



House of Commons
Treasury Committee

Banking Crisis: dealing with the failure of the UK banks

Seventh Report of Session 2008–09

Report, together with formal minutes

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The Treasury Committee

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Contents

Report	<i>Page</i>
Summary	3
1 Where are we now?	7
The collapse of the banking sector	7
Scope and structure of the banking crisis inquiry	8
Structure of this Report	11
2 How did we get here?	12
Economic introduction	12
The experience of the banks until recapitalisation	14
Bradford & Bingley	14
RBS	18
Leverage	20
HBOS	22
Lloyds	26
The experience of the building societies	27
Key themes emerging from the experience of banks and building societies	31
Risk and complexity	31
Leverage	37
The performance of the Financial Services Compensation Scheme	39
Moral hazard	41
Funding	42
3 What has been the Government response?	45
Government support to Northern Rock	45
Government intervention in Bradford & Bingley	50
The HBOS and Lloyds merger	51
The October 2008 support package for the banking sector	54
The Government's approach	54
Bank recapitalisation	55
RBS	57
Lloyds	58
Barclays	58
Conclusion	60
Conditions attached to receipt of Government money	60
4 The January 2009 package	64
Asset Protection Scheme	64
Insurance scheme versus 'bad' bank	69
Beyond the January 2009 package: the prospects for further bank nationalisation	71
5 Bank lending	73
Lending to consumers	73
Lending to small and medium sized businesses	75

2 Banking Crisis: dealing with the failure of the UK banks

Government intervention	76
Missing links?	80
Conclusions	81
6 UKFI	83
Introduction to UKFI	83
UKFI as shareholder	85
Arm's length?	87
Return of investee banks to the private sector	88
7 The future of the banking sector	91
Introduction	91
Investment banks	92
Narrow banks	94
Trading of financial instruments	97
Competition in the banking sector	101
Lloyds-HBOS merger	103
Rebuilding confidence in the banking sector	104
Annex: Committee visits in conjunction with this inquiry	108
Conclusions and recommendations	110
Formal minutes	118
Written evidence	118
Reports from the Treasury Committee during the current Parliament	119

Summary

Roots of the banking crisis

The origins of the banking crisis were many and varied, including low real interest rates, a search for yield, apparent excess liquidity and a misplaced faith in financial innovation. These ingredients combined to create an environment rich in over-confidence, over-optimism and the stifling of contrary opinions. Notwithstanding this febrile environment, some of the banks have been the principal authors of their own demise. The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed. Bankers have made an astonishing mess of the financial system. However, this was a failure not only within individual banks but also of the supervisory system designed to protect the public from systemic risk.

The Financial Services Compensation Scheme

The Report praises the Financial Services Compensation Scheme (FSCS) for its response to the failure of several UK banks, in particular the variety of innovative solutions deployed by the FSCS to suit the particular challenges presented by each institution.

We think that financial institutions must make clear to their customers where they are subsidiaries of other institutions where this is relevant in terms of deposit protection. Ideally, we would like to see each brand holding a separate banking licence.

Northern Rock's lending policy

We welcome the Government's decision to allow Northern Rock to expand lending. We ask the Government to set out how this change of policy will also change the timescale over which the taxpayer loans to Northern Rock will be fully repaid and, in turn, the timescale over which a new ownership structure, whether by trade sale, privatisation or remutualisation, could be achieved.

The merger between Lloyds and HBOS

The merger between Lloyds and HBOS has been described in some quarters as a 'shotgun wedding'. Lloyds Group Chief Executive Eric Daniels conceded that the merger proceeded swiftly on the basis of relatively little due diligence and that the Government was involved to the extent that it offered to waive the competition rules. We also note that the merger may have prevented the collapse of HBOS with the consequent loss of many thousands of jobs and also avoided the outright nationalisation of the company. Nevertheless, from the evidence we received, if the merger has had injurious consequences for Lloyds TSB we consider that the responsibility for this lies primarily with the Lloyds Board.

Bank recapitalisation

We support the decision to implement a recapitalisation programme. The unavoidable speed of implementation did, however, mean that the implications for both banks and Government were neither fully understood nor worked out.

Government's strategic objectives for the banking sector

We welcome the fact that the Government has attached conditions to those banks in receipt of public funds for the purpose of recapitalisation. The Government's priority now must be to ensure that these conditions—in particular those relating to remuneration and lending levels—are adhered to.

That said, we are concerned about the contradictions of the Government's objectives for the banking sector especially with regard to the part-nationalised banks. There is a pressing need for the Government to clarify its strategic objectives and priorities with respect to the banking sector.

Toxic Assets and the Asset Protection Scheme

We welcome the approach taken in the Asset Protection Scheme, but are concerned about the need for greater clarity over the possible impact on the public purse, and urge the Government to complete the due diligence on assets in the scheme as quickly as possible, to make public the proportion of assets, by value, in each category covered by the scheme, and to disclose as soon as possible the mechanism for determining and the projected timeline for the crystallisation of any losses. We question whether more analysis should have been instituted by the regulators earlier to clarify the nature and value of assets on which banks were relying. It is unclear at this stage whether the APS is a precursor or an alternative to the introduction of a so-called bad bank and we would welcome clarity as to the Government's intention in this area. We would welcome transparency regarding the methods used to calculate the fee charged for participation in the Asset Protection Scheme and the relationship between the fee charged and the degree of risk. It is also as yet unclear how the Office for National Statistics will classify the potential liabilities assumed.

Bank Lending

Whilst noting some positive signs, we are very concerned about the availability and terms of credit to the small business sector, and the slow movement on this issue by the banks. We regret the reports of sharp increases in bank charges and arrangement fees which can often be more damaging to businesses than higher interest rates. We deplore the behaviour of a number of those banks who have received so much public money and behaved in such an insensitive manner particularly to established customers.

There are currently a number of Government schemes aimed at encouraging lending by the banks. However, it is difficult to form an overall picture of how effective those efforts

are, and how well they are working together. We recommend that the Government, via the Lending Panel, ensure that there is published a clear overall strategy, with each of the schemes outlined, indicating its aim and progress to date. At present, the approach seems to be piecemeal and disjointed

UKFI

UKFI is managing billions of pounds of taxpayer money but at this stage too little of its activities are in the public domain. We urge the Treasury to complete UKFI's Investment Mandate expeditiously so that the public, the markets and Parliament understands the full details of UKFI's objectives with respect to its investee banks. The Government must publish a strategy for UKFI addressing how it will use its control of the investee companies, and what role it envisages for UKFI in promoting change within the banking sector more generally. We do not think it is in the national interest for UKFI to remain so enigmatic a body.

It is right that the Government's investments in UK banks should be managed at arm's length and it is important to retain a clear division of responsibility between UKFI's role as an institutional investor, and any other public policy objectives that the Government may pursue. However, we think it important that "arm's length" in this instance is clearly defined so that what is appropriate behaviour can be discerned. Certain aspects of UKFI's institutional arrangements do lead us to wonder just how "arm's length" UKFI actually is from the Treasury. Given the importance of the task entrusted to it and the vast sums of public money involved, we believe that UKFI should be established, at the earliest opportunity, on a proper statutory basis. While the current ad hoc administrative arrangements persist we have no confidence that UKFI will have the real operational independence that is necessary. We recommend that the Treasury provides details of an exit strategy for the taxpayer's investment in the banking sector.

The future of the banking sector

The rebuilding of consumer trust is closely wound up in depositors having faith in the safety of their deposits, and the stability of payment systems and other utility aspects of banking. In our view, depositor reassurance can in the short term best be provided through improving and strengthening the regulatory regime for all types of bank. We do not lightly dismiss the Governor of the Bank of England's instinct that a separation of retail from investment banking functions is "very attractive". We believe that this is a live issue which requires further debate, and one to which we will return.

We acknowledge that the toxic shock that major financial institutions have been exposed to by securitisation is likely to result in changed business practices. We expect that one such change will see banks returning to the practice of keeping a greater portion of the loans they originate on their own balance sheets. But we also believe that a regulatory response may be required and recommend that the FSA coordinate efforts with its international counterparts to require that those undertaking securitisation retain a tranche of the commodities they trade.

We are concerned about the lack of transparency inherent in over-the-counter trading. One of the many reasons why “toxic” assets had such a devastating impact was that institutions had only a shaky grasp on where they were, what they comprised and what their value was. Their judgment was further clouded by the strong correlation between complexity and profitability. Looking to the future it is desirable that such obscurity is avoided. We recommend that the FSA takes steps to encourage trading through clearing houses and where appropriate on exchanges. The international nature of finance means that unilateral action by the UK would be ineffective. Nevertheless, the UK’s central role in world finance makes it a key player in moving forward this agenda.

1 Where are we now?

The collapse of the banking sector

1. On 2 April 2007, nine banks occupied places in the FTSE 100 all share index. They had a market capitalisation of £316.9 billion and constituted the single largest component by sector of the index. By 7 April 2008, Northern Rock and Bradford & Bingley had dropped out of the index and the capitalisation stood at £245.1 billion. Finally, by 6 April 2009, the FTSE top 100 banking sector was worth only £138.1 billion (see Table 1).

Table 1: Market capitalisation of banks in FTSE-100 (£ billion)

Banks in FTSE-100	02 April 2007	07 April 2008	06 April 2009
Alliance and Leicester	5.0	2.2	..
Barclays	47.1	32.1	14.3
Bradford & Bingley	2.9
HBOS	39.3	21.5	..
HSBC	103.1	100.9	74.8
Lloyds-TSB/ Lloyds Banking Group	31.6	25.8	12.9
Northern Rock	4.8
RBS	62.8	37.1	17.2
Standard Chartered	20.3	25.5	18.9
Total	316.9	245.1	138.1

Source: *Financial Times*

2. As is well known, the huge drop in value was not the only vicissitude to face these institutions during this period. Five of the nine FTSE 100 banks in March 2007, Bradford & Bingley, HBOS, Lloyds TSB, Northern Rock and RBS, are now partly or wholly in public ownership. None of the four demutualised building societies, Alliance and Leicester, Bradford & Bingley, HBOS and Northern Rock, now exists as a stand-alone bank in its own right. Thousands of jobs in the financial services sector have been lost. The full implications of the credit squeeze on the UK's industries and services remains unclear but its impact is likely to be highly damaging. Unemployment is fast rising. The stock market has suffered severe losses. Property prices have fallen sharply and mortgages are much harder to obtain. Other lending has also contracted. It is hard to estimate what will be the eventual cost to public funds of the banking crisis but the damage will be substantial and long-term.

3. Yet even with signs of the current crisis being evident, the banks were bullish in their optimism. Here for example is HBOS's Annual Report for 2007, published on 27 February 2008:

Tough though this may be, we are confident that we are well positioned to take advantage of the opportunities that this scenario will inevitably present and that we will continue to create shareholder value in these markets. To do so requires no let-up on the discipline we apply to each part of our strategy. Growth will be tempered as necessary by strong capital and liquidity disciplines. ... Shareholders can be assured that the perspective that shapes our ambition is the recognition that responsibility for the Company's performance is ours and ours alone.¹

RBS's Annual Report for 2007, which appeared the next day, was no less reassuring:

We have a great deal to do in 2008 but we also have an unparalleled set of opportunities and their realisation will allow us to continue on the impressive growth trajectory that has characterised RBS over the past decade.²

4. These comments look remarkable in hindsight. Capital and liquidity indiscipline were at the heart of HBOS's downfall, and rather more emphasis was placed in HBOS's evidence to us on the catastrophic global context of recent events than on a genuine recognition that responsibility for the Company's plight lay with the Board and the Board alone. Similarly, RBS's desire to continue on the "impressive growth trajectory" that was characteristic of the company's recent history was to prove its undoing. The purchase of ABN Amro which was intended to sustain that trajectory only served to prove how reckless RBS's growth had become, and how it had over-reached itself.

Scope and structure of the banking crisis inquiry

5. Our inquiry into the banking crisis spans 17 evidence sessions and incorporates an additional 800 pages of written evidence. We are grateful to all those who submitted oral and written evidence.³ This evidence will be the source for a series of Committee reports. We have already issued a report on the impact of the failure of Icelandic banks on savers.⁴ The current report takes as its focus the failure of the banks and the measures the Government has taken to address that failure. We will also shortly report on remuneration, corporate governance and market-based control mechanisms. A future report will examine aspects of public regulation while follow-up inquiries will look at the international dimension and at consumer issues.

6. Our terms of reference for the overall banking inquiry were announced on 25 November 2008. We decided to issue particularly comprehensive terms of reference to encourage those submitting written evidence to address very specific points.

1 HBOS plc, *Annual Report and Accounts 2007*, www.hbosplc.com

2 RBS, *Annual Report and Accounts 2007*, www.rbs.com

3 A full list of witnesses for this inquiry can be found at Treasury Committee, Banking Crisis, HC 144-I, pp1-4; written evidence can be found in HC 144-II and HC 144-III. In this report references to oral evidence are to the first of these volumes and prefaced by Q or Qq to refer to the Question number; written evidence relates to the second and third volumes. Ev p or pp refers to these, with pp 1-590 appearing in vol II.

4 Treasury Committee, Fifth Report of Session 2008-09, *Banking Crisis: The impact of the failure of the Icelandic banks*, HC 402

Terms of reference for the inquiry

The Treasury Committee is seeking to identify lessons that can be learned from the banking crisis. To that end, we would welcome written evidence on the following four key areas, from a wide variety of stakeholders.

1. Securing financial stability

1.1 The role of auditors in the banking crisis, and whether any reform to that role is desirable.

1.2 The role, and regulation, of credit ratings agencies in the banking crisis, and whether any reforms are desirable.

1.3 The role, and regulation, of hedge funds in the banking crisis, and whether any reforms are desirable.

1.4 Ongoing reforms to the operation of the Tripartite Committee, and cooperation between the relevant public sector authorities.

1.5 The impact of European Union directives on financial stability, including “passporting”.

1.6 Possible reforms to the remuneration structures prevalent in financial services.

1.7 Reforms to regulatory capital and liquidity requirements.

1.8 Possible improvements to the architecture of international financial regulation and maintenance of global financial stability.

1.9 Regulation of highly complex financial products, and the future of the “originate-to-distribute model”.

1.10 Risks to financial stability emanating from non-bank financial institutions.

1.11 The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises.

1.12 Monitoring and surveillance of financial stability problems by the public sector.

1.13 The role of the banking system within the overall economy.

1.14 The impact of short-selling in the banking crisis and its regulation.

2. Protecting the taxpayer

2.1 The advantages and disadvantages of the UK Government’s response to the banking crisis, including comparisons with alternative approaches adopted in other jurisdictions.

2.2 The nationalisation of Northern Rock and Bradford & Bingley.

2.3 The Government's recapitalisation programme, and part-nationalisation of major high-street banks.

2.4 The aims, objectives and exit strategy of the Government's investments in UK financial institutions.

2.5 The role of UKFI and its relationship with the part-nationalised banks.

2.6 The impact of current Government policy on future taxpayers, including the impact of moral hazard.

3. Protecting consumers

3.1 The role of banks in receipt of public investment in fulfilling the Government's aspirations for assisting customers, and small businesses, in financial difficulty.

3.2 The importance of retail banking as a "utility", and whether retail banks should be separate from other activities such as investment banking and insurance provision.

3.3 The competition impact of further consolidation within the retail financial services sector.

3.4 The product pricing of credit facilities, including mortgages, credit cards, store cards and small business loans.

3.5 The protection of UK citizens investing funds in non-UK jurisdictions.

3.6 The impact of deposit protection on both consumers and competition.

3.7 The role of financial advisers in the banking crisis.

3.8 The impact of the banking crisis on consumer confidence in financial institutions.

4. Protecting shareholder interests

4.1 The rights of shareholders in the context of new sources of investment, including the UK Government and sovereign wealth funds.

4.2 The responsibilities of shareholders in ensuring financial institutions are managed in their own interests.

7. We began taking oral evidence on 3 November 2008 and concluded our current tranche of evidence sessions for these inquiries on 19 March 2009. A full list of witnesses can be found in Volume I of the Evidence relating to this report.

8. We undertook two UK visits in relation to this inquiry. On 2 March 2009 we visited Belfast and on 9–10 March we went to Edinburgh, Halifax and Leeds. Some of our

meetings were open public debates where we listened to the views of individuals; others were targeted at business or community interest groups. We are extremely grateful to all of those who found time to share their views with us. A summary of key points made to us is annexed to this report.

9. We are also most grateful to Professor Geoffrey Wood of the CASS Business School, London, for his expert advice and assistance in this inquiry and on the other inquiries relating to the banking crisis.⁵

Structure of this Report

10. This report examines the failure of the UK banks. Some of the issues relating to the banks, such as those dealing with remuneration and the bonus culture, belong in our forthcoming report on remuneration and market-based control mechanisms. We begin by examining how we arrived at the present position. After looking at the economic situation we address the fate of those banks now partly or wholly owned by the Government. We compare their experiences with those of the building societies. This analysis leads us to conclude that several key factors can be identified as triggering this crisis. First, the growth of risk and complexity, with a concomitant growth in profit, meant that too few people (including many of those in charge) had a clear idea of what was on the banks' books. Second, the banking sector became over-reliant on wholesale funding and discounted any possibility that the wholesale market would dry up; third, rapid growth in the sector was facilitated by increased leverage.

11. We then examine the response of the Financial Services Compensation Scheme which had to cope with a dramatic surge in its workload to help compensate those savers in failing institutions. After that we assess the package of measures the Government has taken to address the problems in the banking sector. We well understand that these have been implemented in the face of fast-changing events and often under enormous pressure. Equally, many of them are extremely recent and determining their success at this stage may well seem premature. Nevertheless we offer our initial view on these measures to which we will return in future reports.

12. The Government's multi-billion pound stake in the banking sector is being managed by UK Financial Investments Limited (UKFI) and our next section looks at its early work. Although this body is only a few months old we think it important that its remit is clearly defined and its work transparent and these are some of the issues we pursue.

13. Finally, we look at the future of the banking sector, to see if structurally steps can be taken to limit the possibility of another banking crisis.

