and support our customers.

Jim Cousins: The British taxpayer is standing behind you. Can I ask you both to make the Committee aware of any legal actions you may be aware of, from for example tax authorities or regulatory bodies or groups of people with an interest in your companies, who may be bringing issues of fiduciary duty to the attention of whatever courts they have access to? The British taxpayer will be defending them alongside you and therefore it is in the public interest that we should be aware of that. If you could do that it would be helpful. I am not asking you to do it right now.

Q1141 Chairman: On the bonus aspect, did you take any legal advice on breaking contracts regarding bonuses? Have you ever taken any legal advice?

Mr Hester: We have. It is an ongoing process. We are taking more and more legal advice. I do not want to recommend a single penny of bonuses more than is in the interests of our shareholders. I have nothing to gain from that.

Q1142 Chairman: Have you taken any legal advice on that, Eric?

Mr Daniels: On the contracts?

Q1143 Chairman: Yes.

Mr Daniels: Yes, we have.

Q1144 Chairman: Is that ongoing?

Mr Daniels: No, it is not.

Q1145 Chairman: What is the answer?

Mr Daniels: The answer is that for the HBOS employees their remuneration was decided by contracts and by the board of HBOS before we took over on 19 January. All policies after 19 January and ----

Q1146 Chairman: Those are legally binding and cannot be broken?

Mr Daniels: Correct. They will be the responsibility of the Lloyds Banking Group thereafter.

Q1147 Chairman: Stephen, on the point about derivative contract obligations, it has been mentioned to me that some people in the City may be wrong, but I would like you just to knock it down or whatever, that the RBS has, say, up to 1.3 billion of derivative contract obligations on their books.

Mr Hester: We have, in terms of notional contracts, many trillions of derivative contracts in terms of the balance sheet recording of that. Because we have not published our year end results, I cannot give you the figure. At the last balance sheet, it was some 500 billion and will be significantly higher when we reveal our balance sheet for the year end.

Q1148 Chairman: I heard it was 1.3 billion. You are saying it is 500.

Mr Hester: In the last balance sheet, it was some 500 billion and it will be substantially higher in or next balance sheet.

Q1149 Chairman: I would not mind if you communicated that to us at the right time.

Mr Hester: Of course.

Q1150 Ms Keeble: I wanted to ask something about short selling and also about risk. John Varley, Barclays are supportive of its stock market value just after the short selling ban was lifted. The hedge fund managers, when they came here, said that it was not down to the short selling. Do you agree with their analysis?

Mr Varley: In a normal market, I would be in support of short selling. It is an ingredient of a normal market. I do think it would have been helpful had the ban remained in place. That is partly for reasons of form and partly for reasons of substance.

Q1151 Ms Keeble: Did they contribute to your share price fall?

Mr Varley: I will try and come to the answer. I apologise for being slow in doing so. There clearly has been some shortening of Barclays' shares. Now there is a disclosure regime, as you know, which is designed to ensure that there is transparency. The second point though is the point of form as opposed to the point of substance, which is that the perception of the ability of hedge funds to short stock at a time of instability itself feeds instability, which is why as I felt as I did about the lifting of the ban.

Q1152 Ms Keeble: Stephen, you said previously in response to other questions that you had seen some weaknesses in RBS and what had been done previously, particularly around risk management. What were those weaknesses? What do you want to see improved, just briefly, because I want to ask the others that as well?

Mr Hester: Unfortunately, it is a long and rather detailed question. The most important thing is some very big elements of control which I think we can improve.

Q1153 Ms Keeble: Control of risk?

Mr Hester: Control of risk and rules on size and concentration, types of risk and amounts of risk which we can improve from what we have at the moment. There are many other aspects to risk which I am afraid will take almost a book to answer.

Q1154 Ms Keeble: Do you want to put those in a note to summarise the main points?

Mr Hester: Of course, these are of interest to the whole market and at our year end results in two weeks' time we will be saying some things on this and other matters. If I may, I will leave it at that.

Q1155 Ms Keeble: When we had your predecessors in, Tom McKillop was reduced to speechlessness when he was asked about the value of the AB and AMRO deal. As you have trawled through the paperwork and what happened, what is your analysis of how they have got that call so badly wrong? What was wrong with their risk management?

Mr Hester: The risk management of AB and AMRO?

Q1156 Ms Keeble: When your predecessors were looking at that deal, why did they assess it wrongly?

Mr Hester: I am afraid I am not in a position to know what they did and did not do and how they reached those conclusions. I do not want to be an apologist but I want to be fair. With many of the things that have gone wrong in the world, in the banking system and at RBS, the sadness is that they were there for all to see: the lack of saving, the excessive consumer spending, the house price boom, the trade deficits. When we turn to the banking system, it was there for all to see that RBS had a leverage business model and that AB and AMRO doubled up that risk, how it was funded, the shareholders' approval and everything. Many of the issues were judgments honestly made on very big things that have turned out to be very badly wrong, but they were judgments that were very visible to many.

Q1157 Ms Keeble: Eric, you have also talked to others about the risk and about what you saw. When your predecessors came in, they were very defensive indeed about the risk management structures. What is your assessment of what happened with HBOS? Why did they get it so badly wrong?

Mr Daniels: I think there were two principal issues. The first was the funding issue. As you know, banks do not go bankrupt usually because of credit but usually because of liquidity. They had a wholesale funding model. When liquidity dried up across the world last year, HBOS clearly had some problems.

Q1158 Ms Keeble: That is about their model. What was it about their risk management which meant that it did not become obvious to them that they were in serious problems, particularly given that we had evidence that we all saw about problems about both the structures and the culture of the risk management inside HBOS? Would you agree with the criticisms?

Mr Daniels: A lot has to do with the risk appetite which is set by the management and the board. Whenever a strategy is drawn up, either implicitly or explicitly - in the case of Lloyds it is very

explicit - we set risk parameters and a risk appetite. That includes liquidity risk, credit risk, market risk and so on. Then we put in a governance structure that rigorously monitors and measures, so whenever we get close to a limit we examine it carefully and then we see whether we want to make the necessary adjustments.

Q1159 Ms Keeble: John Varley, I wanted to ask you also about the Gulf deal and the decisions taken around that because quite a number of commentators have said that put Barclays at some risk. Why did you agree to the ratchet clause? Is there a serious risk that you might need to go for more capital and the clause would be triggered?