5 Relevant declarations of interest relating to Geoffrey Wood can be found in the Minutes of the Committee. See www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_formal_minutes_by_session.cfm www.parliament.uk

2 How did we get here?

Economic introduction

14. Before the start of the current financial crisis, the UK economy had experienced a sustained period of economic growth. In a speech in 2003 Mervyn King, Governor of the Bank of England, termed the previous years the “nice” (non-inflationary consistently expansionary) decade.⁶ In the United States in 2004 Ben S. Bernanke, at the time a member of the Board of Governors of the Federal Reserve, stated that “One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility”, noting that other writers had described this period as “The Great Moderation”.⁷

15. While key macroeconomic indicators, such as inflation and growth appeared benign during ‘The Great Moderation’, vulnerabilities were forming in the world economy. Richard Lambert, Managing Director of the CBI, highlighted “the enormous capital imbalances” that had developed in the world over the last 10 or 15 years “with huge deficits in the United States, the UK and other developed economies”, alongside “enormous surpluses in Asian economies” followed by attempts to intermediate those imbalances in “different ways”.⁸ Mervyn King, Governor of the Bank of England, told us that he felt that the “failures in the international monetary system led to imbalances in capital flows between countries that created the conditions of remarkably low interest rates and encouraged risk-taking”.⁹ This increased risk taking became known as the ‘search for yield’. The dependence of the UK on flows of capital from abroad, and the recycling of those inflows into secondary exports of capital which created large rewards for those who brokered these flows was, however, a particularly British and US phenomenon.

16. In a speech in January 2009, the Governor of the Bank of England outlined the steps, as he saw it, that led from these global imbalances to the financial crisis. He explained that “the entry of the rapidly growing economies in Asia into the world trading and financial systems provided a huge new pool of savings”.¹⁰ Will Hutton suggested that these imbalances grew as “a direct consequence of the way Asian countries in particular responded to the Asia financial crisis in 1998, a deliberate policy to peg their exchange rates and acquire foreign exchange reserves at an extraordinary rate, and that is the Japanese story and the Chinese story certainly”.¹¹ The Governor went on to explain that at the same time as these surpluses grew, in the industrial world policies “were aimed at ensuring a

6 Speech given by Mervyn King, Governor of the Bank of England, East Midlands Development Agency, Leicester, 14 October 2003, www.bankofengland.co.uk/publications/speeches

7 Federal Reserve Board, *The Great Moderation*, Remarks by Governor Ben S. Bernanke, At the meetings of the Eastern Economic Association, Washington, DC, 20 February, 2004

8 Q 728

9 Q 2355

10 Speech by Mervyn King, Governor of the Bank of England, to the CBI Dinner, Nottingham, at the East Midlands Conference Centre, 20 January 2009

11 Q 730

sufficient level of total demand to maintain stable inflation, and so desired levels of output and employment”, which triggered a stimulation of domestic demand, and current account deficits, as the Asian countries surpluses were absorbed.¹² Large amounts of savings entering the world economy, and the success of central banks at controlling inflation, led to low nominal interest rates in industrialised nations.¹³ As the Governor remarked: “nominal risk free returns fell to levels not seen in a generation”.¹⁴ This prompted the “search for yield” through “the combination of a fall in risk-free returns, and large amounts of capital looking for a home in western capital markets” which then “created a demand for assets offering higher returns”.¹⁵ The Governor noted several effects:

Investors, including banks, overlooked the fact that higher returns could be generated only by taking higher risks. As a result, money was lent on easier terms. That helped to push up further asset prices that had already risen as real interest rates were falling. It also led to an explosion in the size of the financial sector as new instruments were created to satisfy the search for yield. As well as lending to households and businesses, banks lent to other banks which bought ever more exotic instruments created by the financial system itself. The effect was to replicate the original risky loans many times over. Over the past five years, the balance sheets of many of the world’s largest banks more than doubled.¹⁶

Lord Turner, in his review, agreed with this analysis, where he argued that the demand for yield uplift stimulated by the macro-imbalances had been met “by a wave of financial innovation, focused on the origination, packaging, trading and distribution of securitised credit instruments”.¹⁷ The Governor was also clear as to where the international system needed to be reformed:

failures in the international monetary system led to imbalances in capital flows between countries that created the conditions of remarkably low interest rates and encouraged risk-taking and that has to be tackled somehow. It is not a question of financial stability but it is vital. It is getting back to the objectives of Bretton Woods that were never achieved of imposing symmetric obligations on surplus countries and debtor countries.¹⁸

Despite the warning signs, the full consequences of the collapse of Lehman Brothers investment bank in September 2008, and in particular the interconnectedness of Lehman’s with other financial institutions, was largely unforeseen, as many of our witnesses attested.

12 Speech by Mervyn King, Governor of the Bank of England, to the CBI Dinner, Nottingham, at the East Midlands Conference Centre, 20 January 2009

13 *Ibid.*

14 *Ibid.*

15 *Ibid.*

16 *Ibid.*

17 Financial Services Authority, *The Turner Review: A regulatory response to the global banking crisis*, March 2009 ,p 14

18 Q 2355

17. We acknowledge the international aspects of the present crisis, and welcome the call from the Governor of the Bank of England and others for reform to the design of the international financial architecture. We will consider such reforms in our inquiry into the international context of the banking crisis. Governments, politicians, regulators and central bankers in the UK and across the world share a responsibility for sustaining the illusion that banking growth and profitability would continue for the foreseeable future. A culture of easy reward, illustrated by risky lending of credit and capital, has been underpinned by an assumption of continuous expansion in banking accompanied by an expectation of ever bigger bankers' rewards.

The experience of the banks until recapitalisation

18. Although most major financial institutions in the UK, and indeed throughout the world, have suffered as a consequence of the banking crisis the extent to which they have been affected varies widely. In examining how the banking crisis had an impact on the institutions which are now partly or wholly state-owned it becomes apparent that a range of factors caused different banks to fail.¹⁹

Bradford & Bingley

19. Bradford & Bingley plc has a history stretching back to 1851, the year in which both the Bradford Equitable Building Society and the Bingley Building Society were established. The two societies merged in 1964 and operated as the Bradford & Bingley Building Society until the year 2000 when Bradford & Bingley's members voted to demutualise the society and form a public limited company.²⁰ After 149 years as a mutual, Bradford & Bingley's life as a plc lasted a little over eight years, ending on 29 September 2008 when the Chancellor announced that, under the Banking Supervisions (Special Provisions) Act 2008, Bradford and Bingley's retail deposit business and branch networks would be transferred to Abbey with the remainder of the business being taken into public ownership.²¹ When examining the rise and fall of Bradford & Bingley there are two features of its business model which cannot pass without comment. The first is its focus on self-certified and buy-to-let mortgages and the second is the rapid expansion of the business.

20. Bradford & Bingley's Annual Report in the year prior to demutualisation, 1999, reports that Bradford & Bingley had a loan book of £18.4 billion and retail savings balances amounting to £15.5 billion.²² It was from this robust platform that the demutualisation of the building society received overwhelming support from its members: 94% of voting investors and 89% of voting borrower members supported the resolution.²³ By June 2008,

19 We do not include here Northern Rock since this was the subject of a separate inquiry, Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56-1

20 Bradford & Bingley website, www.bbg.co.uk

21 "Bradford & Bingley Plc", HM Treasury press release, 29 September 2008

22 "Group Annual Results", Bradford & Bingley press release, 1 March 2000

23 "Bradford & Bingley members back conversion to plc in record numbers", Bradford & Bingley press release, 17 July 2000

Bradford & Bingley's residential loan book stood at £41.3 billion while customer deposits amounted to £24.5 billion.²⁴ The gap in the size of the increase in retail deposits (59%) relative to that in loans (124%) suggests that Bradford & Bingley, in common with many other financial institutions, funded much of this growth via the wholesale markets.

21. Bradford & Bingley's expansion was aided by a number of acquisitions which began prior to demutualisation. These included the acquisition of Mortgage Express in 1997, John Charcol Holding Ltd, a mortgage broker with a growing internet mortgage broking arm in 2000²⁵ and the Independent Financial Advisor company Aitchison & Colegrave Group Ltd in 2003.²⁶

22. The acquisition of Mortgage Express was a definitive act by Bradford & Bingley's board: Mortgage Express was a specialist mortgage lender focusing on lending to the self-employed using self-certification mortgages. After that acquisition, Bradford & Bingley began rapidly to expand this area of its business, using its Mortgage Express arm to focus on self-certification, buy-to-let and 100% mortgages.²⁷

23. A second element to Bradford & Bingley's growth was a series of deals with the US company General Motors Acceptance Corporation (GMAC). The first of these, announced in 2002, committed Bradford & Bingley to acquiring a mixed loan portfolio of £650m buy-to-let, self-certified and standard loans from GMAC.²⁸ This deal was followed by a flurry of loan acquisitions in 2003: £470m was taken on from GMAC in March;²⁹ £106m in October; £450m in November;³⁰ and a three year agreement covering £1.4 billion of loans was signed in December 2003.³¹ A second three year agreement was signed in 2006. Bradford and Bingley continued to implement this agreement after it fell into public ownership. The last tranche of loans was handed over from GMAC to the rump of Bradford and Bingley in public ownership on 27 February 2009.³² This committed Bradford & Bingley to purchasing a minimum of £350m of UK mortgage assets per quarter for three years.³³ In total, Bradford & Bingley had taken on £6.5 billion of self-certified and buy-to-let UK mortgages from GMAC by the time it was nationalised.³⁴ As a result the UK

24 Bradford & Bingley, Interim Financial Report For the 6 months ended 30 June 2008, 29 August 2008, p 5-6

25 "Bradford & Bingley acquires John Charcol - The UK 's leading mortgage broker and internet mortgage provider", Bradford & Bingley Press Release, 16 February 2000

26 "Bradford & Bingley Plc agrees to acquire IFA, the Aitchison & Colegrave Group Ltd", Bradford & Bingley Press Release, 22 September 2003

27 "Bradford & Bingley agrees to acquire up to £1.4bn of mortgage portfolios from GMAC- RFC over the next year", Bradford & Bingley Press Release, 12 December 2003

28 "Bradford & Bingley plc Acquires Portfolio of 6,000 Mortgage Loans from GMAC-RFC", Bradford & Bingley Press Release, 27 September 2002

29 "Bradford & Bingley plc acquires portfolio of 3,900 mortgage loans from GMAC-RFC Limited", Bradford & Bingley Press Release, 31 March 2003

30 "Bradford & Bingley completes on £440m loan portfolio acquisition from GMAC-RFC", Bradford & Bingley Press Release, 28 November 2003

31 "Bradford & Bingley agrees to acquire up to £1.4bn of mortgage portfolios from GMAC- RFC over the next year", Bradford & Bingley Press Release, 12 December 2003

32 Bradford & Bingley, *Annual Report & Accounts 2008*, p 54

33 Q 370

34 Q 372

Government is now a significant presence in the UK buy-to-let mortgage market, a matter on which we will comment later in this report.

24. At the time of this first GMAC deal the then Group Chief Executive of Bradford & Bingley, Christopher Rodrigues, argued that such acquisitions would “improve return on equity for our shareholders”.³⁵ The current Chairman, Richard Pym, told us that one of the reasons for buying loans from GMAC was that its network of mortgage intermediaries differed slightly from that of Bradford & Bingley.³⁶ However Mr Pym admitted that, with the benefit of hindsight, “the inflexibility that was built in to the GMAC contract did not allow us the flexibility that we would otherwise have liked as the market deteriorated”.³⁷ He identified the principal problem as the fact that “the underwriting criteria were written into the contract in December 2006, which meant that when credit conditions deteriorated there was no ability to change the underwriting criteria for the loans”.³⁸ In defence of the Board’s decision to pursue the GMAC contract, Mr Pym argued that when the restrictive contract was signed, they simply found it “difficult to envisage [the] economic circumstances” which later emerged. He defended his predecessors, arguing that at “that point there was probably no real reason why you would do that because you were not expecting the highly adverse situation that we have now”.³⁹

25. The legacy of the GMAC contract is a striking one for the taxpayer. Mr Pym informed us that the contract remains legally binding and under public ownership Bradford & Bingley will have to continue to purchase mortgages from GMAC. Under the terms of a September 2008 renegotiation these amount to £225m in the fourth quarter of 2008 and £250m in the first quarter of 2009.⁴⁰ The mortgages taken on from GMAC may also be disproportionately costly for the taxpayer because, as Mr Pym acknowledged, the default rate on GMAC mortgages was “marginally higher” than the default rate of Bradford & Bingley’s own mortgages.⁴¹

26. The Chancellor identified the two problems with Bradford & Bingley as being that “it was very exposed to the buy-to-let market [and that] it also had a problem with the self-certification of mortgages”.⁴² When seeking to trace the history of this business model the acquisition of Mortgage Express stands out as the point at which Bradford & Bingley nailed its colours to the self-certification and buy-to-let mortgage mast. Upon acquisition, Mortgage Express accounted for 4% of total Bradford & Bingley lending; after just a year, in 1998, this figure had risen to 15% of new loans; and by 2000 it was 40%.⁴³ Bradford &

35 “Bradford & Bingley plc Acquires Portfolio of 6,000 Mortgage Loans from GMAC-RFC”, Bradford & Bingley Press Release, 27 September 2002

36 Q 377

37 Q 378

38 Q 385

39 Q 389

40 “Bradford & Bingley and GMAC-RFC announce new terms for mortgage agreement”, Bradford & Bingley Press Release, 24 September 2008

41 Q 381

42 Q 33

43 “Group Annual Results 2000”, Bradford & Bingley Press Release, 28 February 2001

Bingley continued to use Mortgage Express to sell buy-to-let and self-certified mortgages until 2006 when it began selling its own-brand versions.⁴⁴ When he came before us in November 2008, Mr Pym confirmed that Bradford and Bingley's business was 60% buy-to-let and 20% self-certified⁴⁵ and that the value of buy-to-let mortgages alone on Bradford & Bingley's book was £24 billion, a figure which represented 20% of the UK buy-to-let market.⁴⁶

27. In Mr Pym's view, this business model had left Bradford & Bingley materially more exposed than other mortgage lenders.⁴⁷ He confirmed that "the total arrears in the business ... including [re]possessions was 2.48% at the end of June, which is above the level of the Council of Mortgage Lenders overall, and at the end of September it was over 3%".⁴⁸ In defending this business model, Mr Pym argued that "the strategic analysis was done that these mortgages were paying a higher interest rate, a higher spread over base rate" and were attractive even when the return was adjusted for risk.⁴⁹ He went on to admit that "obviously that [assessment] has not turned out to be the case".⁵⁰

28. In its memorandum, Bradford & Bingley argued that its downfall was caused by difficulties in obtaining both wholesale and retail funding:

The availability of wholesale funding reduced and the cost of both retail and wholesale funding increased. The market value of some of the bank's treasury assets reduced. Mortgage arrears increased and customers found it more difficult to secure mortgages elsewhere, increasing Bradford & Bingley's funding needs.⁵¹

These adverse conditions necessitated a drive to raise capital and in May 2008 Bradford & Bingley announced a rights issue. It was during this capital-raising process that the deterioration in Bradford & Bingley's trading outlook for the year became apparent.⁵² Through June and July 2008 Bradford & Bingley had its credit rating cut by the major ratings agencies which, it reported, led to withdrawals of wholesale and retail deposits.⁵³ When the collapse came for Bradford & Bingley it was sudden and dramatic. As Mr Pym explained to us, in the week commencing 22 September 2008, in a single 24 hour period, the company had £90m withdrawn from its branches:

The position on the Wednesday was we had an outflow of funds from the branches and from online of only £12 million. Previously that week it had been a lot higher

44 "Bradford & Bingley to sell its own-branded mortgages bringing expertise in buy-to-let and self-cert mortgages to the high street", Bradford & Bingley Press Release, 13 November 2006

45 Q 334

46 Qq 360-1

47 Q 335

48 Q 334

49 Q 393

50 *Ibid.*

51 Ev 81

52 *Ibid.*

53 *Ibid.*

because of media speculation, so by the Wednesday things had normalised, we were holding our own in UK deposits, but on that Thursday ... we lost £26 million. On the Friday, following further media reporting, we lost around £90 million and by lunchtime on the Saturday we had an outflow of around £200 million from branches and online, and it was that which forced the FSA to act.⁵⁴

29. Mr Pym accepted that there was a certain inevitability to Bradford & Bingley's decline. He suggested that after the Lloyds HBOS merger was announced on 18 September 2008 the media turned its attention to Bradford & Bingley: "As the last mortgage bank standing that meant that all the media focus was on us ... poor little Bradford & Bingley ... and, therefore, there was a loss of customer confidence".⁵⁵ Taken alone, this characterisation of events casts Bradford & Bingley as more of a victim than perhaps Mr Pym was intending. Certainly he accepted that "there is no denying that a mortgage bank with a large element of self-certified mortgages and a buy-to-let book is not going to be an attractive asset in these financial markets".⁵⁶ Mr Pym estimated that, based on an assumed 25% fall in house prices, Bradford & Bingley's losses would fall in the £600m–800m range but could offer no guarantees that even these estimates would not be exceeded.⁵⁷

RBS

30. The Royal Bank of Scotland (RBS) was founded in Edinburgh in 1727 and grew as a consequence of both organic growth and acquisitions through the nineteenth and twentieth centuries, whilst remaining a regional bank focused on retail banking in the UK, predominantly in Scotland and northern England.⁵⁸ During the 1980s the Group diversified, setting up a car insurance company, Direct Line, in 1985, and acquiring Citizens Financial Group of Rhode Island in the USA in 1988. Following a series of acquisitions, Citizens became one of the largest US banks, operating a branch network in 13 states. In 2000, RBS acquired the NatWest Group to create a much larger group with a more diversified portfolio of services for personal, business and corporate customers. This included the larger part of what is now RBS's Global Banking and Markets division, and Greenwich Capital, a US lender with exposure to sub-prime losses, which was to make a significant contribution to the recent losses of RBS.⁵⁹ Since 2000, RBS has acquired First Active in the Republic of Ireland, Charter One in the USA and Churchill Insurance in the UK, along with various other smaller businesses and, most recently, in October 2007, RBS's share of the Dutch bank ABN Amro.⁶⁰ In 2005 RBS was restructured and a Global Banking and Markets division was created which "is a leading banking partner to major

54 Q 245

55 Q 251

56 Q 253

57 Q 400

58 Royal Bank of Scotland website, www.rbs.com

59 Qq 1841–50; Ev 657

60 Ev 657

corporations and financial institutions around the world, providing an extensive range of debt financing, risk management and investment services to its customers”.⁶¹

31. As we discuss below, RBS announced a £20 billion capital raising programme in October 2008, which was underwritten by HM Treasury. The terms of the share offer proved unattractive to RBS shareholders, and the Government ended up acquiring a majority stake in the bank. RBS, a once proud financial institution with a fine heritage in prudent banking, had had to be bailed out by the taxpayer. This section of our Report addresses the causes of RBS’s problems.