(The Committee suspended from 4pm to 4.15pm for a division in the House)

Mr Varley: First of all, on the anti-dilution clause, it is a pretty standard feature of these sorts of security instruments - convertible notes - and in the generality it is a standard feature. If you look at the issuing of such instruments during the course of the last two years for bank recapitalisations, again, it has been quite a common feature. That was why it was included.

Q1160 Ms Keeble: According to some of the literature that is going around, a number of the banks that have used this have ended up in very substantial difficulties. The issue is really what assessment you have done as to whether you will need to raise capital.

Mr Varley: Which takes me to your second question, which is whether we have enough capital. As you know, the capital requirements were reset by the Financial Services Authority in October of last year. We have a capital plan which we have agreed with the Financial Services Authority. We have significantly increased the amount of capital that we have in Barclays since then. We now run ratios that are not just a bit but very substantially above the regulatory minima that are required of us and with that surplus of course goes very significant loss absorption. The loss absorption itself is strengthened if the bank is profitable and Barclays have made profits during the course of 2008.

Q1161 Ms Keeble: Why did you decide to go for that type of a deal rather than look at other means of raising extra capital? Why did you choose to do it through a particular dealer rather than perhaps again going out to existing shareholders first, which would perhaps have been more the norm? Why Amanda Staveley?

Mr Varley: On your last point, Amanda Staveley is not employed by Barclays. She is not employed as an agent of Barclays. She was employed by one of those who invested in Barclays. On your broader point, you are right that in normal circumstances our instinct, our practice and indeed our history would have been to have offered the opportunity to subscribe to our existing shareholders. That would be an absolutely normal thing for us to do, but as you know the circumstances were very far from normal. We needed speed, certainty and size. We made the decision that we did to recapitalise in the way that we did. Looking back on it, given the extreme fragility of the sentiment in the markets at that time, I am very glad indeed that we managed to raise the capital that we did raise at that time.

Q1162 Ms Keeble: If you did not employ her, how did she come to get all the publicity for negotiating the deal and the £40 million fee? Is it true that there was another 300 million in fees and commissions paid? What was the government scrutiny that was applied to the way that those commissions were paid and who were they paid to?

Mr Varley: Those who subscribe for stock on such occasions, particularly if they subscribe in size as happened on this occasion, may choose to have independent advisers. As it happens, the Abu

Dhabi interest chose to employ Amanda Staveley. The way in which she was remunerated was a decision for them, certainly not for us.

Q1163 Ms Keeble: Paul Thurston, everybody else said that the warnings were on the wall and there for all to see, but they did not see them and your company clearly did. Why did you take such different decisions apparently from some of the other businesses here?

Mr Thurston: I think we have always been relatively conservative as a lender. We also had extensive business in the United States and saw what was happening in the United States with the housing market there. As a result of that, we continued to look at all our business across the whole world in terms of what was the risk profile and the risk appetite we had. We have never believed in running our business on the basis of lending more money than we have in deposits. We have always had controls on every country around the world in the different currencies that we have, making sure that we are managing our funding as well as our liquidity position.

Q1164 Mr Mudie: Mr Daniels maybe six months ago would not have thought he was going to need government money. You spurned the opportunity to get money from the Labour Government and went instead to the Middle East for more expensive money. This might worry some people because there are different details in the press that part of that agreement stops you taking government money should the need arise. Could you put on the record what that clause is? If I were an employee or a customer of Barclays, I would worry that you would run into the same situation. You would need to get money. The Labour Government is going to offer you money and this time round you do not want to spurn it but there is something in your agreement. What is the agreement?

Mr Varley: We had a choice, just as you are saying. We could have taken money from the UK.

Q1165 Mr Mudie: I am not worried about that. I just want you to put on record the different rumours that are going about. What is in this deal? Are you restricted from taking government money and, if so, how long does the restriction last? Thirdly, how can you get out of it if you need to?

Mr Varley: We would not be restricted from taking government money; nor were we restricted back in October from taking government money. We have chosen not to take government money. I put that in the following context: is it a natural pursuit of the British Government to deploy taxpayers' money more than it has to ----

Q1166 Mr Mudie: I will save time for you. I am not worried about that aspect. You are absolutely saying that all these authoritative reports that have been in the newspapers and the financial papers are nonsense.

Mr Varley: Our freedom of choice is maintained.

Q1167 Mr Breed: When the history of this sort of financial saga is being written, probably the collapse of Lehman Brothers is going to feature very large. In your opinion, was the Lehman failure a symptom or a cause in the collapse of the wholesale funding markets?

Mr Daniels: I find that very difficult to answer. I am not intimately familiar with Lehman. The confidence that was shaken around the world when Lehman fell clearly upset and paralysed the markets.

Q1168 Mr Breed: Did it impede your own bank's ability to borrow on the market?

Mr Daniels: After Lehman weakened, the markets got very short indeed. It was almost impossible to find term lending. Lloyds, as you know, is one of the most creditworthy banks. Our triple A rating is something that is rare, so we have no trouble funding. We fund more cheaply than many other institutions. The issue is that the tenor with which we could borrow was shortened considerably after Lehman.

Q1169 Mr Breed: At any time did you feel that the bank's position was threatened in any way because of that freezing up of the market?

Mr Daniels: It is very clearly worrisome when the loans that one makes are of a greater tenor than the deposits. Then you have a fundamental mismatch.

Q1170 Mr Breed: Might it even have affected the survival of the bank?

Mr Daniels: If things got really severe enough, yes, it could.

Q1171 Mr Breed: António, could we talk about what may be referred to as "the Madoff affair" and Santander's investments? I think some of us are quite surprised, bearing in mind the history of your bank and the good acquisitions you have made and perhaps good investment decisions. What did you do in terms of due diligence on Madoff before you put quite substantial amounts of customers' funds into it?

Mr Horta-Osório: We are as you know a bank which is very prudent in terms of risk management and controls. In order for you to be aggressive commercially, you should have certain areas such as risk management, auditing, control and compliance as very strong areas.

Q1172 Mr Breed: What happened with Madoff?