32. We put it to Sir Fred Goodwin, the Chief Executive until the point of the firm’s failure, that RBS had been over-optimistic about the economic situation, despite warnings to the contrary from various organisations including the Bank of England and the Financial Services Authority. Sir Fred argued that he was aware that the economy and financial markets were going to slow down, but did not foresee the pace of events turning so quickly, and that in making that mistake he was not alone “Everyone I think saw that it was to turn at some point, but for it to turn in the way it has and so profoundly and globally I think is the part which has just caught everyone out, and it was not possible at the time to envisage”.⁶² The new Chief Executive, Stephen Hester, told us that RBS failed because it became “cruelly exposed to a downturn which has proven to be the greatest of modern times”. He accepted that that exposure was as a result of decisions that RBS itself made.⁶³

33. One of the problems identified by Mr Hester since his arrival at RBS was the presence of inadequate risk management systems, which, he said, needed “a lot of change”.⁶⁴ The most important issues related to control—“control of risk and rules on size and concentration, types of risk and amounts of risk.”⁶⁵ Sir Fred explained to us that there had not been a lack of control of trading decisions, but that the controls themselves were incorrectly designed. His re-examination of RBS’s trading positions had led him to conclude that traders were trading within the parameters set for them, and were conducting activities for which they were authorised by senior management based on what the risks were believed to be. “At the heart of this”, he said, “there was an issue not about risk recognition but about how the risk was calibrated... The risk was recognised but in the risk systems it was quantified as being very small: it turned out to be very large and it was wrong”. Sir Fred confirmed to us that there had been no “siren calls” from the risk management function within the bank that had been overlooked.⁶⁶

61 Ev 658

62 Q 1645

63 Qq 2122-3

64 Q 1963

65 Q 2035

66 Q 1660

Leverage

34. Mr Hester has said that “RBS leveraged itself too much in good times”.⁶⁷ Sir Fred Goodwin agreed, but had only reached that conclusion “relatively recently”, claiming that RBS had run “a tight balance sheet for a very long time”. Between May and August 2008, RBS “raised about £20 billion” of new funding, with another £3 billion at the beginning of September 2008. Sir Fred suggested that the collapse of Lehman’s had been critical: “The degree of leverage became a material issue quite late on in the piece as the funding started to dry up”. Sir Fred argued that the funding model of RBS had been “very transparent” for all to see.⁶⁸

35. In October 2007 RBS took a step which was to prove fatal to its survival as a privately owned company when it formed a consortium with Fortis (a Dutch-Belgian bank) and Santander (a Spanish bank) to take over the Dutch bank ABN Amro.

36. On 20 March 2007, Barclays Bank and ABN announced that they were in exclusive talks about a merger.⁶⁹ On 12 April 2007, RBS contacted ABN to propose an alternative deal in which a consortium, also including Fortis and Santander, would jointly bid for ABN and thereafter break up the different divisions of the company between them. According to the proposed deal, RBS would take over ABN’s Chicago operations, LaSalle, and ABN’s wholesale operations, while Santander would take the Brazilian operations and Fortis the Dutch operations.⁷⁰ On 23 April ABN and Barclays announced the proposed acquisition of ABN by Barclays. The deal was valued at €67 billion. Part of the deal was the sale of LaSalle Bank to Bank of America for \$21 billion.⁷¹ Two days later the RBS-led consortium brought out their indicative offer, worth €72 billion, conditional on ABN abandoning its sale of LaSalle Bank to Bank of America.⁷² Notwithstanding this offer, LaSalle was sold to Bank of America. On 23 July Barclays raised its offer for ABN to €67.5 billion, but it was still short of the RBS consortium’s offer.⁷³ Barclays withdrew its bid for ABN on 5 October, clearing the way for the RBS consortium’s bid to go through, along with its planned dismemberment of ABN.⁷⁴ Fortis would acquire ABN’s Dutch and Belgian operations, Santander would obtain Banco Real in Brazil and Banca Antonveneta in Italy, and RBS would get ABN’s wholesale division and all other operations, including those in Asia. On 8 October, 86% of ABN shareholders accepted the RBS consortium’s offer.⁷⁵ This

67 www.reuters.com/article/rbssFinancialServices%20-%20Diversified/idUSLJ54400820090119 (relating to statement made by Mr Hester on 19 January)

68 Q 1840

69 Announcement by Barclays, 20 March 2007

70 Announcement by RBS, 16 April 2007

71 Announcement by Barclays, 23 April 2007

72 Fortis, RBS and Santander Announcement, 25 April 2007

73 Announcement by Barclays, 23 July 2007

74 Announcement by Barclays, 5 October 2007

75 Announcement by RBS, 8 October 2007

level of acceptance cleared the way for the consortium to take formal control. The group declared its offer unconditional on 10 October.⁷⁶

37. The acquisition of ABN Amro by RBS opened up a funding gap which had given RBS cause for concern. RBS had drawn up a plan to resolve this gap but, unfortunately for RBS, Sir Tom McKillop, former Chairman of RBS, told us, “no sooner had we acquired ABN Amro then the world changed dramatically and we were unable to implement that plan”, leaving the newly combined group vulnerable to the subsequent freezing of wholesale money markets.⁷⁷ ABN Amro was to become severely affected by poorly performing assets following the takeover, which appeared to take RBS by surprise. RBS’s failure to recognise the scale of credit problems at ABN Amro prior to the takeover may have been linked to the fact that it had carried out due diligence on the transaction in May 2007, a full six months before the transaction was completed.⁷⁸ In that time, Northern Rock had failed, and there had been a marked deterioration in the interbank credit markets. RBS carried out no due diligence on ABN Amro in that period of six months, instead choosing to rely on “very reassuring” public statements from ABN Amro about their resilience to the economic crisis: “[On] 17 September 2007 ABN Amro reconfirmed their earnings estimates for 2007 and specifically stated that credit market markdowns had not affected them. They specifically stated that their credit portfolio and credit outlook was good.”⁷⁹

38. The RBS stake in the ABN Amro takeover consortium amounted to “about £10 billion.”⁸⁰ On 19 January 2009, RBS issued a trading statement, which noted a groupwide write-down of goodwill of £15billion-20 billion, a “significant part” of which related to ABN Amro.⁸¹ Sir Tom McKillop added that “the bulk of what we paid for ABN Amro will be written off as goodwill”⁸². Sir Fred Goodwin labelled the acquisition of ABN Amro as “a glaring mis-step”⁸³ and Sir Tom McKillop admitted that ABN Amro was bought “at the top of the market, so anything we paid was an error”,⁸⁴ confirming that the £10 billion spent on ABN Amro was now worth nothing. He was “sorry” that RBS had bought ABN Amro, and acknowledged that “the deal was a bad mistake”,⁸⁵ but claimed that at the time there had appeared to be a “very good” financial case for the acquisition, indicated by the support of 94.5% of shareholders.⁸⁶ Mr Hester agreed that the RBS strategy had been there for all to see:

76 Announcement by RBS, 10 October 2007

77 Q 1674

78 Qq 1680-1

79 Qq 1691-3

80 Qq 1694, 1670

81 RBS announcement, 19 January 2009 and Q 1668

82 Q 1670

83 Q 1571

84 Q 1666

85 Q 1677

86 Q 1678

RBS had a leverage business model and ... ABN AMRO doubled up that risk, how it was funded ... 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.⁸⁷

It was not just shareholders who approved of the acquisition: the directors of RBS were unanimous in supporting the deal. The acquisition of ABN Amro by RBS was a protracted, complex, and expensive affair, but at every stage of the deal, Sir Tom explained, the whole Board of RBS was unanimous in agreeing the steps taken.⁸⁸ The scale of the damage caused by the takeover was made clear when Sir Philip Hampton, the new chairman of RBS, revealed that the bank, which made a loss of £24.1 billion in 2008, would have made a profit but for the ABN Amro deal.⁸⁹ As Sir Philip told shareholders at the AGM on 3 April 2009:

I don't think there can be any doubt that the key decision that led RBS to its difficulties was the acquisition of ABN AMRO. That is the painful reality that we can now do nothing to change. With the benefit of hindsight it can now be seen as the wrong price, the wrong way to pay, at the wrong time and the wrong deal.⁹⁰

HBOS

39. On 18 September 2008 Lloyds TSB announced that it had reached an agreement on the terms of a 'recommended acquisition' of HBOS, thereby ending weeks of speculation about the fate of the UK's largest mortgage lender.⁹¹ HBOS was formed in 2001 when the Bank of Scotland, the UK's oldest commercial bank (established in 1695), merged with the Halifax, the company which emerged in 1997 when the Halifax Benefit Building and Investment Society demutualised.⁹² According to the 2007 HBOS Annual Report, HBOS held 20% of the mortgage market and 16% of the savings market.⁹³ When invited to characterise the cause of HBOS's downfall, outgoing Chief Executive Andy Hornby informed us "it was the combination of being property-based on one side of the balance sheet with a significant reliance on wholesale funding on the other".⁹⁴ In this section we will examine these two factors and also the quality of risk management within HBOS, before examining the merger with Lloyds TSB.

87 Q 2038

88 Q 1671

89 Interview on BBC Radio 4 Today programme with Robert Peston, 3 April 2009

90 Royal Bank of Scotland website, www.rbs.co.uk

91 "Recommended acquisition of HBOS plc by Lloyds TSB Group plc to be implemented by means of a scheme of arrangement under sections 895 to 899 of the Companies Act 2006", Regulatory Announcement by Lloyds TSB, 18 September 2008

92 HBOS website, www.hbosplc.com

93 HBOS plc, *Annual Report and Accounts 2007*, p 8

94 Q 1872

40. HBOS had two major divisions involved in property lending, Retail and Corporate. The Corporate division focused on businesses with turnover in excess of £1m.⁹⁵ It is apparent that much of the commentary surrounding the collapse of HBOS has focused on its commercial property lending, which took place within the Corporate arm. Indeed, the HBOS preliminary results for 2008 show that its retail arm made a profit of £1,267m while its corporate arm made a loss of £6,793m.⁹⁶ The outgoing HBOS Chairman, Lord Stevenson, was frank when he told us “on the issue of property, the fact is we made some mistakes and that is the bottom line”.⁹⁷

41. In 2007, as the market began to respond to the first shock-waves, Peter Cummings, HBOS’ Corporate Chief Executive, oversaw growth in advances and loans to corporate customers of 22%, a significant increase on growth in 2006 of just 8%.⁹⁸ The continuing expansion of HBOS even during times of uncertainty did not go unnoticed and Mr Cummings was quoted in the press as stating that “some people look as though they are losing their nerve—beginning to panic, even—in today’s testing property environment. Not us.”⁹⁹ Invited to defend Mr Cummings’ statement in light of the subsequent events, Lord Stevenson argued that the quotation should be construed as “saying if we have to choose between customers we will stay with our existing long-term customers”.¹⁰⁰ Lord Stevenson did not attempt to defend his Corporate Chief Executive’s actions, acknowledging that HBOS “lent too much and [Peter Cummings’] division lent too much”.¹⁰¹ When discussing responsibility for this error, Lord Stevenson denied that Mr Cummings had been allowed to build “an empire within an empire” and insisted that “given the risk management system [in HBOS], it would have been quite impossible for anyone to do it”.¹⁰² He went on to contend that the Board was “hugely engaged” in the decisions made regarding commercial and retail lending.¹⁰³ With regard to Board performance in this area, Lord Stevenson argued that it had taken some evasive action but accepted that a grave error had been made:

We were already by then lowering our growth, as it turned out by not enough. I would say to you absolutely frankly it is quite clear, with the wisdom of hindsight, that we were over-exposed, that we lent too much at the wrong parts in the cycle. Simple as that.¹⁰⁴

42. Lord Stevenson declined to identify the point at which HBOS realised it was over-exposed in property, suggesting instead that he would “put it differently”:

95 HBOS plc, *Annual Report 2007*, p 26

96 HBOS plc, *Preliminary Results 2008*, 27 February 2009

97 Q 1834

98 HBOS plc, *Annual Report 2007*, p 27

99 “Peter Cummings stayed loyal and brave at wrong time”, *The Times*, 13 December 2008

100 Q 1838

101 Q 1835

102 Q 1834

103 Q 1835

104 Q 1833

The Bank of Scotland has always been a specialist in commercial property. The exposure as a percentage of the balance sheet to commercial property has not increased dramatically over time, that is not what has happened. Looking back, with the wisdom of hindsight, we did not foresee the deterioration in asset values that took place, it is as simple as that”.¹⁰⁵

43. In common with many other banks, HBOS experienced rapid growth in the five years preceding its demise: HBOS’s 2007 Annual Report discloses an expansion of debt in issue from £112 billion in 2003 to £231 billion in 2007 and an increase of total assets from £408 billion in 2003 to £667 billion in 2007.¹⁰⁶ Reviewing this progress, Andy Hornby admitted “we would have liked, in retrospect, to have delivered less of that growth through wholesale funding”.¹⁰⁷ As HBOS entered 2008, it was drawing a greater proportion of its funding from the wholesale markets than from retail deposits with £248 billion of wholesale funding exceeding the £243 billion of retail deposits.¹⁰⁸ Mr Hornby admitted “it is clear with the benefit of hindsight that, over many years of reliance on wholesale funding, that left us in a vulnerable position”.¹⁰⁹

44. The defence put forward by Mr Hornby and Lord Stevenson was that they had recognised the risks posed by the business model and had taken some mitigating actions. Mr Hornby claimed that by 2006–07 HBOS executives “tried to increase deposit growth and grew deposits faster” in order to reduce risk.¹¹⁰ Lord Stevenson argued that HBOS had reduced its “share of the housing market from 30% to 20% ... out of good countercyclical caution” and “deliberately took a P&L [profit and loss account] hit so as to lengthen the maturity in wholesale markets”.¹¹¹ What Mr Hornby did accept was that HBOS had been “over-reliant on wholesale funding”¹¹² and that the Board “should have done more to reduce this reliance”.¹¹³

45. In a written submission to us Paul Moore, former Head of Group Regulatory Risk at HBOS, argued that HBOS had “a cultural indisposition to challenge” and that the task of “being a risk and compliance manager ... felt a bit like being a man in a rowing boat trying to slow down an oil tanker”¹¹⁴ due to the prevalence of the sales culture in HBOS.¹¹⁵ Mr Moore suggested that the “balance and separation of powers was just far too weighted in

105 Q 1836

106 HBOS plc, *Annual Report 2007*, Five Year Summary, p 14

107 Q 1876

108 HBOS plc, *Annual Report 2007*, p 74

109 Q 1747

110 *Ibid.*

111 Q 1644

112 Q 1766

113 Q 1758

114 Ev 435

115 Ev 545

favour of the CEO and their executive”¹¹⁶ and alleged that his team had been subject to “threatening” behaviour during the course of its risk compliance work.¹¹⁷

46. Mr Moore was dismissed by HBOS in 2004. He sued for unfair dismissal and settled his claim against HBOS in 2005. In response to Mr Moore’s accusations, HBOS maintained that his claims had been investigated in an independent investigation carried out by KPMG, that enquiries had been made by the FSA, and that the FSA were satisfied with the response by HBOS. It should be noted that Mr Moore has disputed the independence of the KPMG report and has also argued that its scope was limited.¹¹⁸ The FSA issued a public statement in which it confirmed that it had its own concerns about risk management at HBOS:

Having examined carefully the files relating to this issue, the FSA can confirm that specific allegations made by Paul Moore in December 2004 regarding the regulatory risk function at HBOS were fully investigated by KPMG and the FSA, which concluded that the changes made by HBOS were appropriate ... In conclusion, the FSA confirms that the allegations made by Mr Moore were taken seriously, and were properly and professionally investigated. It should also be noted that the FSA’s concerns about HBOS’s risk management framework considerably pre-dated the allegations by Mr Moore.¹¹⁹

47. In response to the charge that risk management in HBOS was inadequate, Lord Stevenson argued that “HBOS had very elaborate systems of risk management and stress testing, worked out over the years ... hand-in-hand with our regulator”.¹²⁰ Similarly, Andy Hornby contended that he had “listened to siren voices very carefully”¹²¹ and adduced as evidence a number of ways in which HBOS had sought to reduce its risk profile. These actions included terminating “share buyback programmes in order to preserve capital”, extending longevity in the wholesale market and pulling “back further on [HBOS’s] mortgage market shares, which fell to 14% net lending in 2007 and down to 8% in 2008” against a historical high of 25%.¹²² In their written submission, Lord Stevenson and Mr Hornby argued that these decisions had enabled HBOS to “continue funding ourselves adequately through the wholesale markets for 14 months since August 2007”.¹²³ Mr Hornby did however acknowledge that more could have been done:

116 Ev 436

117 Ev 437

118 Ev 495 [Mr Peter Hamilton]

119 “Statement on HBOS”, FSA, 11 February 2009

120 Q 1688

121 Q 1747

122 Q 1744

123 Ev 431

If I look back and say what could have been done differently, there is no doubt that if we could have gone even further on that over the previous five years that would have been a beneficial situation.¹²⁴

Lord Stevenson maintained that the Board was very heavily engaged in risk management but accepted that “in truth we failed to consider some of the extreme scenarios that have actually happened”.¹²⁵

Lloyds

48. The Lloyds Banking Group came into existence on 16 January 2009, when Lloyds TSB acquired HBOS. The acquisition of HBOS was the most recent, and arguably the most ambitious, in a long line of acquisitions by Lloyds: the first of which reportedly took place in 1865.¹²⁶ We examine the circumstances and implications of the HBOS merger later in this report but at this point it is worth briefly reviewing Lloyds’ position prior to the HBOS merger.

49. In its 2007 Annual Report, Lloyds describes its business as containing three main arms: UK retail banking, insurance and investments, and wholesale and international banking. Lloyds boasted that its retail arm, incorporating the Cheltenham & Gloucester brand, was the “UK’s largest personal current account bank” and had been “voted the most trusted bank in Britain for seven years running”.¹²⁷ As at 31 December 2007, Lloyds had UK retail customer deposits of £82.1 billion against customer mortgage balances of £102 billion.

50. The narrative promoted by Lloyds throughout the current crisis has been that it had “limited exposure” to the crisis. In its written submission to us, Lloyds argued that it had entered the economic downturn in a robust position:

Lloyds TSB entered the financial crisis in a strong position. This was due to our relationship banking strategy, our strong business model, our prudent risk approach and our philosophy of taking a through the cycle approach. Furthermore, we had anticipated that the benign economic environment was unlikely to last and had as a result positioned our business to avoid riskier parts of the lending market.¹²⁸

51. The Lloyds 2007 Annual Report reflects this claim, noting that “Lloyds TSB has no direct exposure to US sub-prime” mortgages and arguing that Lloyds had “maintained a strong liquidity position”.¹²⁹ Lloyds also maintained that part of the reason for its comparative resilience was that the rate of earnings growth of Lloyds, in its Chief Executive’s own words, did “not always match” that of its competitors.¹³⁰

124 Q 1744

125 Q 1688

126 Lloyds, *Lloyds TSB History*, www.lloydsbankinggroup.com

127 Lloyds TSB Group, *Annual Report and Accounts 2007*, p15

128 Ev 432

129 Lloyds TSB Group, *Annual Report and Accounts 2007*, p 12

130 “2008 Results”, Lloyds News Release, 27 February 2008

52. While the profit before tax from UK retail banking remained steady through 2008 at around £1.67 billion (against £1.73 billion in 2007), the other segments of Lloyds Group's business were less buoyant.¹³¹ The insurance and investment segment saw profit before tax fall from £1.04 billion in 2007 to £0.15 billion in 2008.¹³² The third arm of Lloyds' business, wholesale and international banking saw a profit before tax of £1.82 billion in 2007 converted into a marginal loss (£6m) in 2008.¹³³

The experience of the building societies

53. Building societies hold around 20% (£250 billion) of UK residential mortgages and 20% (£235 billion) of retail deposits.¹³⁴ While they offer many of the same services to retail customers building societies are appreciably different from banks: they are subject to a different regulatory framework, they are owned by their members and, perhaps consequentially, their experiences of the current banking crisis have been different.

54. Perhaps the most striking distinction between banks and building societies is that building societies have members, not shareholders: they “are mutual, they are owned by their customers”.¹³⁵ The importance of shareholders to banks was emphasised by Sir Tom McKillop:

[it] is a kind of given, that [shareholders] would always be pushing the organisation to perform better ... the drift from most institutional shareholders was to increase the dividend, share buybacks, return capital, do not sit on capital and run a very efficient balance sheet.¹³⁶

55. The objective of the basic building society business model is to balance the needs of borrows and savers to ensure that the respective interest rates and fees charged or paid cover the administrative costs of the society. While members may receive a small dividend payment, the primary benefit of membership comes from the comparative attractiveness of interest rate and other charges attached to the money borrowed from or invested with the society. This position stands in contrast to the objective of a bank, namely to deliver “growth in shareholder value”,¹³⁷ where many of the shareholders will not be customers.

56. Adrian Coles, Director General of the Building Society Association (BSA), argued that this difference meant that building societies were “not driven to increase shareholders' returns and profitability and dividends”.¹³⁸ He went on to suggest that there is no “stock

131 Lloyds TSB Group, *Annual Report and Accounts 2007*, p15; “2008 Results”, Lloyds News Release, 27 February 2008, p 15

132 *Ibid.* p18; “2008 Results”, Lloyds News Release, 27 February 2008, p 15

133 *Ibid.*, p26; “2008 Results”, Lloyds News Release, 27 February 2008, p 15

134 Ev 276 [Building Societies Association]

135 Q 1566 [Adrian Coles, Building Societies Association]

136 Q 1815

137 HBOS plc, *Annual Report 2007*, p 17

138 Q 1566

market inducement to deliver short-term returns ... and the incentive ... [for] taking excessive risk does not exist in the mutual model".¹³⁹

57. A review of building societies which have demutualised provides ammunition for defenders of the mutual mode. As demonstrated in Table 2, of the ten building societies that have demutualised, six now form part of entities in receipt of government support, three have been subject to takeovers by major banks and one (the Bristol and West) was effectively remutualised by Britannia in 2005.

Table 2 – Demutualised building societies

Building Society	Details
Bradford & Bingley	Floated 4 December 2000
Birmingham Midshires	Taken over by Halifax plc, 19 April 1999
Northern Rock	Floated 1 October 1997
Bristol & West	Taken over by Bank of Ireland, 28 July 1997. Bristol and West transferred its branch network and direct savings business to Britannia Building Society on 21 September 2005
Woolwich	Floated 7 July 1997, taken over by Barclays Bank in October 2000.
Halifax	Floated 2 June 1997 [<i>Merged with Bank of Scotland, May 2001</i>]
Alliance & Leicester	Floated 21 April 1997 [<i>Acquired by Santander, July 2008</i>]
National & Provincial	Taken over by Abbey National plc, 5 August 1996 (ceased trading under this name)
Cheltenham & Gloucester	Taken over by Lloyds Bank plc, 1 August 1995
Abbey National	Floated 12 July 1989 [<i>Acquired by Santander, November 2004</i>]

Data Source: Building Society Association

58. The Building Society Act 1997 explicitly prevents building societies from obtaining more than 50% of their funding from the wholesale funding market.¹⁴⁰ Graham Beale, Chief Executive of Nationwide, explained “the regulatory structure prevents high gearing, it prevents trading in the more esoteric instruments, it prevents making markets”.¹⁴¹ Recent changes have been made to the legislative framework for building societies in the form of the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007. This Act opens up the possibility of building societies obtaining more than 50% (but less than 75%) of their funding from the wholesale market by allowing for the Treasury to issue secondary legislation changing the limit. The Act also states that if a society wishes to exceed the 50% ceiling its membership would have to pass a resolution.¹⁴² The BSA informed us that typically the amount of wholesale funding employed by building societies is around 30%¹⁴³ and that secondary legislation allowing for the 50% limit to be exceeded had not yet been laid. Mr Coles suggested that this was not something that the BSA would advocate “at the moment”.¹⁴⁴

140 Building Societies Act 1997, section 8

141 Q 1604

142 The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007, section 1

143 Q 1594

144 Q 1605

59. Mr Beale explained that the comparatively low reliance of building societies on wholesale funding limited the impact they felt from the disruption of the wholesale markets but that it did not insulate them completely:

The disruption to the wholesale markets which are well-rehearsed are impacting on building societies as well as the banks. To the extent that funding is restricted, it will restrict our ability to lend ... we would lend according to the cash that we could bring in to the business. So a year ago we brought in £9.1 billion and we lent £8.9 billion, so broadly matched it. This year, so far, we have only brought in a small fraction of that £9.1 billion which will reflect on what we can lend to borrowers.¹⁴⁵

Mr Beale said that building societies tended “to use the wholesale funding to generate ... liquidity and some of the other assets on the balance sheet” and that most of their residential lending was “secured against or funded by retail deposits”.¹⁴⁶ He told us “building societies keep, typically, about 20% of their funds in liquidity” because that was typically the level required by the FSA.¹⁴⁷ This, Mr Beale argued, meant that there was less risk and “the length of the funding for retail will more or less match the length of our lending”.¹⁴⁸ This contrasts with some banks in which short term wholesale funding has been used to finance longer term residential lending.¹⁴⁹

60. The building societies we heard from argued that their focus on protecting members’ financial interests and avoiding large scale wholesale funding had shielded them from the worst of the banking crisis. Indeed the building societies appeared confident in the benefits their business model had over the banks’. Mr Coles told us that:

If you look at the mutual model, it is lower risk, better customer service, better pricing, so send the banks into our branches and they will learn a lot.¹⁵⁰

61. However the building society sector has not been completely immune to recent developments. On 30 March 2009, the Treasury announced that Dunfermline Building Society’s retail and wholesale deposits, branches, head office and originated residential mortgages had been transferred to Nationwide while its social housing portfolio had been placed into a “bridge bank, wholly owned by the Bank of England”.¹⁵¹ The remainder of Dunfermline’s business, including commercial loans and acquired residential mortgages, was placed into administration. Dunfermline’s collapse followed on the heels of a period of rapid consolidation in the sector: in December 2008 alone there were four instances of smaller building societies submitting to rescue mergers with larger societies, the highest

145 Q 1594

146 Q 1618

147 Q 1597

148 Q 1618

149 Q 20

150 Q 1638

151 “Dunfermline Building Society, 32/09”, HM Treasury Press Notice, 30 March 2009

number of mergers in a single month since April 1987.¹⁵² The Britannia has also announced its intention to merge with Cooperative Financial Services pending a vote of its members in April 2009. It is worth noting that the posited Britannia–Coop merger was only made possible by a second element of the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 which allows mergers between different types of mutual societies.¹⁵³

62. Mr Beale argued that those societies that had suffered the most were those which had expanded their operations without managing the risk adequately:

typically where building societies have expanded their activities and gone into areas of risk that they either have not fully understood or where they did not have the right resource in place to be able to deal with them... [For example, with] the Derbyshire ... the risks were beyond the capacity of the balance sheet.¹⁵⁴

63. **To date, building societies have generally been shown to have operated a safer business model. Certain features of the building society model, including the comparatively low reliance on wholesale funding and the focus on the protection of members rather than the service of shareholders, have left building societies better equipped to defend against the shockwaves of the current crisis. We heard evidence that establishing new building societies was now harder than it was when the Ecology Building Society was started in 1981. The Government should examine, with the sector, whether any legislative or regulatory changes are required to facilitate building society start-ups and remutualisation.**

Key themes emerging from the experience of banks and building societies

Risk and complexity

64. The banks have acknowledged that some market participants did not understand the risks being taken: John Varley, Group Chief Executive of Barclays, admitted that it is “true to say that the financial system did not properly understand the risks”.¹⁵⁵ The issues of risk and complexity in the banking system may be inextricably linked and the relationship between them has been characterised to us in many different ways: the defenders of complexity insist that it reduces risk through diversification and distribution, while their opponents argue that complexity obscures risk. In considering these issues we will first assess two beliefs which appear to have been held by many in the banking sector: first the belief that risk had declined; and second the belief that risk was being managed. We will

152 Transfers of Engagements, Barnsley BS to Yorkshire BS, Catholic BS to Chelsea BS, Cheshire BS to Nationwide BS and Derbyshire BS to Nationwide BS, The Building Societies Association website, www.bsa.org.uk

153 The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007, para 3(1)

154 Q 1603

155 Q 2083

then examine how these beliefs conspired together to facilitate the rise of complex products and the decline of due diligence.

65. We have already considered the emergence of a belief in the ‘great moderation’. Part of this moderation was a belief that risk had been reduced. Professor Goodhart of the LSE told us that risk was “underpriced” largely because many simply thought that risks had disappeared.¹⁵⁶

The period between 1992 and 2007 was probably the best years of economic developments that the world has ever seen and this had led people to believe that risks generally had declined, that we would not see future problems, so everyone poured into asset markets because risk had gone, and of course risk had not gone.¹⁵⁷

66. One of the factors which contributed to this view was the widespread belief that securitisation had distributed risk. Sir Tom McKillop summed up the anticipated benefits of securitisation:

securitisation, the originate and distribute model, was seen as a stabilising influence in the financial systems ... This was distributing risk. This was making the whole system more stable.¹⁵⁸

67. However, he accepted that “it has not turned out that way. It has turned out completely the opposite to expectations. Everyone has been surprised about that, the regulators, the companies and the banks involved in it”.¹⁵⁹ He went on to claim that very many well informed people “genuinely imagined” that securitisation was distributing risk.¹⁶⁰ We have had many ‘well informed’ witnesses before us and none of them has disputed this claim.

68. In our March 2008 report on *Financial Stability and Transparency*, we reviewed the growth of the ‘originate and distribute’ model as an alternative to the traditional ‘originate and hold’ model. Banks operating the originate and hold model issue loans which they then hold to maturity, while under the originate and distribute model the issuing bank sells the loan on to investors.¹⁶¹ In our *Financial Stability and Transparency* report, we noted that “the financial market turbulence since mid-2007 has illuminated the strengths and, in particular, weaknesses of the ‘originate to distribute’ banking model”.¹⁶² The consensus amongst the witnesses we heard from at that time was that the originate and distribute model had failed to deliver the promised diffusion of risk and the evidence we have taken more recently has echoed these concerns.¹⁶³ As Lord Turner has explained:

156 Q 672

157 Q 689

158 Q 1804

159 *Ibid.*

160 Q 1827

161 Treasury Select Committee, Sixth Report of Session 2007-08, *Financial Stability and Transparency*, HC 371, paras 43-55

162 *Ibid.*, paras 210-211

163 *Ibid.*, paras 210-211

It was argued that securitised credit intermediation could reduce risks for the whole banking system, since while some of the credit risk would be held by the originating bank and some by other banks acting as investors, much would be passed through to end non-bank investors. Credit losses would therefore be less likely to produce banking system failure. But that is not what happened. Because when the music stopped ... the majority of the holdings of the securitised credit, and the vast majority of the losses which arose, did not lie in the books of end investors intending to hold the assets to maturity, but on the books of highly leveraged banks and bank-like institutions. The new model left most of the risk still somewhere on the balance sheets of banks and bank-like institutions but in a much more complex and less transparent fashion.¹⁶⁴

Few of those giving evidence to us were unashamed apologists for securitisation but many offered some defence. For example, Paragon argued that securitisation had been “misunderstood” and was to a certain extent a victim of other forces:

Securitisation is not an inherently risky funding model. Securitisation transactions in the UK have consistently performed within the expected parameters agreed by the various parties involved at the outset. More fundamental problems in the US housing and mortgage market have contaminated the global wholesale funding process.¹⁶⁵

69. Sir Fred Goodwin told us that “the originate and distribute model started off at a relatively simple level and we were intermediaries in it, so we were bringing things in, packaging them up and selling them to investors”.¹⁶⁶ What happened was that things got more complex:

as the industry went on, there became more and more demand from investors ... so [banks] started to get into doing the exercise with synthetics and other products related to sub-prime. One of the consequences of this was that it magnified the effect and individual loans were being referenced more than once. That is why you got a big multiplication that went on and that is why, when the music stopped, some of these were still held.¹⁶⁷

The scale of the failure of the originate and distribute model to deliver what it promised has been made even more apparent by the events of the last 12 months. Sir Tom McKillop identified Lehman’s collapse as pivotal: “what happened when Lehman’s went down is that people realised they did not know where this distributed risk was and then a freeze took place. There was a complete lack of confidence, you did not know who you could deal with and the whole thing cascaded from there”.¹⁶⁸

164 The Economist ‘s Inaugural City Lecture, Speech by Adair Turner, FSA Chairman, 21 January 2009

165 Ev 170

166 Q 1882

167 Q 1890

168 Q 1805

The belief that risk was being managed

70. Earlier we noted the ‘search for yield’ created by the macro-economic conditions of the past few years. A number of the witnesses we heard from drew a connection between this search and the increase of risk appetite of bank boards. Amongst them was John Varley of Barclays:

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.¹⁶⁹

Mr Varley’s argument was supported by Sir Fred Goodwin, who informed us that RBS had found that when it was undertaking securitisation, “there was actually latterly a bigger appetite for the junior tranches¹⁷⁰ than the seniors because the junior tranches, because of higher risk, had higher yield”.¹⁷¹

71. Eric Daniels, Group Chief Executive of Lloyds, argued increases to risk appetite were accompanied by bespoke governance systems put in place to monitor and manage risk.¹⁷² However, Dr Jon Danielsson, of the LSE, considered that some banks were better at managing these risks than others:

I think those institutions who will survive this crisis the best are the institutions with the best management. To my mind this crisis has shown that it is management of risk that is important.¹⁷³

72. In his speech of 13 February 2009, Andy Haldane, Executive Director for Financial Stability, Bank of England discussed the evolution in the techniques used to control risks. He described how the last two “low tide marks” for the financial system, the stock market crash of 1987 and the failure of the hedge fund LTCM in 1998, “both prompted a sea-change in risk management practices and technologies”.¹⁷⁴ In particular Mr Haldane identified 1987 as the birth of ‘value at risk’ reporting and 1998 as a pivotal year for the development of stress testing. Mr Haldane argued that banks thought “risk was being held in check by a shift in the technological frontier of risk management” and indeed the evidence we have reviewed suggests that banks had great confidence in their risk management systems. Lord Stevenson told us of HBOS’s “very elaborate systems of risk

169 Q 2062

170 The word ‘tranche’ is used to denote an individual security or a group of securities with similar characteristics. A single offering of securities will usually contain a number of tranches. These are considered to sit on a spectrum ranging from the most ‘junior’ to the most ‘senior’. The more junior tranches will be higher risk while the most senior tranches will be made up of safer, lower risk securities.

171 Q 1890

172 Q 2040

173 Q 676

174 Speech by Andrew G Haldane, Executive Director for Financial Stability, Bank of England, 13 February 2009

management and stress testing”¹⁷⁵ and HBOS’s 2007 Annual Report boasted of ‘three lines of defence’ against risk.¹⁷⁶

73. The error made by banks, Dr Danielsson told us, was that they treated the economy as an “engineering system” which could be “run through a model” to give a risk. Their stress testing and value at risk reporting did not take sufficient account of the fact “that people are intelligent and people react to risk”.¹⁷⁷ Dr Danielsson argued that “economists learned 30 or 40 years ago that you cannot think about the economy as an engineering system whereby you can just create a whole bunch of equations trying to describe how the economy works ... we need to take into account expectations, and we need to take into account that people are intelligent and people react to rules”.¹⁷⁸ Lord Stevenson would only acknowledge that the banks had “failed to consider some of the extreme scenarios that have actually happened”.¹⁷⁹ He explicitly accepted that stress testing at HBOS had been deficient: “the stress testing did not stress test adequately”¹⁸⁰ and went on to argue that “there are real issues about how stress testing is carried out and risk management takes place. I imagine we are not unlike many other large banks, but we stress tested regularly ... The question is why we did not foresee certain scenarios”.¹⁸¹ In its written submission to us, RBS informed us that the scenarios it had used in stress testing incorporated a lack of access to key wholesale funding sources but that “in reality the disruption has been extreme and that extended impact was not fully factored into any stress model”.¹⁸²

The rise of complex products

74. Paul Boyle, Chief Executive of the Financial Reporting Council, summed up the view of many when he told us he had been “surprised” to discover that so many high street banks were dealing in complex financial instruments.¹⁸³ The problem, articulated by Lord Turner, was that some of these instruments had become “so complex that they have become very difficult to understand”.¹⁸⁴ Lord Turner argued that such complexity added little to society and served only to generate money for some and risk for all:

you can have financial innovations in financial markets which survive for a long period of time, which fundamentally extract what economists call “economic rent” from the rest of society rather than adding value to the rest of society and which create significant risk ... What did happen with the more complex forms of securitised credit is that we were doing things where the possible benefits to allocated

175 Q 1688

176 HBOS plc, *Annual Report 2007*, p 86-87

177 Q 675

178 *Ibid.*

179 Q 1688

180 Q 1778

181 Q 1791

182 Ev 658

183 Q 230

184 Q 2155

efficiency ... were pretty trivial and which were creating, through their complexity and the fact that they were so difficult to understand, huge risk”.