Mr Horta-Osório: It is in our opinion absolutely impossible to stop all frauds. This, as you know, is a fraud that was very wide, of very high dimensions, supervised by the SEC and the company and the person involved previously had a very high reputation.

Q1173 Mr Breed: As a very minimum, most people would have looked at the auditing arrangements. The auditing arrangements in terms of Madoff consisted of a 78 year old man living in Florida, one qualified accountant and a secretary. What sort of due diligence did you do on that?

Mr Horta-Osório: It is easier to say that with hindsight.

Q1174 Mr Breed: Absolutely, but why did you not do it?

Mr Horta-Osório: We have strong due diligence processes. We are absolutely convinced we followed them as we normally do and, as you know, we decided to compensate all of our private clients as a commercial decision.

Q1175 Chairman: I do not think we are going to get a sorry out of you today, are we? I looked at the congressional hearings and there was a man called Harry Marcopolis who reported this from 2000 to 2008 to the Securities Exchange Commission in the United States. If you look on YouTube, you will see his evidence. I looked at it. He said, "The Key Tip-Off. It took me five minutes to figure out he was a fraud. I basically read his strategy description and knew that that was not the

source of his returns. Then I knew right away by looking at his performance chart." He made an illustration to the Committee and he said, "His performance chart was a 45 degree angle without any variation. It only went in one direction: up. It never had any variation like the market does." That was a key tip-off. If it took Harry Marcopolis five minutes, why did a credible bank like Banco Santander get duffed up on it? Why did you lose £2 billion pounds on it? I put it to you that your due diligence was absolutely and utterly duff.

Mr Horta-Osório: Banco Santander did not lose two billion euros. Santander had a small amount invested in those funds.

Q1176 Chairman: How much did you lose?

Mr Horta-Osório: We lost 20 million euros.

Q1177 Chairman: That is still quite considerable for people.

Mr Horta-Osório: According to the total size of the bank and the total fraud which was \$50 billion, that is a very small amount. Within our total asset management we had a significant amount of money and a small percentage of our customers who invested in these funds. We are absolutely convinced, as we have already said publicly, that we followed the due diligence procedure, as did many other banks around the world but despite that we have decided to compensate our private customers. On top of this, because we are in the UK, I would like to add that we have no UK clients at Abbey who invested in those funds.

Q1178 Chairman: It is not that I want to fall out with you but I do not believe you in terms of how the bank went about its structure because, again, Harry Marcopolis says, "What I saw and when I saw it. I was repeatedly ignored after an eight and a half year period between May 2000 and December 2008. Detailed, repeated warnings to the SEC." That was when it could only have been a \$3 billion fraud which ended up with a \$50 billion fraud. When you get a one man accounting team who was a college friend of Madoff and he has two of his family in auditing, surely to goodness, with a big company, you should have exercised sufficient due diligence?

Mr Horta-Osório: I sympathise with your comments, but if it had taken five minutes for anyone probably it would have taken five minutes for the SEC as well, which supervised those funds.

Q1179 Chairman: The SEC did not take him on, because your man was the chief executive of NASDAQ and it was the old boys' club. When you are investing other people's money, you should have adequate due diligence. That is the point I am trying to make to you.

Mr Horta-Osório: Yes, and I agree with you. On top of that, we have offered to reimburse those customers.

Q1180 Mr Mudie: Yesterday we were speaking to the bankers and we accused them of being in denial. I do not think we could accuse you of that because I do not think we have largely got to that. This is about looking at a bank crisis and how we got here and your part in it. That is very important because, at some stage, we are going to get out of it. It is going to be a different world, regulation etc. It is important we know where it started, who was to blame and what we have to address. Mr Varley, I hope you do not think I am picking on you, but in response to the Chairman's first question about the financial markets and how unpopular they were, you accepted there was unpopularity and you said, "I have to accept that we contributed to that." That is on a par with William Biscard's remarks on New Year's Day on Radio 4 when he was asked, "Did the banks

contribute? Were the banks to blame?" "Well, partly. Maybe 40%. Maybe 60%." You are busy rewriting history, it seems to me, so that when we come to redrawing the new world our memories are dimmed, but you are on the record. You are on the record as saying "Contribute." How big a contribution? I am not talking about you. I am talking about the financial markets.

Mr Varley: I understand. There is a chain that goes something along the following lines: for a variety of reasons, a very great deal of easy money - cheap money is what I mean by that - was made available for the world over a long period of time. Some of those were policy reasons. Some of those were reasons that were driven by events such as 9/11. For a long period of time, cheap money had been made available to the world and, as a result of that, asset prices rose as we know. You saw that all around the world and in multiple asset classes. As asset prices rose, yields fell. People with falling yields needed to increase their risk appetite to maintain yield. There was around the world a significant and very noticeable increase in risk appetite. That risk appetite was fuelled by the banks. I accept that. It was partly fuelled by the risk appetite of the buyers but it was certainly fuelled also by the inventiveness and innovation of banks. In part - and I acknowledged it earlier; I say it again - I think the compensation structure in the banks contributed to the fuelling of that pursuit of yield. What we need now is a period of time when asset prices stabilise. If you ask me singly what is the most important feature of the normalisation of markets, we need to see the stabilisation of asset prices, particularly in US housing.

Q1181 Mr Mudie: You are going too fast for me now. We have got to the stage where it could be borrowers but it is largely yourself. The old age pensioner in Florida who got a £450,000 mortgage. She was 92 and a cleaner. It was her fault that she took the loan and bought that house. Are those the two people you blame? Are you blaming yourselves? Are you blaming the borrowers? I would ask you which proportion. If you are saying "contributed", what would your contribution be?

Mr Varley: I wish I could be that precise.

Q1182 Mr Mudie: As Mr Daniels answered earlier, "It was within the range", we will let you do it within the range.

Mr Varley: You are very kind. I do not think it is both borrowers and lenders who are uniquely to blame. There are a number of players in this drama. They include governments, central banks and they certainly include banks. If you ask me as I sit here today, "Is it understandable that the public sentiment is that the banks have the majority of blame?" - in other words, if you think about blame attributable to any particular sector, is the largest particular sector the banks? - I think that is a perfectly understandable and reasonable conclusion.

Q1183 Mr Mudie: You have a majority now. That could be 51%.

Mr Varley: I did not actually say a majority. I said the single, biggest contributor among a number of players would be the banks. That was what I was trying to say in any event.