75. It is worth noting at this point the distinction between different types of securitisation. In its written submission, Paragon argued that a distinction should be drawn between complex instruments such as “collateralised loan obligations (CLOs) and collateralised debt obligations (CDOs) [which] brought new technology to the capital markets and heightened risk” and the “simple, straightforward and traditional securitisations”.¹⁸⁵ The more straightforward securitisations are often referred to as ‘vanilla products’. Vanilla products include, in the British Bankers Association’s words, “issues based on high quality loans, good quality mortgages and receivables that, even in these difficult times, perform reasonably well”.¹⁸⁶ As we noted in our *Financial Stability and Transparency* report, these more straight-forward securitisations tend to include the pooling together of reasonably homogenous assets.¹⁸⁷

76. With the growth of complex products, some have argued, came a decline in due diligence. Graham Beale, Chief Executive of Nationwide, told us that complex securitisation products “tended to blend the assets so that you had some very risky assets with some very safe assets and people were looking at the blend rather than the actual composition of it”.¹⁸⁸ Jon Moulton, of Alchemy Partners, felt that due diligence within the banks “went from tolerable to notional to virtually non-existent as we got near the end of the boom”. In the leveraged loan market, for example, “half the people who were taking pieces of the loan did not even bother to go to look at the due diligence materials”.¹⁸⁹ If they had ‘bothered to look’ at the materials, witnesses suggested they would have been busy for rather a long time; Mr Moulton gave the example of Northern Rock’s capital issue for an off balance sheet vehicle which had “11 layers of debt, three currencies, interest rate swaps, currency swaps [and] 415 pages of prospectus”. The result was that “nobody understood it”.¹⁹⁰ Professor Buiter similarly told us that some CDOs had “four million pages [of documentation] which even the very well-paid lawyer would not have time to deal with”.¹⁹¹

77. Underpinning this decline in due diligence, Professor Buiter argued, was the fact that ever increasing layers of securitisation weakened any incentive to gather information:

The problem is that when you commoditise relationships, which effectively you do, and make them tradable you tend to destroy the incentive for gathering information or at least weaken that incentive, from the original borrower. What information is

185 Ev 172

186 Ev 316

187 Treasury Select Committee, Sixth Report of Session 2007-08, *Financial Stability and Transparency*, HC 371, para 45

188 Q 1620

189 Q 738

190 Q 740

191 Q 698

gathered is no longer traded with the instruments when they get bundled with 7,000 other instruments.¹⁹²

78. Mr Moulton concluded that this lack of information and complexity meant “in the case of some of these assets the products are simply incapable of being analysed by the vast majority of people out there.”¹⁹³ Indeed, the Credit Rating Agency Standard and Poor’s, according to one report, admitted that it could “take a whole weekend for computers to perform the calculations needed to assess the risks of complex CDOs”.¹⁹⁴ The banks denied that they were not aware what was being bought and sold, Sir Fred Goodwin told us that securitised products “were knowingly being originated by professionals and sold on to professional investors and rated by their agents. The content was known”.¹⁹⁵ But other witnesses, such as Dr Danielsson, maintained that the bank bosses did not have a firm grasp of what their employees were doing:

the individual making things complicated is not at the top of the bank, [he] is in the middle of the bank. This is the ‘quant guy’ [quantitative trader], the 35-year-old, whatever he is; he creates instruments. His boss has no understanding of what he has is doing, the regulator has no understanding of what he is doing. All they know is that he is making money from some black box.¹⁹⁶

79. The executives and chairmen we heard from were, with the exception of Lord Stevenson, willing to accept that they did not understand all of the complex vehicles operating within their banks. As justification for the gaps in his own knowledge Sir Fred Goodwin suggested—rather unconvincingly it might be thought—that his lack of understanding was “part of the secret of how you risk-manage it”.

Leverage

80. A final emerging theme from our survey of the banks which ran into trouble has been the link between rapid growth and leverage. The last decade has seen a rapid increase in leverage across the UK banking sector. As the Bank of England’s October 2008 Financial Stability Report observed, major UK banks almost tripled their assets between 2001 and 2007. This growth was driven by a rapid rise in trading book activity and lending, leading to sharp increases in leverage ratios—assets relative to equity—at some banks.¹⁹⁷ The Governor told us that the most important common feature which distinguished the failed banks from the survivor banks was leverage:

Most financial crises in the past have been characterised by excessive leverage, borrowing, debt, and that has been true here too ... 40 years ago if you had asked any

¹⁹² *Ibid.*

¹⁹³ Q 740

¹⁹⁴ “Lost through destructive creation”, *Financial Times*, 10 March 2009

¹⁹⁵ Q 1888

¹⁹⁶ Q 701

¹⁹⁷ Bank of England, *Financial Stability Report*, October 2008, p 8

of the clearing banks ... what fraction of their balance sheet was in liquid short-term assets they would have said about a third and the answer now is 1%. There has been a massive change in the balance sheet structure of our banking system and it is not surprising, therefore, that you make more money in banking doing that because you are using the assets in a riskier form and most years that generates a higher return, but it means that when things go wrong the costs are so much higher, so excessive leverage is the common theme.¹⁹⁸

81. Professor Buiter agreed that the world had enjoyed “a classic credit and asset boom”, with “excessive lending” and “excessive leverage which became more and more risky”. He referred to the securitisation problems emanating from the US, but argued that there were “country-specific financial excesses” in most countries in the North Atlantic area.¹⁹⁹ Professor Goodhart suggested that the reason why banks became over-levered was “a belief that we had overcome the economic and financial problems of the world” which “led to hubris”, particularly within the financial sector.²⁰⁰ The Governor told us that the model of wholesale funding “was in large part responsible” for the degree of risk that was incurred by banks, and one of the lessons that needed to be learnt from this banking crisis was that “the amounts of capital that banks were required to hold were simply too low”.²⁰¹

82. We note that risk and complexity within the banking sector has increased dramatically over the last twenty years. The widespread—but at sometimes misguided—belief that risk was being dispersed and ‘managed’ led many banks to increase the complexity of their operations and their overall risk exposure. This was manifestly a false premise. Indeed one of the factors that is key to understanding the banking crisis is that some forms of securitisation, far from mitigating risk, actually obscured it.

83. We note that the financial sector has significantly increased its leverage over the last two decades, and those firms that showed the greatest appetite for rapid growth, particularly in the last five years, through leverage are amongst the heaviest casualties. Increased debt simply led to increased risk. We will consider potential measures to control leverage in our forthcoming report on public regulation.

84. The origins of the banking crisis were many and varied, including low real interest rates, a search for yield, apparent excess liquidity and a misplaced faith in financial innovation. These ingredients combined to create an environment rich in over-confidence, over-optimism and the stifling of contrary opinions. Notwithstanding this febrile environment, some of the banks have been the principal authors of their own demise. The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed. Bankers have made an astonishing mess of the financial system. However, this was a failure not only within

198 Q 2364

199 Q 687

200 Q 700

201 Q 2338

individual banks but also of the supervisory system designed to protect the public from systemic risk.

85. Bankers complicated banking to the point where the location of risk was obscured, abandoned time-honoured principles of prudent lending and failed to manage their funding requirements appropriately. There were major failures in the modelling, procedures and structures for risk management, which we will address more fully in our future report. They did this in a reckless environment, and one in which their corporate governance was often totally ineffective. Whilst we would hope that the nature of banking, and bankers, would change in response to the crisis, and no doubt bankers will be chastened by recent experience for a short while, the responsibility falls to the financial regulator, the FSA, to create a more durable framework for stable finance. We will address the FSA's task in our forthcoming report.

The performance of the Financial Services Compensation Scheme

86. The banking crisis has generated unprecedented demands on the Financial Services Compensation Scheme (FSCS). Since September 2008, five banks have been declared in default by the FSA (Bradford & Bingley, Heritable Bank, Kaupthing Singer and Friedlander, Landsbanki (Icesave) and London Scottish Bank). Each default triggered FSCS protection. Prior to September 2008, the FSCS had never dealt with the default of a bank. From its inception in 2001 to September 2008, the FSCS had paid out just over £1 billion in compensation mainly relating to insurance and investment failures. In the five months following September 2008, the FSCS paid out about £20 billion for the five bank defaults, largely on its own behalf but also for the Government, and in respect of the liability of the Icelandic Deposit and Investors Guarantee Fund. Compensation has been paid to protect the holders of approximately three million bank accounts, an activity which has involved three bulk account transfer payments, and the processing of more than 200,000 individual claims to date.²⁰² Loretta Minghella, the Chief Executive, was proud of the way the FSCS had managed “in really very challenging circumstances”.²⁰³ Each of the compensation issues had presented different challenges, as can be seen from the box below:

The different compensation methods used by the FSCS²⁰⁴

Bradford and Bingley

The FSCS contributed £14 billion to the cost of transferring Bradford & Bingley's retail deposit book to Abbey on 29 September 2008, giving depositors continuity of banking services in relation to 2.5m accounts, without having to engage individually with a compensation process. The £14 billion payment represented an estimate of the gross cost of compensation, had the FSCS processed individual claims from all the bank's customers

202 Ev 495-6

203 Q 2275

204 Ev 495-6

in the normal way. That cost is now being validated by FSCS and the results will determine whether or not there is more for the FSCS to pay or a refund to the FSCS to be made.

Kaupthing Singer and Friedlander Ltd (KSF)

The FSCS contributed £2.5 billion to cover the cost of transferring the firm's 157,000 online accounts, known as Kaupthing Edge accounts, to the Dutch bank ING. This amount paid is subject to a validation exercise, similar to that being carried out for Bradford and Bingley. The FSCS is also handling individual claims for compensation in respect of KSF accounts not transferred to ING. So far, over 4,800 claims have been received and are being processed. In excess of £27m has now been paid in compensation in respect of the non-Edge accounts. Claimants are entitled to the FSCS protection up to £50,000. The Government has agreed to pay such claimants compensation for losses above £50,000 and the FSCS is administering those payments on behalf of the Government.

Heritable bank plc

The position with Heritable is similar to KSF but on a smaller scale: 22,000 accounts were transferred to ING at a cost to the FSCS of £500m and FSCS is currently processing claims for the remaining eligible claimants. Approximately 350 manual claims have so far been received. Again, the FSCS is paying compensation up to the limit of £50,000, and is administering top up payments for the Government for amounts over £50,000. Sums paid in respect of accounts not transferred to ING amount to about £7m.

Landsbanki 'Icesave'

Icesave was the UK internet branch of Landsbanki, an Icelandic bank with an EEA passport. The bank had 'topped up' into the FSCS, meaning that the Icelandic Deposit and Investors Guarantee Fund is liable for the first €20,887 of any claim, and the FSCS for the amount above that to the UK limit of £50,000. The Icelandic fund did not step forward at the point of failure to receive claims in respect of Icesave. In the event, the FSCS stepped in with the Government to make sure that the 214,000 people with money deposited in the UK branch of Icesave could receive compensation.

The FSCS developed an online claims system based on the Icesave internet banking platform and more than 190,000 people successfully transacted electronically using this quick web-based process. The remaining customers have made manual claims. Over 17,000 payments have been made to them so far and further payments will follow as quickly as possible. Most outstanding claims are not due for payment at this time, as they relate to fixed term deposits which have not yet matured. A total of £3.7 billion has so far been paid in compensation for this default.

London Scottish Bank plc

London Scottish Bank had approximately 9,500 people all holding either fixed term deposit or notice accounts worth over £270m. Over 9,000 individual claims have so far been received, and the vast majority of claimants are now being paid shortly after the maturity date of their deposits. Eligible claims below £50,000 are being met by the FSCS, and the FSCS is acting as the Government's agent in paying eligible claims to the extent that they exceed the FSCS compensation limit.

87. The unprecedented volume of accounts at defaulting banks required the FSCS to adopt new approaches to compensation. In four of the five failures, a standard manual claims process was established. In the case of Bradford & Bingley, the FSCS facilitated the transfer of deposits to Abbey, which meant that savers “went to bed on Sunday night banking with Bradford & Bingley and woke up on Monday banking with the Abbey”.²⁰⁵ In the case of Icesave, the company's online banking platform was converted into an online compensation platform in a matter of days.²⁰⁶

88. The FSCS deserves praise for the way in which it fundamentally increased its response to the unprecedented compensation claims arising from the default of five banks in just a few months. We are particularly impressed with the variety of innovative solutions deployed by the FSCS to suit the particular challenges facing them.

Moral hazard

89. The current ceiling of deposit protection provided by the FSCS is £50,000 per individual, per bank. The European Commission's Deposit Guarantee Scheme Directive will introduce an EU-wide minimum of €50,000, with the possibility of a further increase to €100,000 by December 2010. To a certain extent though, these considerations are a sideshow, because recent actions taken by HM Treasury in respect of the five failed banks included guaranteeing, at taxpayer expense, any deposits greater than the £50,000 formal protection limit. The Investment Management Association (IMA) suggested that the Government needed to develop a strategy to pull back from such an absolute guarantee, because a blanket guarantee “goes against the intention of the deposit protection legislation”.²⁰⁷ There is also a danger that if deposit protection is set at too high a level then it will give rise to moral hazard, giving depositors little reason to consider anything other than the interest rate when choosing where to deposit savings. The Association of British Insurers (ABI) commented that in such circumstances firms would have no incentive to manage risks, as consumers would be attracted to accounts paying the highest interest, safe in the knowledge that they would not lose out in the event of their provider becoming insolvent. This would therefore allow reckless firms to take market share from well-managed competitors. For this reason, the ABI argued that there had to be a limit on the

205 Q 2275

206 Ev 495-6

207 Ev 233

level of compensation available.²⁰⁸ the Financial Services Consumer Panel, however, argued that the concept of moral hazard was not helpful in this context, because consumers were not in possession of sufficient knowledge to make sensible choices about the risks involved in selecting a particular bank.²⁰⁹

90. We think that there should be a limit to the level of deposit protection offered by the FSCS to mirror arrangements in Europe in order to avoid a competitive disadvantage for UK banks. Once financial stability has returned and there has been clear communication about the scope of protection, it should be made clear that the new £50,000 limit will be applied. This would reintroduce the depositor's obligation to consider matters other than the bald interest rate in choosing where to locate their investments, and thus ensure that the banks had a disincentive to be reckless. The FSA should think now about a strategy for shifting the expectations of the banking consumer from one of total protection, to a partial protection basis. This strategy should be developed sufficiently to be readily deployed by the time that immediate concerns about bank safety have been calmed. One measure we would like to see adopted would be a requirement for all savings institutions to publish all relevant documentation and advertising, and also within branches, notice of the £50,000 deposit ceiling. We renew our recent recommendation that the FSA should carry on its website a list of all banking products covered by the deposit protection scheme.

91. We also think that financial institutions must make clear to their customers where they are subsidiaries of other institutions where this is relevant in terms of deposit protection. Ideally, we would like to see each brand holding a separate banking licence.

Funding

92. The FSCS is funded by levies from the financial services industry. Firms are pooled with their competitors, and each year levies vary between these pools according to the cost of compensation arising from each pool. The funding rules of the scheme were amended in 2007 to allow a degree of cross-subsidy, such that costs borne by the FSCS in respect of depositors of failed banks are shared to some extent by the entire financial services industry, rather than just by other survivor banks. In the case of the pool of deposit-takers, the levies are based on the market share of each institution in terms of deposits. Ms Minghella justified this funding system to us by saying that levies were charged in line with the scale of the benefit being delivered, because banks and building societies benefited from being able to assure prospective customers that their money was protected by the FSCS.²¹⁰

93. Representatives of the building society sector argued that this funding model unfairly punished their institutions, which paid a disproportionate share relative to the failed banks. As the BSA's memo stated:

208 Ev 156

209 Ev 269

210 Q 2269

FSCS coverage is not a free good: the scale of the FSCS levies now forms a heavy and disproportionate burden on societies, and indirectly hurts all their members.²¹¹

Mr Beale, for Nationwide Building Society, described the impact of the levies as “hugely significant”, potentially amounting to 15% of building society profits, but only 2% for banks, because of the higher proportion of building society funding coming from retail deposits than in banks. It was “highly likely”, he noted, that for some societies the levy would be the difference between making a profit or a loss this year.²¹² The building societies claimed that the very basis on which levies were charged—market share of deposits—penalised the safest institutions. As we have noted, those banks which relied most heavily on wholesale funding, rather than deposits, have proven to be most likely to fail. Yet, perversely, those very same higher-risk banks have paid least into the coffers of the FSCS. Adrian Coles, for the BSA found it “particularly galling that those institutions that funded themselves in the riskiest way on the wholesale markets” were paying the least into the scheme.²¹³ For example, Yorkshire Building Society, has been forced to set aside £14.7m in its 2008 accounts for the FSCS levy, which as a percentage of total assets, represents “three times more than the levy paid by Northern Rock and twice as much as HBOS”.²¹⁴

94. In our report *The run on the Rock* we called for the FSCS to be pre-funded using risk-sensitive criteria to determine levies.²¹⁵ This would mean that institutions which employed safer funding models would pay less into the fund than high-risk institutions. In addition to equity considerations, this would have the added benefit of incentivising institutions to fund themselves in sensible ways. Mr Coles supported some form of risk-related funding, “perhaps related to the FSA’s assessment of your capital requirements and liquidity requirements”.²¹⁶ Mr Cornish, for the Yorkshire Building Society, gave alternative suggestions for risk assessment: the funding model, capital levels relative to the risks taken, liquidity levels, and the quality and riskiness of loans.²¹⁷

95. Lord Turner recognised the building societies’ concerns and promised that the FSA would review the issue.²¹⁸ Mr Sants told us that there was no prospect of the building societies being retrospectively refunded fees that had already been paid.²¹⁹

96. We are very sympathetic to the plight of building societies in funding more than their share of the FSCS burden and call on the FSA to review the situation with urgency. It is entirely inappropriate that institutions that are recognised as having a safer funding model, indeed have such a funding model enshrined in legislation in

211 Ev 277

212 Q 1611

213 Q 1612

214 www.ybs.co.uk

215 HC (2007-08) 56-1

216 Q 1612

217 Q 1614

218 Qq 2272-3

219 Q 2274

order to protect their depositors, should be required to contribute more to the industry's insurance scheme than competitors with funding models that have failed in the current crisis. The principle seems to have been that the riskier the business model, the less that is paid. The absurdity of this serves to reinforce our previous recommendation that levies be charged according to risk, and we renew that recommendation in this Report.