Q1184 Mr Mudie: I still want you to define how big is bigger.

Mr Varley: I am not being obstructive to your question. It is very difficult to be spuriously scientific about that percentage contribution. What I hope you are hearing me say and what I certainly intend to say is that it is right for the banks to shoulder a substantial part of the blame because I think that we have contributed to the problem.

Q1185 Mr Mudie: We could have had this exuberance in the normal fashion, with all the money floating in. What is different in this situation is that you were party, as an industry, to manufacturing instruments that contaminated the financial world, that we are still trying to clear out of our system. It is not the usual thing about deflating and getting everything cooled down. The whole system is contaminated and we do not know where we are because we do not know the value of any of these instruments.

Mr Varley: I think it is fair to say that, alongside the real economy, there was constructed for a variety of reasons - and I think the banks contributed to this as well - a debt driven, financial economy that was being developed. The two got out of touch with each other. What we are doing at the moment is going through the pain of bringing those two back into touch with each other. I would not want you to conclude that everything about this trend over the course of the last years is culpable or wrong, because it is perfectly clear to me that the securitisation of assets, as an example, has created the opportunity for people to buy houses all around the world which would not otherwise have happened. That is all to the social good.

Q1186 Mr Mudie: I understand that but I am also giving you the opportunity to differentiate between securitisation and securitisation that has at its core duff securities or toxic securities. That is the point. There is securitisation you can control hopefully and keep economies from overheating, but that is not the problem this time. The problem this time is, even if we brought it down, we do not know which security is good or bad. Do you know how many there are? There are 64,000 different ones, all with triple A classification. That is how deep the poison is. It was the financial markets. It was not the borrowers. It was not the government. It was not the regulators. It was your industry that put in that contamination that we are all suffering from.

Mr Varley: The starting point, as I said a moment ago I think, was the pursuit of yield. I have acknowledged, I hope you feel clearly, that the fuelling of that pursuit was something for which the banks have a lot of responsibility. I think it would be wrong to characterise all securitisation as bad. I am not sure whether you are doing that.

Q1187 Mr Mudie: I did not say that. I went to the trouble of separating securitisation as a principle, which I think definitely has the ability to expand economies certainly in the developing world. Lovely, but when you do it with toxic securities and nobody knows what the hell is in them, with a bad starting point, and even sophisticated bankers as we had yesterday and even the regulators do not know what is in them, but they pass them on gaily in huge amounts, it was always bound to finish in tears, was it not? I am not asking you to say sorry but that is very much something the financial world should accept and want to repent over and not want us to think we contributed to this.

Mr Varley: I accept your point.

Q1188 Mr Mudie: Mr Daniels, you gave me a hard stare. It was like being looked at by a Mafia don. I do not know whether I should ask these questions.

Mr Daniels: I am not sure whether I have received a promotion. The last time you compared me with Bill Clinton.

Q1189 Mr Mudie: You will understand I am understandably reluctant to accept anything a banker tells me now. This is going back to where you agreed with the government to get this money, RBS and yourselves. It is not a trick question. Can either of you tell the Committee specifically how much money you put into small businesses last year, 2008?

Mr Daniels: I can certainly calculate it for you. I do not want to risk giving you a bad number so perhaps I may write to you on that.

Q1190 Mr Mudie: I would prefer you to write to the Committee. What about you, Stephen?

Mr Hester: Our small business lending was up 10% last year. Obviously it slightly depends on how you define it but, as we would define it, it would be £2 billion on 20 billion. Our total aim was 20 billion and we increased by 10% so that was two billion, but it slightly depends on how you define "small business." That would be our definition.

Q1191 Mr Mudie: Eric, will you get me a figure?

Mr Daniels: I will get you a figure. I can hazard a guess but I would much rather give you a precise figure.

Q1192 Mr Mudie: We have had the Chancellor here and we have not got a straight tale out of the Chancellor either. I am concerned about my constituents who think that the government has achieved an agreement with the banking industry that it is going to deliver loans for mortgages at 2007 levels and small business spend at 2007 levels. Will you confirm it is just the two gentlemen in the middle, yourself and Stephen, because you have borrowed this money? You may wish to do it, John, and being the kind lad that you are you will probably be doing it, but these two individuals are the only individuals where the Chancellor could look me in the eye and say, "I have an agreement and I will make sure you stick to it."

Mr Daniels: One thing bears clarification. Our agreement, at least with Lloyds TSB, is very explicitly around availability and level of marketing. It does not guarantee a level of lending, although in the case of Lloyds we have increased our lending quite a bit. The reason why the amount was not put into the agreement was because we have to maintain prudent credit standards.

Q1193 Mr Mudie: That is very useful. That is the first time a banker has given us information without us pulling teeth. What we have is a commitment to immediately restore and maintain availability and active marketing of competitively priced lending so SMEs at a level at least equivalent to that of 2007. This is why I am asking you these questions, because I am desperate to get a marker down as to what is on the table and what is meant in this agreement. Are you saying that you do not recognise that, at least equivalent to the figure in 2007?

Mr Daniels: Yes, but I completely agree. The level that is referred to is the availability and the level of marketing.

Q1194 Mr Mudie: Tell me, just a simple lad, what that means. The way I read this, you are agreeing to deliver at least the sum that you gave in 2007.

Mr Daniels: I do not believe that is the interpretation. That said, Lloyds TSB more than delivered the sum that we lent in 2007.

Q1195 Mr Mudie: Let us put it on the record. What is your interpretation?

Mr Daniels: My interpretation is we have to have the availability of competitively priced products and the level of marketing that was extant in 2007.

Q1196 Mr Mudie: Stephen? You would not have been party to this at the time of the negotiation but do you agree with Eric?

Mr Hester: I am not sure we disagree. It is our responsibility to lend more than we did in 2007 provided that there are people who want to borrow from us. Obviously you cannot lend to someone who does not want to borrow. There is a caveat in that respect, but I am very clear. It is our goal to lend more in 2007 and we are lending 10% more and we will go further. There are no ifs, buts or caveats.

Q1197 Mr Mudie: You said "provided". Eric has put another interpretation on this. You two screwed the Chancellor then, did you not?

Mr Hester: That is an outrageous thing to say and simply not true.