3 What has been the Government response?

Government support to Northern Rock

97. The growing market turbulence, which began during the second half of 2007, triggered by rising default rates on sub-prime mortgages in the United States, led to Government intervention to support Northern Rock. As discussed in our Report *The run on the Rock*, Northern Rock's business model was highly dependent on wholesale funding. Thus, when wholesale funding markets tightened during the summer of 2007, Northern Rock was left unable to fund its operations.

98. On 17 September 2007 the Government announced guarantee arrangements in respect of all existing retail savings in, and certain existing wholesale liabilities of, Northern Rock.²²⁰ The Government's decision to take this step was a direct response to the large-scale withdrawal of deposits that followed Northern Rock's announcement on 13 September that it had asked for and received emergency financial support from the Bank of England. In our Report on Northern Rock we concluded that:

The directors of Northern Rock were the principal authors of the difficulties that the company has faced since 2007. The directors pursued a reckless business model which was excessively reliant on wholesale funding. The Financial Services Authority systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systemic risk.²²¹

99. Northern Rock was taken into 'temporary public ownership' in February 2008 using powers under the Banking (Special Provisions) Act. The Act granted HM Treasury powers to transfer the securities or property rights and liabilities of distressed banks and building societies to the public sector, or any private sector company.²²² In March 2008 Northern Rock published its provisional restructuring plan, which stated that "Northern Rock's prime objectives are the repayment of the Bank of England debt, the release of HM Treasury guarantee arrangements and a successful return to the private sector". This was to be achieved through:

- repaying the facilities provided by the Bank of England, principally by reducing the business so that it became smaller and more sustainable—reducing the balance sheet from around £107 billion in 2007 to around £50 billion by the end of 2011 and withdrawing from several non-core businesses;
- aligning the organisation and operation of Northern Rock under a new executive management team with a proposed downsizing and reshaping of the organisation;

220 "Statement by the Chancellor of the Exchequer on financial markets", HM Treasury Press Notice, 17 September 2007

221 HC (2007-08) 56-1

222 HM Treasury, *2008 Pre-Budget Report*, November 2008, p 52

- building a stand-alone funding and capital position; and
- strengthening the risk and control environment throughout the Bank.²²³

In August 2008, the Government announced that it would strengthen Northern Rock's capital position by converting up to £3 billion of the Government loan into equity, and converting £400 m of preference shares into ordinary shares.²²⁴

100. In November 2008, when he appeared before us, Ron Sandler, Non-Executive Chairman of Northern Rock, outlined how Northern Rock had fared against its objectives and strategic priorities since being taken into temporary public ownership. Mr Sandler felt the most significant achievement since February 2008 was that the Bank had “repaid a very considerable proportion of the Government debt, and therefore reduced the exposure to the taxpayer” as well as having completed “a quite significant restructuring of the business, ... [with] something in the order of 4,500 employees versus a number in excess of 6,000 at the start of the year.” He concluded that “the organisation is now of a size that makes it much more likely to achieve the objective of returning back to private ownership in due course”. Mr Sandler also outlined changes to the management team that had been made since February 2008, telling us that “of the eight senior executives within the company, six are new to the business”. This new management team he felt was “well equipped to undertake the challenges of the coming years”.²²⁵

101. Mr Sandler noted that, on the downside, Northern Rock “did make a very substantial loss in the first six months of the year”, but explained that this was “not unanticipated”. He predicted that the company would continue to be significantly loss-making through 2009, and that it would take longer for “the company to return back to break-even and in due course profitability”.²²⁶

102. Gary Hoffman, incoming Chief Executive Officer at Northern Rock, told us that one of the key risks to Northern Rock now concerned the rapidly deteriorating economic environment. He noted that “the consequence of house price deflation on Northern Rock has meant a substantial increase in arrears over the last few months”.²²⁷ Northern Rock was questioned as to its approach towards repossessions, in the light of evidence that the rate of repossessions at Northern Rock was approximately three times the industry average. Mr Hoffman acknowledged that Northern Rock's rate of repossessions was “somewhat above the industry average” and predicted that at the end of 2008 Northern Rock would account for “just over 10% of total repossessions”. In his view the high level of repossessions was a consequence of Northern Rock's ‘Together’ mortgages—mortgages where individuals were

223 Northern Rock Plc, *Provisional Northern Rock Restructuring Plan: Executive Summary*, 31 March 2008, p 3-4

224 Northern Rock Plc, *Half Year Results*, 5 August 2008

225 Q 415

226 *Ibid.*

227 Q 417

allowed to borrow up to a loan to value ratio of 125%—which accounted for around one third of Northern Rock’s mortgage book, but around 50% of arrears.²²⁸

103. Mr Hoffman explained that he had reviewed Northern Rock’s policies in this area and that they were “in line with industry standards ... the Council of Mortgage Lenders’ guidance and the mortgage code”.²²⁹ The Chancellor subsequently told us that the Treasury had talked to Northern Rock about repossessions and confirmed it was having discussions with a number of people to see how they could improve their procedures. He said that “there is a specific problem with Northern Rock and that is that they have a number of mortgages where they lent at over 100% where it is quite clear that there are more people in that category who are getting into difficulties”, but stressed that Northern Rock “ought to be behaving in exactly the same way as all other mortgage lenders”.²³⁰

104. When challenged as to whether, given its unique status as a wholly nationalised bank, Northern Rock should show greater forbearance than its competitors towards people struggling to make mortgage payments. Mr Hoffman rejected this suggestion, telling us that “I do not think we should be doing that because we are nationalised, because of the framework we operate in, because we are at arm’s length”. Mr Hoffman stressed that he wanted to work together with the Council of Mortgage Lenders and lead the industry on developing solutions to the problem of mortgage arrears.²³¹

105. Ron Sandler accepted that there was a “contradiction” between the Government’s business plan for Northern Rock, which included running down its loan book, and the Government’s general policy which was to sustain the flow of mortgages and encourage banks to continue lending at 2007 levels. He explained that this contradiction had arisen from the need to repay the taxpayer and reduce the size of the bank and its balance sheet before it could be returned to the private sector. Mr Sandler summarised Northern Rock’s strategy as “travelling down a plan which we, the board and the Government agreed was the correct plan, and nothing has happened to change the path that we have been travelling on”.²³² He did, however, reveal that the bank’s business plan was currently under review.

106. When the Chancellor appeared before us on 3 November 2008 we asked him about the decision to run down Northern Rock’s mortgage book. He acknowledged that this was a condition of Government support for the bank, explaining that this was partly a consequence of the European Union’s state aid rules which “precludes, in crude terms, us running a state owned bank aggressively against other privately owned banks”.²³³ The Chancellor went on to say that:

228 Qq 433, 442

229 Q 433

230 Q 40

231 Q 435

232 Q 480

233 According to the European Commission, “The objective of State aid control is, as laid down in the founding Treaties of the European Communities, to ensure that government interventions do not distort competition and intra-Community trade. In this respect, State aid is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities”.

the state aid rules, whether you like it or not, are part of the domestic law of this country and we cannot get out of that and we do have to stick to them. That is the reason that Northern Rock is reducing the size of its loan book at the present time.²³⁴

107. However, on 19 January 2009, the Government announced that it would “consider further ways of addressing the loss of mortgage lending capacity in markets”, and that, as a first step, Northern Rock would no longer actively pursue a policy of rapidly reducing its existing mortgage book.²³⁵ On 23 February 2009 Northern Rock announced the conclusions of the strategic review of its business plan, revealing that it planned to return to the mortgage market “and support Government policy to increase mortgage lending capacity in the market”. Northern Rock’s statement said that “in addition to the previously announced slow down in the rate of its mortgage redemption programme, the Board has now agreed that Northern Rock will launch a programme of additional new lending”, offering up to £14 billion of new mortgage lending over the next two years. Additional funding to support this new lending was to be partly provided by an increase in the Government’s loan to Northern Rock, with an extended repayment schedule.²³⁶

108. John Kingman, Chief Executive of UKFI, which is to manage the Government’s shareholding in due course, rejected accusations that the reversal in lending policy had been purely at the behest of the Government. He thought that the “Northern Rock board felt that with the original remit they had been given, which was very much to run the business down, they were missing commercial opportunities” and that they had been making this point to the Government for some time.²³⁷ Mr Kingman, who was the lead civil servant in the Treasury’s negotiations with Northern Rock in the period leading up to its nationalisation, argued that the reversal in lending policy stemmed from changed economic circumstances:

The priority at that time [immediately subsequent to nationalisation] was very much to get the taxpayers’ money back and I think that that was understandable. The world has moved on, the economy has moved on and the mortgage lending market has moved on. If there are commercial opportunities to be had genuinely on the basis of commercial credit scoring and commercial credit pricing, I do not think it is right to stand in the way of that.²³⁸

The Chancellor, when he appeared before us on 19 March 2009, confirmed that the decision to reverse policy on Northern Rock was “his and his alone” and that in the present circumstances “it would be wrong to take more capacity out” of the mortgage market. He explained that the Government had to obtain state aid approval for what it was doing and was in talks with Commissioner Nellie Kroes at the European Commission whom he said had been “exceptionally helpful in recognising that governments are having to do things

234 Q 102

235 “Statement on financial intervention to support lending in the economy”, HM Treasury Press Notice, 19 January 2009

236 “Northern Rock returns to mortgage market”, Northern Rock Press Notice, 23 February 2009

237 Q 2583

238 Q 2584

very quickly”.²³⁹ The Chancellor appeared optimistic that the European Commission would approve the plan as long as it was “satisfied that Northern Rock will be competing on a level playing field with other institutions [and] not offering something that is hugely preferential”.²⁴⁰

109. We also learned that Northern Rock has been paying a ‘penalty’ or ‘higher rate’ of interest on Government loans. Ms Ann Godbehere, Chief Financial Officer at Northern Rock, explained that this was because “a company that is a beneficiary of state aid has to meet a number of compensatory measures, and in part that is the cost of the debt”.²⁴¹ Mr Sandler expressed concern that Northern Rock was being treated unfairly in relation to other banks which had been nationalised since his own bank’s failure, but which were not paying this ‘penalty’ rate:

the world has undoubtedly changed in recent months, and whereas we were in a rather unique situation at the start of this process, we now find that not just in this country but in many countries in Europe bank rescue schemes have been put in place, and they all have their own state aid implications ... it is clear that there are inconsistencies—inevitably. If Northern Rock is disadvantaged in that process, that has to be a source of concern.²⁴²

110. We asked Richard Pym, Chairman of Bradford & Bingley about the rates of interest that Bradford & Bingley was paying on Government loans. He said that the rates varied, but were “designed to replicate, as far as is possible, a commercial rate to avoid any state-aid considerations arising”.²⁴³

111. The Government’s initial policy of requiring Northern Rock to run down its loan book immediately after nationalisation stood in clear contradiction to its public exhortations to other banks to increase lending levels to small firms and individuals. Given the economic downturn and the need to maintain overall lending levels, we welcome the Government’s decision to reverse this policy and allow Northern Rock to expand lending. We ask the Government to set out how this change of policy will also change the timescale over which the taxpayer loans to Northern Rock will be fully repaid and, in turn, the timescale over which a new ownership structure, whether by trade sale, privatisation or remutualisation, could be achieved.

112. We are concerned that Northern Rock is suffering a ‘first starter’ disadvantage because it was one of the first European banks to request public funds. Northern Rock is paying a relatively high rate of interest on its Government loans whilst banks which have subsequently entered public ownership are paying lower charges in comparable circumstances. We recommend that the Government ensures consistent rates on loans

239 Q 2838

240 Q 2837

241 Q 485; Mr Sandler, the non-executive chairman, was not in a position to disclose the details of the rate paid (see Q 485).

242 Q 487

243 Qq 355-356

made to banks in receipt of public funds or explains the justification for continuing discrepancies in such rates.

Government intervention in Bradford & Bingley

113. On 27 September 2008, the FSA determined that Bradford & Bingley was unable or likely to be unable to satisfy claims against it and as a result no longer met its threshold conditions to operate as a deposit-taker under the Financial Services and Markets Act 2000 and FSA rules.²⁴⁴ This was because, as we have noted, the bank was heavily reliant on buy-to-let and self-certified mortgages which proved particularly vulnerable to a sharp rise in the rate of arrears during the current economic downturn. As a result Bradford & Bingley lost market confidence, its share price fell sharply and it found it increasingly difficult to access funding.

114. Using provisions contained in the Banking (Special Provisions) Act 2008, the Government transferred Bradford & Bingley's retail deposit business along with its branch network to Abbey National plc following a competitive sales process (albeit attenuated and in 'fire sale, circumstances) whilst the remainder of Bradford & Bingley assets and liabilities—comprising its mortgage book, personal loan book, headquarters and relevant staff, and treasury assets and its wholesale liabilities—was taken into public ownership with the intention of winding down operations.²⁴⁵

115. As part of the transfer order, the Government put in place guarantee arrangements for six months to safeguard certain wholesale borrowings and deposits with Bradford & Bingley in order to provide “assurance to wholesale depositors and borrowers and preserve wider financial market stability and maximise proceeds in the downturn”. These guarantee arrangements were approved by the European Commission under its state aid rules. On 27 March 2009 the Government announced that it had sought approval from the Commission for the continuation of the guarantee arrangements.²⁴⁶

116. Richard Pym, Chairman of Bradford & Bingley, explained that the decision to divide the bank between its mortgage side and the rest of the business was based upon the FSA's “standard contingency plan” for such scenarios. He praised the speed with which both the Bank of England and the FSA had acted such that on the same Saturday [27 September 2008] on which Bradford & Bingley was told it did not meet its threshold condition, an information memorandum was “issued to a large number of banks across Europe to enable them to conduct the auction which ultimately resulted in the sale of the deposit business to Abbey”.²⁴⁷

117. Mr Pym told us that prior to August 2008 Bradford & Bingley employed 3,100 people, but that the transfer to Abbey reduced the headcount by 1,700 with the closure of new

244 “Bradford & Bingley plc”, Financial Services Authority Statement, 29 September 2008

245 *Ibid.*

246 “Statement on the Government Guarantee Arrangements for Bradford & Bingley plc”, HM Treasury Press Notice, 27 March 2009

247 Q 329

mortgage processing reducing this by a further 300 members of staff. The company now employed just 1,100 people, the vast majority of whom were based in West Yorkshire.²⁴⁸ Mr Pym noted that the Chancellor had guaranteed that there would be no compulsory redundancies before 31 March 2009 and that this would be “complied with precisely”.²⁴⁹ Thereafter, Mr Pym explained that job losses would be “phased over a period”, to mitigate the disruption it would create within the local community.²⁵⁰ Mr Pym said he was unable to say how many people Bradford & Bingley would have in employment by the end of 2009, but suggested “it might be quite similar to where we are now because as some of the other areas run down, the arrears function will be building up depending on the economy”.²⁵¹

118. Mr Pym suggested that Bradford & Bingley differed slightly from Northern Rock “where a return to the private sector is intended at some stage”; Bradford & Bingley, in contrast, was in “runoff” [running down its loan book].²⁵²

119. We strongly recommend that the Government assesses the impact on the buy-to-let mortgage market of its share of that market, and how it proposes to use the influence it has.