Q1198 Mr Mudie: You were not there.

Mr Hester: It is still an outrageous thing to say and it is not true.

Q1199 Mr Mudie: I say outrageous things all the time. You got 37 million and you have agreed to reach the levels of spending. You did not stop there. You said "provided" and Eric, fair enough, puts a different interpretation on it. I am interested because it is vital for the people out there who are queuing up for loans or losing their houses that this agreement sticks. Even if the Chancellor had got you both, his idea of the agreement was that you were going to do this. Adding the two together, what proportion of the UK lending to SMEs do you two corner?

Mr Daniels: We have approximately a 20% market share of SMEs, about 100,000 customers.

Mr Hester: I believe we have about 30%.

Q1200 Mr Mudie: 50%, so half of them. Do you accept these figures?

Mr Thurston: We have 16%.

Mr Varley: We have 20 but this is going to add up to more than 100% quite soon.

Q1201 Chairman: Is it solely a story of risk appetite? Some, in their eyes, were taking high risks when they took on complex products that were rated triple A. Was it the financial system that hid the risk but advertised the return?

Mr Varley: It would be true to say that the financial system did not properly understand the risks.

Q1202 Chairman: You were not very forthcoming with George in terms of an apology. I am going to mention somebody. You probably do not want to hear his name. He is a certain Robert Peston. He interviewed you on 20 December and I have your comments here. I do not know if it was Christmas and you were merry, but you said, "Mr Varley told the BBC that the banking industry was going through what he called 'a public relations crisis and must apologise for what went wrong. We have to have a banking industry in which consumers and in some cases that trust has broken down. I ask myself do I feel the industry should be self-confident about recreating that trust through time. I do feel that, but it starts by saying sorry'." Do you agree with that?

Mr Varley: I do. I said it.

Q1203 Chairman: You are saying sorry. Good. António, you said that Santander only lost 20 million euros.

Mr Horta-Osório: Around that.

Q1204 Chairman: Press reports say Santander clients lost up to 2.3 billion euros. What I want on the record from you is this: are you claiming that they did not advise or help clients to invest in Madoff? Are you being economical with the truth in making the distinction between Santander's own funds, which are the 20 million, and those invested on behalf of clients, because your own funds and those invested on behalf of clients should have the same due diligence.

Mr Horta-Osório: I think I made that very clear. I told you that Santander itself had lost around 20 million and clients around two billion.

Q1205 Chairman: The two billion figure was right?

Mr Horta-Osório: Exactly. I confirmed that to you and I also told you that that out of a commercial decision Santander decided to compensate those private customers.

Q1206 Chairman: In terms of the Royal Bank of Scotland, Stephen, earlier on we were talking about the credit derivatives and exposure. I said 1.3 billion. I meant 1.3 trillion. That is a matter for the record.

Mr Hester: Unfortunately, until we publish our year end results, I cannot comment.

Q1207 Mr Tyrie: This commitment to maintain levels to those of 2007 lending includes the phrase "competitively priced". It is widely held out there that spreads have widened and the cost of lending has therefore gone up proportionate to base rate, which obviously has fallen. Was any definition given of "competitively priced" and are you free to decide for yourselves what that means?

Mr Hester: UKFI are in the process of defining it. The way I define it is that we have to be in the best half of the market in terms of most favourable prices to customers.

Q1208 Mr Tyrie: It is a relative measure. Mr Daniels, could I have your view?

Mr Daniels: There is no definition but I would agree that in-market parameters would probably make a great deal of sense.

Q1209 Mr Todd: I want to explore the relationship with shareholders. You in your remarks, Mr Varley, referred to the search for yield. What were the priorities of institutional shareholders when they questioned your bank as the years 2006-07 unfolded? Were they interested in the business model and the risk profile of your bank or were they simply pressing you to improve yield to shareholders? I think Mr Hester is a bit away out of this since he was not around then, but to the other four, what would characterise that relationship during that period?

Mr Horta-Osório: I can tell you that during 2006 and the first half of 2007 there were, as you were saying, less stringent risk criteria, more interest in asset growth and less prudence and less focus on funding and risk criteria.

Q1210 Mr Todd: That was characterised by shareholder representations?

Mr Horta-Osório: No, by investors and analysts. In spite of that, in our specific case, as you can see from the data, during 2006 and 2007 we decreased our market share targets of mortgages and of unsecured lending.

Q1211 Mr Todd: What I am looking for here is were there institutional shareholders crying wolf about problems in this sector and not being listened to, as simple as that.

Mr Daniels: The quick answer is, in the case of Lloyds TSB, no.

Mr Varley: I wish I could give you a very simple answer. The reason I struggle to do that, Mr Todd, is because there is not a homogeneity of view or expectation from our investors.

Q1212 Mr Todd: I am more expecting examples. Obviously individual investors make their own decisions for all sorts of reasons. The picture that is emerging is of a fairly complacent institutional shareholder base which was merely interested in yields for your institutions and not interested in how you achieved those yields or whether there were hazards involved.

Mr Varley: I think that is a bit unfair, frankly, to institutional investors, but of course their natural line of movement if they disagree is to sell, that is their natural line of movement. So if they have a particular problem with a business model or a risk profile or an absence of growth or excessive growth, they vote with their feet.

Q1213 Mr Todd: They would not normally do that without saying a word about it.

Mr Varley: Again, practices are very disparate.

Mr Thurston: In 2006 I think there were a number of commentators who were suggesting banks like ours were probably over-capitalised, ought to be returning capital, should be leveraging the balance sheet, so most of our discussions with institutional investors were about going through our risk model with them and explaining to them why we believed in strong capital and strong liquidity.

Q1214 Mr Todd: That is a broadly, I think, confirmatory set of answers. Can I ask about the relationship with regulators, and if I can bring in the two wings in this football formation here because you two would have particular experience of a regulatory environment outside the UK, and so would you, Mr Daniels, and be able to compare the experience between other countries and our own. What is your perception of the relationship with the FSA with your institutions in the run-up to this period? What comparisons do you draw?

Mr Hester: We deal with around 500 regulators around the world in 83 different countries and we try to work closely with all of them. We produce an awful lot of information. We have always sought very close contact with them and I hope there was close contact with all of our regulators throughout the period. In recent months we have probably seen a build-up in the amount and frequency of information required but there have always been continuous meetings at all levels. At the FSA we have very structured levels of meetings with all members of management on a very frequent basis.