The HBOS and Lloyds merger

120. In examining the Lloyds-HBOS merger, we must consider at least three perspectives: the perspective of HBOS, the perspective of Lloyds and the perspective of the Government. Presenting the HBOS angle, outgoing Chief Executive Andy Hornby cited three benefits of the merger:

first of all, vastly improved funding; secondly, greater security for colleagues over time, although clearly, when the integration comes together, there would be job losses, but we believed it would be, in the long term, a much stronger business; and, thirdly, benefits for shareholders.²⁵³

He contended that going it alone, without the merger, was a higher risk strategy and “not in the benefit of long-term stakeholders”.²⁵⁴ The collapse of Lehman Brothers, Mr Hornby argued, forced HBOS into a corner:

the bankruptcy of Lehman Brothers led to a significant further deterioration in the London interbank wholesale markets. Wholesale funding was now operating virtually on an overnight basis only. This quickly led to the conclusion that we

248 Q 284

249 Q 284

250 *Ibid.*

251 *Ibid.*

252 Q 299

253 Q 1897

254 Q 1897

should secure a more stable long-term solution in the form of the acquisition by Lloyds TSB.²⁵⁵

A perhaps more controversial angle from which to consider merger is from the perspective of Lloyds. There are two main issues which have invited comment. The first is the impact of the merger on the financial position of Lloyds, the second is the extent of the due diligence performed prior to the merger. The Group Chief Executive of Lloyds, Eric Daniels, insisted that the HBOS acquisition was “a prudent one”.²⁵⁶ He also maintained that Lloyds would not have required state aid if it had not taken over HBOS:

Lloyds was ... well capitalised. I did not think we needed state aid or capital. The facts are that HBOS ... had to take the state package ... we said that as long as HBOS was going to take the capital that in fact Lloyds would as well ... What we did is we took the state capital in an effort to not only takeover HBOS but to promote public stability.²⁵⁷

121. Invited to reconcile these two statements, Mr Daniels assured us that “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”.²⁵⁸ Other statements by Lloyds have suggested that, as well as the general boost to market share, HBOS brings a strong insurance arm and a Scottish presence to the Lloyds Group.²⁵⁹ Mr Daniels reiterated that the acquisition of HBOS was “a very good purchase” but acknowledged that “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”.²⁶⁰ When invited to confirm that this purchase offered best value for Lloyds shareholders, Mr Daniels replied “we believed it was at the time and we continue to believe that”.²⁶¹

122. Mr Daniels’ claim that Lloyds would not have required Government recapitalisation without the HBOS merger has been challenged by the UK Shareholders Association (UKSA) who argue that, in documents accompanying its merger proposal, Lloyds acknowledged that it might require government funding even if the merger were to fall through.²⁶² In a circular issued to shareholders, Lloyds declared that:

If the Acquisition and Placing and Open Offer do not complete, HM Treasury has stated that it would expect Lloyds TSB to take appropriate action to strengthen its

255 Ev 432

256 Q 1923

257 Q 1922

258 Q 1957

259 Scottish Affairs Committee, *Banking in Scotland*, Uncorrected oral evidence, Q 270

260 Q 1969

261 Q 1970

262 “Bank Investors Campaign – Update No. 8”, UK Shareholders Association, Quoting extract of 15 February 2009

capital position. The FSA has advised Lloyds TSB that if the Acquisition were not to occur, it would require Lloyds TSB to raise £7 billion of additional capital, made up of £5 billion of Core Tier 1 equity and £2 billion of Tier 1 instruments. Whilst Lloyds TSB would be able to seek to raise such additional new capital in the public markets, there can be no certainty that Lloyds TSB would be able to successfully raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising, or as to whether any such fundraising would be on a pre-emptive basis.²⁶³

123. Turning to the question of due diligence, Mr Daniels told us that Lloyds had “put approximately 5,000 man days into the diligence effort” on the HBOS merger, largely employing hired experts.²⁶⁴ He admitted that had Lloyds had more time, they “probably would have put in somewhere around three to five times as much time” on due diligence work.²⁶⁵ The amount of due diligence performed has been criticised by the UKSA.²⁶⁶ Questions have also been raised about whether this was enough given the subsequent impact of HBOS on the fortunes of the Lloyds banking group: HBOS recorded a loss of £10,825m in 2008, compared with a profit of £807m generated by Lloyds TSB in the same period.²⁶⁷

124. One aspect of the merger which has invited considerable public comment is the role of the Government. The press has characterised the merger as a “shotgun marriage brokered by Gordon Brown”.²⁶⁸ When challenged on this point, the Chancellor acknowledged that the Government had played a role in so far as it decided to place competition concerns to one side, a position he defended as in the interests of financial stability.²⁶⁹ He was supported in this position by the Governor of the Bank of England who told us that he had advised the Government that the merger was in the interests of UK financial stability because “HBOS was suffering from a very rapidly falling share price and clearly a loss of confidence which was undermining its ability to continue as an individual entity”.²⁷⁰ He argued that “the only alternative to the merger would have been a full-scale nationalisation”.²⁷¹ There remain continuing concerns regarding competition which we address later in this report

125. With regard to any further role of the Government, beyond agreeing to put the competition rules to one side, the Chancellor maintained that the decision to undertake the merger had been a commercial decision which emanated from the banks:

263 “Lloyds TSB Group plc publishing shareholder circular in connection with proposed acquisition of HBOS and proposed capital raising”, Lloyds TSB, 3 November 2008, p 4

264 Q 1979

265 Q 1981

266 “Bank Investors Campaign – Update No. 8”, UK Shareholders Association, Quoting extract of 15 February 2009

267 “Preliminary Results 2008”, HBOS plc News Release, p 4; “2008 Results”, Lloyds News Release, 27 February 2008, p 7

268 “Lloyds investors threaten legal action”, *Financial Times*, 16 March 2009

269 Q 2810

270 Q 24

271 *Ibid.*

The decision to start merger discussions was taken by those two banks. They did it on a commercial basis ... There was nothing the Government could have done to have made that merger go ahead if the shareholders had not wanted it.²⁷²

126. The Chancellor accepted that “the landscape changed” when the Government subsequently decided to recapitalise the banks. But again he argued that shareholders could have rejected the merger.²⁷³ He denied that Government support was contingent on the merger going ahead.²⁷⁴

127. Andy Hornby, outgoing Chief Executive of HBOS, supported the Governor’s assertion that the merger was an entirely “commercial decision” and told us that had “anyone chosen to come in with another offer, with another proposition for the board, we would have of course considered it”.²⁷⁵ Mr Daniels told us that “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” but declined to suggest that the Government’s role went any further, maintaining that the merger was “a good deal for Lloyds TSB”.²⁷⁶ Addressing the Scottish Affairs Committee, Archie Kane, Lloyds Group Executive Director Scotland, intimated that the Government had made clear that it did not wish to nationalise HBOS. He also maintained that the decision to pursue the merger had been a unanimous one by the Lloyds Board, subsequently endorsed by shareholders.²⁷⁷

128. The merger between Lloyds and HBOS has been described in some quarters as a ‘shotgun wedding’. Lloyds Group Chief Executive Eric Daniels conceded that the merger proceeded swiftly on the basis of relatively little due diligence and that the Government was involved to the extent that it offered to waive the competition rules. We also note that the merger may have prevented the collapse of HBOS with the consequent loss of many thousands of jobs and also avoided the outright nationalisation of the company. Nevertheless, from the evidence we received, if the merger has had injurious consequences for Lloyds TSB we consider that the responsibility for this lies primarily with the Lloyds Board.

The October 2008 support package for the banking sector

The Government’s approach

129. On 8 October 2008, the Government announced that it was “bringing forward specific and comprehensive measures to ensure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers”.²⁷⁸ These measures were intended to

272 Q 2809

273 Q 2810

274 Q 2811

275 Q 1898

276 Q 1986-7

277 Scottish Affairs Committee, *Banking in Scotland*, Uncorrected oral evidence, Q 274

278 “Financial support to the banking industry”, HM Treasury press notice, 8 October 2008

address what the Government described as the three root causes of the current financial crisis: concerns about liquidity, capital and funding.²⁷⁹

130. To address concerns about liquidity, at least £200 billion was to be made available to banks under the Bank of England's Special Liquidity Scheme (SLS). The SLS, which was first introduced in April 2008, provides banks and building societies with short-term liquidity by allowing them to swap temporarily pre-existing, illiquid financial assets, including mortgage-backed securities, for highly liquid Treasury bills. We asked representatives of five banks—HSBC, Abbey, Barclays, RBS and Lloyds—whether they had used the SLS, but were told that the banks had been asked not to make any “indication whatsoever of any utilisation of the Special Liquidity Scheme”.²⁸⁰

131. To address concerns about solvency, the Government asked the banks to increase their “Tier 1” capital ratios and established the Bank Recapitalisation Fund, which provided support for those banks who wished to strengthen capital ratios through the Government rather than via the private sector. The Government argued this would enable participating UK banks and building societies to “strengthen their resources permitting them to restructure their finances, while maintaining their support for the real economy”.

132. To address funding concerns, the Government established a Credit Guarantee Scheme. This made available to participating institutions a government guarantee to refinance maturing debt and was designed to unblock the interbank money market. The Debt Management Office was charged with operating the scheme, which has been extended to run until 2014.²⁸¹ The Chancellor explained to us that the different strands of the October 2008 package were linked in the sense that in return for banks agreeing to recapitalise the Government would guarantee inter-bank lending for a fee. This fee, which was reduced in December 2008, the Chancellor informed us was designed to ensure that the taxpayer was “rewarded” for the risks it is taking on.²⁸² The taxpayer liability has been estimated at £250 billion.

Bank recapitalisation

133. The tripartite authorities were united in their view that the recapitalisation was essential to restore confidence in the banking sector. The Chancellor explained to us, when he appeared before us on 3 November 2008, the rationale behind the establishment of the Bank Recapitalisation Fund, telling us that, as a result of the collapse of Lehman Brothers in the United States, problems in the banking sector became acute across most countries in the world and the banks needed strengthening “so they will be able to continue to lend to each other, to businesses and to people”.²⁸³ Lord Turner agreed that: “we had reached a point of view at the tripartite level all together that a very significant recapitalisation of the

279 HM Treasury, *Pre-Budget Report 2008*, November 2008, p 54-55

280 Q 1915

281 HM Treasury, *Pre-Budget Report 2008*, November 2008, p 54-55

282 Q 11

283 Q 2

banking system and of specific banks was required to restore confidence”. The Governor explained that:

When the banking system fails to do that [lending to the real economy] as a result of a complete collapse of confidence in the worldwide banking system that we saw, not just in the UK but around the world, it was necessary to take drastic action and that action, based on the experience of previous episodes we have seen, was one of recapitalisation. I think that was exactly the right thing to do. This was not done in the interests of the banks; this was done to protect the rest of the economy from the banks.²⁸⁴

134. In order to participate in the scheme, participating institutions, undertook to increase their total Tier 1 capital, either through their own actions or, where requested, through support from the Bank Recapitalisation Fund in the form of preference and ordinary share capital. The Treasury announced that “following the completion of these capital investments, each of the ... institutions will have a Tier 1 capital ratio in excess of 9%, well above international minimum standards and at a level that should put them on a strong footing for the future”.²⁸⁵

135. The Chancellor explained that the Government had asked the FSA to assess how much additional capital would be required in relation to each bank which “took into account the exposure which we were aware that banks had to deal with”.²⁸⁶ Lord Turner expanded on the Chancellor’s comments, telling us that the scale of the recapitalisation was:

worked out by running extreme stress tests—and we deliberately used fairly extreme stress tests—on the assets of the bank, looking separately at their UK mortgage assets, the ordinary mortgages which were on balance sheet; at their ordinary corporate lending assets on balance sheet; and at the assets in their treasury and capital markets activities, which might include some of the ones which people tend to call toxic, though there is no precise definition of what we mean by “toxic”, but it certainly includes several where the present market value of those is very much below the original value.²⁸⁷

Lord Turner concluded by saying that the objective was to ensure that the banks had a level of capital “where people could absolutely clearly and without doubt have confidence in them” with “the net effect ... that we have taken them [the banks] to a level of capital which is well beyond what the classic international rules of capital adequacy defined”.²⁸⁸

136. Following discussions convened by HM Treasury, Abbey, Barclays, HBOS, HSBC Bank plc, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland (RBS) and

284 Q 4

285 “Treasury statement on financial support to the banking industry”, HM Treasury Press Notice, 13 October 2008

286 Q 9

287 *Ibid.*

288 *Ibid.*

Standard Chartered, confirmed their participation in a Government-supported recapitalisation scheme. The Chancellor clarified to us the options open to the participating banks:

The position is that we said, “You need to recapitalise and there are two ways you can do it. One is you can do it through the markets in the normal way,” ... “or you can get capital through the bank recapitalisation scheme and the conditions are different if you do that.”²⁸⁹

137. The Chancellor told us that, of the eight participating banks in the recapitalisation scheme, RBS, HBOS and Lloyds TSB were using the recapitalisation fund with the remainder turning to the market. He explained that the Government would get shares in return for the recapitalisation which could eventually be sold.²⁹⁰ As a result, the Government underwrote the raising of £37 billion shared between RBS and, upon successful merger, HBOS and Lloyds TSB.²⁹¹

RBS

138. On 13 October 2008, RBS announced a £20 billion capital raising programme. Some £15 billion of core Tier 1 capital was to be raised through an offer of ordinary shares, underwritten by HM Treasury at a fixed price of 65.5 pence per share. As a result, any new shares not taken up by RBS shareholders would be purchased by HM Treasury at 65.5 pence per share. Additionally, HM Treasury subscribed for £5 billion of preference shares²⁹² with a coupon of 12%.²⁹³ Just 0.24% of available shares offered to private shareholders were subsequently taken up with the result that the Government took up the remaining shares and therefore acquired a 57.9% stake in RBS.²⁹⁴

139. Stephen Hester, Group Chief Executive for RBS, explained to us that subsequent to the initial October 2008 agreement with the Government, “the preference shares are in the process of being converted to equity and there will be an offering to our shareholders of that amount”.²⁹⁵ The Government and RBS’s decision to take this course of action was to make additional core Tier 1 capital available to the bank and was justified on the grounds that it would strengthen the bank’s resources and enable it to “build its capital further”.²⁹⁶

289 Q 16

290 Q 2

291 “Treasury statement on financial support to the banking industry”, HM Treasury Press Notice, 13 October 2008

292 Preference shares are class of equity that rank ahead of common shares in respect of dividends and the distribution of assets should the company be dissolved or wound up but confer no voting rights).

293 “RBS Announcements—RBS Group plc—capital raising”, Royal Bank of Scotland, 13 October 2008

294 “RBS Announcements—RBS Group plc—results of placing and open offer”, Royal Bank of Scotland, 28 November 2008

295 Q 1909

296 “Treasury statement on restructuring its investment in RBS to deliver further bank lending to industry and homeowners”, HM Treasury Press Notice, 19 January 2009

Mr Hester went on to say that the Government now owned 58% of RBS, but that this “would rise to 70% if the shareholders do not take up their rights”.²⁹⁷

Lloyds

140. Lloyds, which on 13 October 2008 was still in the process of purchasing HBOS, announced that the two banks were planning to raise £17 billion of capital, of which £11.5 billion would be raised by HBOS and £5.5 billion by Lloyds TSB.²⁹⁸ As with RBS, the share offerings were almost entirely shunned by private investors leading to the now combined Lloyds Banking Group receiving £17 billion in public money, with a breakdown, as Eric Daniels explained of “13 billion in equity and four [billion] in preference shares”.²⁹⁹ Mr Daniels told us that this resulted in the Government owning a 43% stake in the Lloyds Banking Group.³⁰⁰

141. Subsequently, Lloyds agreed with the Government on implementation of the Asset Protection Scheme for Lloyds, that the £4 billion of Government preference shares in Lloyds would be converted to ordinary shares. Lloyds shareholders would be able to subscribe to these shares, but if shareholders did not choose to do so then HM Treasury would own approximately 65% of the ordinary shares as a result of the replacement of the preference shares.³⁰¹ In addition, if the ‘B’ shares which the Government holds in Lloyds are converted into ordinary shares and retained by the Government, the Government stake in Lloyds could rise to as high as 77%. The Government has, however, confirmed that, even under this scenario, it will not exercise more than 75% of the voting rights in the Lloyds Banking Group.

142. Eric Daniels, Group Chief Executive for the Lloyds Banking Group, told us that Lloyds “would not have had to have taken government money had we not bought HBOS”. He explained “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” and that “we said that as long as HBOS was going to take the capital that in fact Lloyds would as well ... What we did is we took the state capital in an effort to not only takeover HBOS but to promote public stability”.³⁰²

Barclays

143. Barclays was one of those banks that chose to raise money without recourse to UK Government funds. Instead it raised a significant amount of its capital requirement from sovereign wealth funds.³⁰³ It announced:

297 Q 1912

298 London Stock Exchange, Regulatory Announcement, RNS 6667F, 13 October 2008

299 Q 1909

300 Q 1912

301 “Asset Protection Scheme – agreement with Lloyds”, HM Treasury Press Notice, 7 March 2009

302 Qq 1922-1924

303 Q 1910

The Qatar Investment Authority, which is already a substantial investor in Barclays, is investing a further £2bn in aggregate, and Challenger, representing the interests of the Chairman of Qatar Holding and his family, is investing a further £0.3bn ... In addition, His Highness Sheikh Mansour Bin Zayed Al Nahyan, a member of the royal family of Abu Dhabi, and Chairman of Abu Dhabi's International Petroleum Investment Company is investing a total of £3.5bn.³⁰⁴

By raising its capital elsewhere, Barclays avoided coming into partial Government ownership and was therefore not subject to the conditions attached to Lloyds Banking Group and RBS, an issue we discuss in further detail in the following section.

144. There was some criticism at the time of the deal of the fact that Barclays had chosen to raise capital via sovereign wealth funds rather than, in the first instance, trying to raise this from existing shareholders. For example, Peter Montagnon, from the ABI, voiced dismay that the deal was “very expensive to existing shareholders” and failed to “respect pre-emption rights” which he argued was “very important to confidence in the markets”. Mr Montagnon outlined the difficulties Barclays shareholders faced:

whilst they do not like what is happening, they also will have to take into account what might happen to the bank if the deal did not go through. They have been put by the bank in a rather difficult position.³⁰⁵

145. Mr Varley, for Barclays, defended the decision not to raise money via existing shareholders:

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 [but] circumstances were very far from normal. We needed speed, certainty and size. We made the decision ... to recapitalise in the way that we did ... Given the extreme fragility of sentiment in the markets at that time, I am very glad indeed that we managed to raise the capital.³⁰⁶

Mr Varley brushed aside accusations that the deal Barclays had brokered with the Sovereign Wealth Funds would impact on its ability to access Government support in the future: “we would not be restricted from taking Government money; nor were we restricted back in October [2008] from taking Government money” and “our freedom of choice is maintained”.³⁰⁷

304 “Barclays, Interim Management Statement and Capital Raising Announcement”, Presentation hosted by John Varley – Group Chief Executive, Barclays, 31 October 2008, p 3

305 Q 666

306 Q 2043

307 Qq 2047-2048

Conclusion

146. Bank recapitalisation was necessary to maintain confidence in the UK banking sector. Given prevailing market conditions it was clear that some UK banks would have collapsed without taxpayer support. We therefore support the decision to implement a recapitalisation programme and the Government's support in return for stakes in banks that were unable to raise additional capital through the private sector. The unavoidable speed of implementation did, however, mean that the implications for both banks and Government were neither fully understood nor worked out.