Mr Horta-Osório: We share the same view in that we have a presence in more than 50 countries and deal with all of those regulators. One example which may be especially interesting for the Committee is the example of the Bank of Spain which was quite different from what was done throughout the world - I am not referring specifically to the UK - and which is now quite

commented on, as you know, which was the dynamic provisioning, the fact that you should provision and increase the banks' capital in good times so that you can weather the bad times.

Q1215 Mr Todd: You have had lots of admiring reviews for that, I agree.

Mr Horta-Osório: Not being Spanish, as you know, I think the Bank of Spain was quite prudent in doing that. It was very uncommon at the time. That allowed the Spanish banks to have a substantial amount of anti-cyclical provisions. Just to give you an idea, in the case of Santander it represents about 2% of the assets as anti-cyclical which is €6 billion.

Q1216 Mr Todd: Really quite material. A lot of you will have read the FSA's internal audit document on Northern Rock which described their experience of regulating a UK bank. Did any of you look at that and say, "Yes, that is our experience as well", poorly documented meetings, lack of regular contact? This was through the period 2006-07. We are trying to learn from this. Believe it or not, we are not trying to blame you entirely, there are other people who we need to improve the performance of and I am trying to understand that.

Mr Varley: Mr Todd, what I would say is we certainly did read the document you are referring to and if we stand back from all the drama of the last two years I would say that one of the learning points should be that although at the institution specific level there was, I think, pretty good transparency and flow of information, all the transparency and all the prudential supervision in the world at the institution specific level would not have prevented the crisis that has occurred. What that tells me in any event is the big issue here, and in a sense the big miss, was the absence to spot the systemic risk that existed. I think one of the learning points for me as I think about this is that we need to create the wherewithal and the structures in regulatory supervision going forward that ensure that it is the explicit obligation of a member of the regulatory body to be looking out for the big systemic risks because I think it is a failure of systemic risk that characterises the history of the last two years.

Q1217 Mr Todd: Although the Northern Rock experience showed lots of sloppiness at the institutional level. Specifically, when you read that document, if you did, did any of it have any resonance with you or was this a unique failure amazingly delivered at one UK institution? Any of you? Mr Daniels?

Mr Daniels: I believe that John's answer is right that there may have been specific failures against a particular institution, but the key lesson is that this crisis is different from every other that we have experienced. It is global in nature and it has systemic risk at the heart of it.

Q1218 Mr Todd: I buy all that and we can no doubt address you. It may help you if I ask a final question, which is have you noticed a change in your relationship with the FSA since the Northern Rock experience? Let us start down the end here with our Portuguese friend.

Mr Horta-Osório: From my quite frequent contact with the FSA I can tell you that I see them acknowledging that things were not correct in the case of Northern Rock and I see them trying to address what they think and what they report was not done correctly, as you have just said. I see that culture when I speak to them.

Q1219 Chairman: Give us a brief answer each of you to Mark's question, but very brief.

Mr Daniels: I think we see a great deal more activity from the FSA and a lot more requests for information.

Mr Hester: I have dealt with many regulators around the world and I think the FSA is one of the best, but I think all regulators around the world, including the FSA, were not concentrating enough on liquidity, it was the most under-developed bit of regulation, people were concentrating on capital, and I think that was the problem.

Mr Varley: The relationship has intensified a lot for all the reasons that you can imagine.

Mr Thurston: As I said before, we have had more contact, more information requests and a bigger size of supervisory team. I would agree with Stephen that there was far less attention on liquidity than on the capital.

Q1220 John Mann: I have got four questions and the first one is to all of you. If you would, please, a one word answer. I would like your marks out of ten on the credit rating agencies and how important they are or not for your business, with one being of minimal importance and ten of huge importance. If you could rate them one to ten, we will start with Mr Thurston and work down.

Mr Thurston: I do not think I can put a number on it. What I would say is that they ---

Q1221 John Mann: Give it a go, a number.

Mr Thurston: No. They are an agency and you would have to take no substitute.

Q1222 John Mann: That is easy. You rate them one to ten, are they of low importance or high importance?

Mr Thurston: They are an indicator, so five.

Mr Varley: I would be higher than that, probably at six.

Mr Hester: Seven.

Mr Daniels: Six.

Mr Horta-Osório: Seven.

Q1223 John Mann: So you all disagree then with Mr Blankfein of Goldman Sachs who identifies this outsourcing of risk management as one of the key problems.

Mr Daniels: I think he was referring to something somewhat different. When you ask a question of -
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Q1224 John Mann: Let me ask Mr Hester because it was Mr Goodwin who said yesterday at our hearing that RBS held positions in triple-A securities which turned out to be much higher risk than anticipated. You just rated them as a six, so quite useful to you.

Mr Hester: Actually I said seven. I can still add up anyway!

Q1225 Chairman: We have the same problem with you as with António!

Mr Hester: You were asking for a simple answer to a complex question. The world needs some shorthand of credit analysis because many people who use financial markets do not have the resources and time and expertise to do the work themselves, so the world does need credit rating agencies and we need them to be as good as they can be.

Q1226 John Mann: But a simple issue is whether you having a financial relationship with them and paying them is in your interests.

Mr Hester: If I may. However, people like banks or major institutional investors ought to have their own resources to be capable of second-guessing rating agencies, which many people do not. We seek to do that and, of course, we, along with many others, made the same errors the rating agencies did in respect of these securities.

Q1227 John Mann: Let me ask Mr Varley the second question. There is a vacancy for a senior position in the Financial Services Authority; would it be appropriate for a current or recent banker to be considered for that position?

Mr Varley: I am very much in favour of those who regulate the industry having had practitioner experience, so my one word answer to your question would be yes, why not.

Q1228 John Mann: My third question is on culture because here we have banks, all of you paying credit rating agencies for advice back, so a commercial relationship, and recent bankers becoming regulators overseeing you. Has the culture in British banking from your perspective, what you have seen, changed at all in the last four or five months?

Mr Horta-Osório: This is my second stay in Britain because I was here 15 years ago. My impression of the British financial system is very high. Notwithstanding the systemic issues that were just described, I think the British financial system is of a high standard. In the last six months specifically, as I think you can hear from the comments around the table, I have seen a lot more emphasis on risk management, liquidity, controls and capital considerations, no doubt.

Q1229 John Mann: It is the culture I am interested in. Is there a southern Mediterranean culture that is different from, shall we say, a North Atlantic culture of banking? In other words, is there more risk aversion in the culture and traditions that you have coming out of in banking than the traditions in Britain that these gentlemen and their predecessors have had? Has there been a change in that culture critically in the last four or five months?

Mr Horta-Osório: With absolute transparency, Mr Mann, it is not a matter of British or Mediterranean, as I said at the beginning it is a matter of how you organise institutions and which people you put in each of the key functions. It is much more given to that, which I could refer to as culture.

Q1230 John Mann: Anyone could have said that in the last 10, 20, 30, 40 years, could they not? It does not mean anything.

Mr Horta-Osório: Let me give you a precise example. In terms of risk management, we in Santander believe that you should have the risk management function totally separate from the commercial function. In the case of the bank, the risk management function does not report to the businesses until the boards and even at board level it does not report to the CEO, it reports directly to the chairman.

Q1231 John Mann: So you do have a different culture.

Mr Horta-Osório: I am giving you a specific example. I do not think that culture is specific to being Mediterranean or British, it is specific to a bank which in this case is Santander. I think it is important that you have that dichotomy between risk managers and business managers so you can come to the best decision. In the last resort, in my opinion, the risk manager should have the final word.

Q1232 John Mann: Your competitors here in your view, in your assessment, have they moved sufficiently in that direction for their own good?

Mr Horta-Osório: As you heard from Stephen, it is very early days to assess the changes that have been made. It would not be appropriate for me to comment because I do not know the inside of the organisation and the changes that are being made but you can ask around the table.

Q1233 John Mann: I will ask my final question to Mr Hester. We are all pulling together, I think the quote earlier was we are all working hard, although 2,300 are not going to be working hard for much longer in your banks. You have those staff to face, whoever they are, and there may be more to come, you have your predecessors and their actions, even potentially their share dividends that will come because they have not given up all their shares for the future. You have the whole mess, consumers, small businesses, the economy. My question to you is very simple: can Britain trust its bankers?

Mr Hester: I think you can trust the bankers to do the best that they can.

John Mann: Very convincing then.

Q1234 Nick Ainger: Mr Daniels, in reply to an earlier question from the Chairman, you said that you had sought legal advice on whether the contractual arrangement with HBOS staff in relation to bonuses could be honoured and the advice you received was, yes, you had to honour them. Can you understand the anger that will be felt by Nissan workers who have lost their jobs, other people who are on short-time working, other companies that are asking employees to take a pay cut, not because they poor companies, not because they are inefficient and not productive, but because of the failure of the banking system? Do you appreciate the fact that we have got to try and restore confidence not only in your banking system but in the wider economy and by paying bonuses in a company which has received £17 billion from the taxpayer to bail it out, do you think that is going to help us restore confidence?

Mr Daniels: I completely appreciate your point. You asked whether we had consulted in the case of HBOS and, yes, we did. Do I appreciate that can cause a huge degree of discomfort in society, yes, I do appreciate that.

Q1235 Nick Ainger: But their contracts have been ripped up. Nissan workers have had their contracts ripped up, people who are on short-time working have had their contracts ripped up. Bearing in mind what is happening, not just in your banks but in other banks was well, do you not think given the circumstances, given according to the former Chief Economics Advisor to the Treasury that we are probably entering the worst recession ever, that you should be saying to your staff, "Given these circumstances and that we want to restore confidence and get people appreciate banking the same way that they used to, you are not going to get a bonus or if you are going to get a bonus it is going to be a lot less than Mr Varley is even offering as well"? Do you not think that would be a way forward? What worries me about all of today's session is that I do not get the

feeling that you appreciate that the gold rush is over, that times have moved on dramatically, that we are facing a huge problem economically and you have got a part to play in it. Do you not think you ought to now admit that you are not going to pay bonuses anything like you have in the past, never mind what legal advice you have received?

Mr Daniels: As we said before, we will always observe the law, both the spirit and the letter. That was said in a different context but ---

Q1236 Nick Ainger: Are you talking about the criminal law or the civil law?

Mr Daniels: I think that we have to refer to both, do we not. That answer is a partial answer. Perhaps a wider answer is that Lloyds, as you know, is a retail bank primarily and as such we never paid out the kinds of bonuses that other banks did; investment banking is completely different.

Q1237 Nick Ainger: I accept that.

Mr Daniels: As I have mentioned before, the vast majority of our employees earn fairly modest wages and the bonus is an integral part of their contract, if you will, with the company and they are fairly modest bonuses. I think that our people performed well. We did not do everything perfectly, that is very clear, and for that I am sorry, but I think for the people who worked very hard during the year and performed well it would be a real violation of our agreement with them if we did not, in fact, pay bonuses. Now, that said, for our more senior managers and for the total bonus pool it will be down and down considerably from prior years.

Q1238 Nick Ainger: Do you not see that there is a cultural problem here, and John Mann was referring to it as well? One commentator has said, "the bonus culture is in the DNA of the banking system". We now know that this led to serious problems and Mr Varley has accepted that it was a major contributor to how we ended up with the crisis. Do you not think the bonus culture has got to change or else in a year or two's time we will be exactly back where we are again? Should we not be paying people what they are worth rather than, in some cases, rewarding them to the extent of ten and 20 times their basic salary?

Mr Daniels: I do not disagree with you that behaviour can be driven by compensation. I do not think we are in disagreement but what we are aiming at is two different audiences. The recipients of the bonus that I am referring to are people like you and me, they have relatively modest salaries.

Nick Ainger: I will swap your salary for mine!

Chairman: We will finish that now because you are going to submit evidence to us on that.

Q1239 Ms Keeble: I have just one question about the future of regulation which is probably the Holy Grail in all of this. The Bank of England has talked about a macro-prudential instrument, the building societies have talked about simpler models, John Varley, you spoke about having a countercyclical liquidity rule and, Stephen, you talked about people still have to do it and it is how you get people to do the regulation. What would be the single thing that you would do to make regulation more effective in the future?

Mr Thurston: I think it has to be more than one thing. It has to be to look at the capital rules and the pro-cyclicality of that, to look at the accounting rules and the way that regulators' attention has been focused on liquidity. I think that is a critical requirement.

Q1240 Chairman: We will take that as a submission if you could write on that to us, that would be good. Stephen Hester, Santander and HSBC are still standing, why is RBS not still standing?

Mr Hester: RBS became cruelly exposed to a downturn which has proven to be the greatest of modern times.

Q1241 Chairman: Of its own volition, its own business decisions, its direction?

Mr Hester: Clearly RBS's exposure was about decisions that RBS made.

Q1242 Chairman: So the decisions RBS made were different.

Mr Hester: The impact on RBS was the bigger environment.

Q1243 Chairman: That is fine, I am quite happy with that. Have we hit the bottom yet?

Mr Varley: I do not think so. I talked earlier about the key ingredient of normalisation being the bottoming of asset prices and I think we have some way to go.

Q1244 Chairman: Paul, do you think we have hit the bottom?

Mr Thurston: No, not yet.

Q1245 Chairman: Okay. Stephen?

Mr Hester: I think in the economy, no. It is possible that the disruption of financial markets will be less bad this year than last year.

Q1246 Chairman: We have not hit the bottom yet?

Mr Hester: From an economic standpoint that is correct.

Q1247 Chairman: Okay. Eric?

Mr Daniels: Not yet.

Mr Horta-Osório: 2009 will be tougher economically than 2008.

Q1248 Chairman: So we have not hit the bottom yet. Appetite for risk has been a central theme of the testimony to this Committee. Does the concept of more narrow banks offer a solution to the problem?

Mr Thurston: I am not convinced that it does because if you look at some of the banks that got into considerable difficulty you might say they were narrow banks. They were either retail and commercial banks or stand-alone investment banks. I think there is a value in having a universal bank so long as you have the appropriate control systems, but to be able to develop debt capital market instruments for your corporate customers rather than to create very sophisticated models. I think there is a very important customer ---

Q1249 Chairman: I am reminded of the building societies when they came before us that they never get into trouble and their maximum limit for wholesale funding is 50%. Is there something to learn there?

Mr Varley: I would very much agree with what Paul said, I think he puts it well. There are many lessons, but one of the lessons of the last two years is that risk concentration in a concentrated business model is unsupportable, and you see that in the wholesale funded mortgage banks and in the bulge bracket investment banks.

Mr Hester: I agree, you can go bust in all shapes and sizes.

Mr Daniels: Agreed.

Mr Horta-Osório: I think diversification will increase your security but it increases your complexity, so you have to make a trade-off between being bigger but more complex and being smaller. Smaller is not a solution either as you saw in Northern Rock or Bradford & Bingley.

Q1250 Chairman: As John Mann said to you, in Spain with the central bank the culture seems to be a bit different there.

Mr Horta-Osório: There are examples, as I said, of the Spanish Central Bank which are very useful and if you want me to give you another one, the Spanish Central Bank also never allowed off-balance sheet variables to be deconsolidated from the balance sheet and, therefore, the banks had no incentive to do them because they were fully consolidated.

Q1251 Mr Todd: It would be really useful to get a paper from you setting out some of those comparative experiences. If you can spare the time to write it, it would be very helpful to us.

Mr Horta-Osório: Of course.

Q1252 Chairman: Two or three years ago if you had asked a member of the public about banks in terms of trusting banks you would probably have been reasonably high up but now, given your comments, Mr Varley, I would suggest you are right down. What is your message to the public about your organisation and the banks and the financial services industry? What are you going to say to them?

Mr Thurston: Banks rely not just on capital and liquidity, they rely on trust and confidence, and I think it is one of the critical aspects of what we have been through in the current crisis that that trust has been put under duress and has been tarnished. We have a lot of work to do and now is the time for us to rebuild that trust working with our customers at the most difficult times for them in their personal lives, in their businesses, in helping them through the current crisis. That is the way we will rebuild the trust, but we must also make sure that not all banks are seen in the same way.

Q1253 Chairman: John, a personal comment to the public.

Mr Varley: I would say we must acknowledge our contribution to the problem, we must apologise, but we must not lose our appetite to take risks because the members of the public, whether they are businesses or households, need banks which are prepared to take risks, and we are.

Q1254 Chairman: But not crazy risks.

Mr Varley: The right risks.

Q1255 Chairman: Exactly. Stephen?

Mr Hester: We are going to rebuild RBS to stand-alone strength and along the way we are going to rebuild it around our customers and to support our customers, and that is our mission.

Mr Daniels: The next year or two perhaps will be incredibly tough for shareholders as well as customers. We are committed to working with our customers through these times and helping them work through their difficulties. We are committed to restoring the reputation and the share price of the bank.

Mr Horta-Osório: Santander at its heart is a retail bank. We lent substantially to the UK economy last year as well as substantially increasing deposits from the public. We are committed to continuing to do so and this is not just words, during these tough times in the last nine months we have acquired two institutions in difficulties, Alliance & Leicester and Bradford & Bingley, have doubled our presence in the UK and brought an additional £1 billion in capital into the country showing our confidence in the UK economy.

Q1256 Chairman: Eric Daniels, a last point. As you know, yesterday there was a memorandum provided to us by the former HBOS employee, Paul Moore. I want to be fair to everyone here. I asked Lord Stevenson if he would submit a memorandum to us and I think it is very important because the Select Committee does not want to get in the middle of any employee-employer relationship, whether it is a present or past employee, and therefore I would be grateful if you could communicate with the Committee and put your submission in. If Sir James Crosby wishes to add to that submission we would be grateful.

Mr Daniels: I would be happy to give you a view. This happened in 2005 from my understanding, long before Lloyds banking group had anything to do with HBOS, so I am not sure how much might we will be able to add on the subject.

Q1257 Chairman: I think it is very important because it is a merged company now and the image and trust element of the company is important. You have a story to tell here. It is in the line of fairness that I want you to submit that.

Mr Daniels: Thank you, Chairman, we will.

Chairman: I have found this session incredibly helpful. You are the banks that are standing, you are important to the country. We want banks to work, we want the economy to work, we want both to take place, so with that in mind I am grateful for your attendance today and I look forward to any submissions that you have agreed to provide us with. Thank you very much.