Conditions attached to receipt of Government money

147. The Government has agreed with those banks supported by public funds through the recapitalisation scheme a range of commitments. It will require them to:

- maintain over the next three years, the availability and active marketing of competitively-priced lending to homeowners and to small businesses at 2007 levels;
- support schemes to help people struggling with mortgage payments to stay in their homes and support the expansion of financial capability initiatives;
- address the remuneration of senior executives—both for 2008 (when the Government expects no cash bonuses to be paid to board members) and for remuneration policy going forward (where incentive schemes will be reviewed and linked to long-term value creation, taking account of risk; and restrict the potential for rewards for failure);
- allow the Government to agree with boards the appointment of new independent non-executive directors; and
- restrict the payment of dividends.³⁰⁸

148. The Chancellor outlined the conditions for Government support, telling us that “in relation to those banks where we have used public funds to recapitalise them, we are saying there that additional conditions will attach in respect of lending to small and medium-sized companies and also in relation to the mortgage market”.³⁰⁹ He went on to confirm that “there are also restrictions on payment of dividends”.³¹⁰ He defended the Government's decision to impose conditions on banks receiving public funds for the purpose of recapitalisation:

if we had said, “We are willing to recapitalise you and there are no strings attached,” I think quite understandably you would have been saying “How come you have allowed such a situation to arise?” I do not think it is unreasonable if you take a bank

308 “Treasury statement on financial support to the banking industry”, HM Treasury Press Notice, 13 October 2008

309 Q 11

310 *Ibid.*

where we might have over 60% of its shares or in another case over 40% of its shares that we should not say there are restrictions.³¹¹

149. Much of the evidence we received was supportive of the Government's overall recapitalisation package. Andrew Crockett, President of JPMorgan Chase International, former General Manager of the Bank for International Settlements, and a former Chairman of the Financial Stability Forum, told us in written evidence that "an adequately capitalized banking system is essential for economic recovery" but that given the difficulties that the banks could face in raising capital during "crisis conditions", there was no satisfactory alternative to the Government underwriting the necessary resources through direct funding or guarantees".³¹² Mr Crockett's general support for the Government's approach was echoed by the British Bankers Association (BBA) which was in favour of the Government's overall response to the banking crisis telling us that "in terms of the capital injection, we regard balance sheet support of this type as providing a more workable solution than the toxic bank-type solution first contemplated elsewhere".³¹³ Richard Lambert, Director General of the CBI, told us that the combination of measures to support the banking sector introduced in 2008 "was certainly right in October; whether it is complete is another question. The banking system was close to the edge of a steep precipice and that combination of decisions pulled it back".³¹⁴

150. There were, however, some qualifications to the praise directed at the Government's October 2008 package of measures, most notably relating to the level of dividend payments the banks were required to make on the Government's preference shares in RBS and Lloyds. Professor Charles Goodhart, of the LSE told us that his verdict on the October 2008 package was that it was "extremely well-done". The British initiative at that time was "correct" and justifiably had been followed round the world.³¹⁵ In his view the restriction on dividends was "entirely understandable given the shortage of funds". The guarantees were "sensible" and his only concern "was really the cost of the money that I think was too high".³¹⁶ Will Hutton agreed that the October 2008 package of measures was welcome, although he had some reservations about certain details, including the level of dividend payment, which at 12% he thought was too high. He told us "I do not understand where that 12% came from and I cannot think what they were thinking of when they imposed it on the banks".³¹⁷ This point was made by others, including the BBA who said "that investment made by the UK Government on the taxpayers behalf has been on highly demanding terms and that these potentially may have a penal effect in comparison to support provided in other jurisdictions".³¹⁸ Professor Willem Buiter, of the LSE, however, disagreed that the Government was charging too high a price: "there is nothing wrong with

311 Q 17

312 Ev 296

313 Ev 317

314 Q 757

315 Q 718

316 *Ibid.*

317 Q 764

318 Ev 318

making the banks pay a very high price for government support because, after all, they have failed” going on to say that “you have to discourage the kind of behaviour that brought this about and a financial penalty is the best way of doing that”.³¹⁹

151. Professor Goodhart also pointed out the inconsistency between the Government supporting banks at a rate which ensures the taxpayer does not lose out with its desire to increase lending levels:

none of the other countries imposed anything like as severe a penalty rate on their banks as we did. I think that it was too high, it was counterproductive and ... there was an inconsistency between ... wanting to ensure that the taxpayer does not lose, if anything gains, from the funding provided to the banks, and ... a wish that the banks expand lending. If you are going to impose or put funding with banks on terms which are disadvantageous to the banks, the banks will do everything they can to get rid of it as quickly as they can, and that usually means not expanding their balance sheet.³²⁰

A similar point was made by Richard Lambert who said that “the current structure gives a disincentive for banks to lend as aggressively as we would like them to do”.³²¹ Professor Buiter agreed with Professor Goodhart that the consequence of a high price would be that “banks stop lending simply because they want to get rid of the government or those that are not yet subject to this arrangement want to prevent falling into the clutches of the government”. He felt that such a situation could “only be remedied either by making the capitalisations by the government mandatory and not giving banks discretion as to when to get rid of it, or to complement it by forcing lending in the aggregate”.

152. The wide range of conflicting pressures faced by banks was also stressed by the Council of Mortgage Lenders (CML) in its submission. In its view lenders faced conflicting pressures to:

- re-capitalise against future losses;
- pay the government guarantee fee and service government preference share capital at 12%;
- pay a premium to access the Bank of England special liquidity scheme;
- pay the Financial Services Compensation Scheme (FSCS) to cover consumers deposits in failed banks;
- show forbearance to borrowers in arrears;
- follow base rate moves down to help their existing borrowers;

319 Q 710

320 Q 710

321 Q 764

- keep savings rates high to support existing savers; and
- provide competitive rates to new borrowers and savers, and maintain lending in a recession.

The CML concluded that the Government urgently needed to review the cumulative effect of its re-capitalisation strategy on large lenders' willingness and capacity to lend and that:

Current policy objectives are conflicting and incoherent. The government needs to decide on its key priority. The tug-of-war with lenders being pulled in every direction at once needs to end. There are recent signs that this has now been recognised by government, and we stand ready to help with any further interventions which may be announced.³²²

153. Professor Buiter also told us that he would have liked to have seen one additional condition imposed on the banks in return for the acceptance of Government money, namely “that the top management and the boards of all these failing institutions should have been told to go because the British banks had failed and they had to go to the public trough”. He went on to argue that “the fact that it only happened to a few people continues the moral hazard in the future”.³²³

154. We welcome the fact that the Government has attached conditions to those banks in receipt of public funds for the purpose of recapitalisation. This is despite the fact that such conditionality may have discouraged other banks from applying for Government support. It is important that Government intervention does not undercut the competitive position of sound banks. Such conditionality should help provide assurances to the public that the banks face a quid pro quo in return for Government money and have not received a cost-free bail-out. The Government's priority now must be to ensure that these conditions—in particular those relating to remuneration and lending levels—are adhered to. We will consider remuneration policy in the part-nationalised banks in a later report.

155. That said, we are concerned about the contradictions of the Government's objectives for the banking sector especially with regard to the part-nationalised banks. For example, there is an inherent conflict between ensuring that the banks maintain high capital ratios, protecting the taxpayer interest and wanting the banks to increase lending levels. This tension was demonstrated by the Government's initial decision to charge a 12% coupon on its preference shares which may have adversely impacted on the ability of the part-nationalised banks to increase lending levels. To this end, there is a pressing need for the Government to clarify its strategic objectives and priorities with respect to the part-nationalised banks as well as towards other banks who are also facing conflicting pressures from Government.

322 Ev 371

323 Q 718

4 The January 2009 package

156. At the time of the October 2008 package of measures it was unclear whether this would be sufficient both to stabilise the banking sector and to ensure the banks increased lending, or whether additional measures would be required at a future stage. The tripartite authorities, when they appeared before us on 3 November 2008, did not give a strong indication that they expected to introduce a further raft of measures to support the banks. However, on 19 January 2009 the Government announced a further package of measures to support the banking sector and address the current barriers to lending. The key measures included:

- extending the drawdown window for new debt under the Government’s Credit Guarantee Scheme (CGS) which is designed to reduce the risks on lending between banks;
- establishing a new facility for asset backed securities;
- extending the maturity date for the Bank of England’s Discount Window Facility which provides liquidity to the banking sector by allowing them to swap less liquid assets;
- establishing a new Bank of England facility for purchasing high quality assets;
- offering capital and asset protection scheme for banks, with proposals for this to be co-ordinated internationally; and
- clarifying the regulatory approach to capital requirements, through an announcement by the Financial Services Authority (FSA).³²⁴

Asset Protection Scheme

157. The Asset Protection Scheme (APS) will allow financial institutions to buy insurance against severe losses on certain assets. The scheme was introduced in January 2009 because of persisting concerns regarding banks’ abilities to absorb potential losses, despite the October 2008 recapitalisation package.³²⁵

158. Under the Scheme, in return for a fee, the Treasury will provide each participating institution with protection against future credit losses on one or more portfolios of defined assets to the extent that credit losses exceed a “first loss” amount to be borne by the institution. The Treasury protection is intended to cover the major part, but not all of the credit losses which exceed this “first loss” amount. Each participating institution will be required to retain a further residual exposure, which is expected to be in the region of 10% of the credit losses which exceed the “first loss” amount.³²⁶

³²⁴ “Statement on financial intervention to support lending in the economy”, HM Treasury Press Notice, 19 January 2009

³²⁵ Bank of England, *February 2009 Inflation Report*, p 12

³²⁶ “Statement on the Government’s Asset Protection Scheme”, HM Treasury Press Notice, 19 January 2009

159. To date both RBS and the Lloyds Banking Group have signed up for the APS, whilst the Chancellor confirmed to us that Barclays was considering whether or not to participate.³²⁷ Barclays has subsequently confirmed that it will not participate in the scheme. RBS was the first bank to sign up to the APS. Under the terms of the ‘agreement in principle’ that RBS has signed with the Government, £325 billion of assets will be insured. The agreement would see RBS bear a first loss of up to £19.5 billion having paid a participation fee of £6.5 billion to the Treasury in capital.³²⁸ On 7 March, the Government announced that it had signed an ‘agreement in principle’ with the Lloyds Banking Group to join the APS. Under the agreement Lloyds will place £260 billion of assets into the APS and Lloyds would bear a first loss amount after existing impairments of up to £25 billion, having been charged a participation fee of £15.6 billion.³²⁹

160. To date the Government has merely signed an ‘agreement in principle’ with the two participating banks. The Chancellor explained that it was not “uncommon in a commercial contract for heads of agreement to be reached” before the parties had finished going through the detail. He said that the alternative of maintaining “radio silence” whilst going through the detailed due diligence process had proved to be very difficult in countries which had attempted to follow such a course of action.³³⁰ In response to questions about whether the final amount being insured by the taxpayer—once due diligence was completed—would differ from the original £595 billion estimate, the Chancellor told us that he expected “the figures to be of that order of magnitude”.³³¹ The Chancellor also explained, in response to concerns as to why the first loss amount to be borne by the two participating banks differed, that this was because “like any insurance policy ... we might get quoted different rates because of our different circumstances”.³³²

161. There are conditions attached to participation in the APS, principally relating to lending and remuneration. The remuneration condition requires participating banks to implement a remuneration policy consistent with the detailed principles set out in the FSA recent code of practice on remuneration policies.³³³

162. The lending condition imposes a legally binding agreement on participating banks to increase lending to homeowners and businesses, the results of which the Government will report to Parliament annually.³³⁴ Ms Mridul Hegde, Director of Financial Services at the Treasury, explained that RBS would be required to increase lending by £25 billion—£9 billion of which was for mortgage lending and £16 billion for business lending. She said that Lloyds would be required to increase lending by £14 billion—£3 billion for mortgages and £11 billion for business. Ms Mridul explained that this would inevitably entail the

327 Qq 2828, 2829

328 “Asset Protection Scheme and increased lending”, HM Treasury Press Notice, 26 February 2009

329 “Asset Protection Scheme – agreement with Lloyds”, HM Treasury, 7 March 2009

330 Q 2827

331 Q 2827

332 Q 2924

333 “Asset Protection Scheme and increased lending”, HM Treasury Press Notice, 26 February 2009

334 “Asset Protection Scheme and increased lending”, HM Treasury Press Notice, 26 February 2009

“scrutiny of existing loan books, because the lending commitments only make sense if you understand where you are starting from” which was necessary “so we can make sure that the lending is indeed additional”.³³⁵

163. Both the FSA and the Bank of England defended the scheme as necessary to bolster confidence in the banking sector. The FSA believed that the establishment of a government bad asset insurance scheme would help tackle “potential fears that lending growth combined with higher than expected losses could drive capital ratios below minimum acceptable levels”.³³⁶ The Governor of the Bank of England stressed that the APS was a response to concerns that ‘toxic’ or ‘under-performing’ assets and uncertainty about the size of such assets still on the balance sheets of banks was contributing to a continuing lack of confidence in the banking system. The Governor considered that the priority, if confidence was to be restored, was to identify ‘bad’ or ‘toxic’ assets on the balance sheets of banks and then for the Government to underpin the balance sheets. There were a range of ways in which this could be done:

One is by injecting capital directly, the other is by providing insurance for a fee against a certain group of assets and the third is just by being willing in the end to ensure that if a bank finds itself in a position where the level of its capital threatens to fall below the absolute minimum, and what matters here is not the fancy regulatory capital ratios but just equity, the amount of core Tier 1 equity, if that falls below a critical level then the Government will step in and put enough capital into the bank to ensure it is a going concern.³³⁷

In the Governor’s view “a promise of sufficient capital to maintain the largest banks was “about all a Government can do to ensure that confidence comes back into the banking system”.³³⁸

164. The Governor said that the priority for policy makers was to find out “what really is on the balance sheet of our major banks”, but went on to say that this was not something that was easy to do or could be done quickly. He explained why a thorough examination of bank balance sheets would take time:

it is affected by the fact that the losses that could arise on any of the assets on the banks’ balance sheets may change as the nature of the world downturn becomes either more or less severe. It is not a fixed picture, it changes over time. There needs to be a continuous process of finding out what is on the banks’ balance sheets to give confidence to investors and prospective investors in banks.³³⁹

165. Lord Turner expanded on the Governor’s comments about the difficulties involved in identifying so-called ‘toxic’ assets. He cautioned that discussions about the APS were “often

335 Q 2768

336 Ev 460

337 Q 2321

338 *Ibid.*

339 *Ibid.*

presented as if there is within the books of the banks ... an absolutely definable set of “toxic assets” which are bad and other assets which are good”. He said that whilst this characterisation may have held true until the third quarter or so of 2008, this was no longer the case. This was because the UK was “now in an environment where the financial crisis itself has produced an economic downturn and that economic downturn is now producing bad assets among what were previously perfectly good creditworthy customers”. He concluded by saying that it made it extremely difficult to say “that is the bad asset, carve it off and here is the separate stuff”.³⁴⁰

166. We questioned the Bank of England and the Treasury on exactly what assets the taxpayer was now guaranteeing, including whether the APS would cover the overseas assets of banks or merely their UK assets. Andrew Bailey, Executive Director, Banking & chief cashier, Bank of England, said that a “whole bank approach” would be taken and that, in the context of RBS entering the APS:

You cannot say, “We are not going to look at that because it is somewhere else in the world.” This is a bank that, of course, went on a global strategy. I think you will find, from the announcements that the Chief Executive has made today that that strategy will of course change but we inherit the assets that we inherit and therefore we have to deal with all the assets. There is just no choice on that matter.³⁴¹

Treasury officials revealed that in the case of Lloyds most of the assets were UK-based whilst in the case of RBS the majority of assets were UK-owned, but with the caveat that the majority of the UK-owned assets were based on overseas collateral.³⁴² The Chancellor defended the decision to insure RBS’s overseas assets, stating that “if we did not insure assets that may be abroad ... it would still prevent RBS from being able to lend ... and you would not achieve the objective, which is to get increased lending”.³⁴³ The implications of the insurance of large scale overseas assets both in terms of taxpayer support and the legal and regulatory consequences of actions in foreign courts and regulatory systems are not known.

167. In response to questioning about the exchange rate risk on overseas assets, Lord Myners, Financial Services Secretary, explained that the Treasury had concluded at this stage that it would bear the exchange rate risk; but that the issue would receive further scrutiny as the scheme came closer to being finalised.³⁴⁴ Ms Hegde did, however, acknowledge that the APS faced a further degree of exposure as a result of exchange rate risk on assets from outside the UK.³⁴⁵

168. We also received evidence from the Treasury on the proportion of assets being insured which fell into the category of complex instruments. Nikhil Rathi, Team Leader on

340 Q 2286

341 Q 2389

342 Q 2774

343 Q 2844

344 Q 2775

345 Q 2778

financial stability issues at the Treasury, told us that “in the case of Lloyds there is a very limited number of complex instruments” whilst in the case of RBS such instruments formed “in the region of 10%-20% of the assets they are putting forward”. Mr Rathi explained that the Treasury was still in the process of conducting “asset-by-asset diligence” and that it planned to publish more details about exactly what assets will be covered by the scheme.³⁴⁶

169. There has been some concern that the insurance fee that the Government is charging, or planning to charge, banks that participate in the APS could lead to the Government building up further stakes in these banks. The Governor expressed little concern about this possibility, arguing that “the banks need to have this protection scheme and I think the taxpayer is entitled to take their share of the returns if they put in money to underwrite the balance sheet”.³⁴⁷

170. Treasury Ministers and officials expressed uncertainty as to the likely cost to the taxpayer of guaranteeing these assets. Ms Hegde was unable to provide a figure, and said that the Treasury was still in the “extensive process of diligencing the assets” and only once this process was completed would the Treasury be able to “build a bottom-up picture of what we think the likely losses are likely to be”.³⁴⁸ Lord Myners said the projections of likely losses would “depend upon the economic outcome” and that “calculating the likely claims is difficult”.³⁴⁹ He used the example of HBOS to illustrate his point, telling us that “because so much of that book is dependent on UK residential and commercial property values, the extent of any claims under the Asset Protection Scheme will be a consequence of how values move there”.³⁵⁰

171. The Treasury defended itself against the charge that the taxpayer would end up with a large bill telling us that the APS had been designed to contain “appropriate safeguards for taxpayers”, by virtue of the fact that participating banks were being charged an insurance fee, as well as through additional provisions whereby the bank took the first loss and a 10% share of any second loss.³⁵¹ Mr Rathi also pointed to the potential upside in that “if at any point the first loss is burnt through, 90% of the recoveries that come from these assets over time, and many of these assets will mature over several years, they come to the taxpayers’ account first”.³⁵² Lord Myners told us that “experience elsewhere of such schemes has suggested that the costs are often a lot less than people originally anticipate” a point which was reiterated by the Chancellor who used the example of Sweden to make his point.³⁵³

346 Q 2772

347 Q 2406

348 Q 2772

349 Q 2770

350 *Ibid.*

351 Q 2772

352 *Ibid.*

353 Q 2831

172. Whilst welcoming the approach taken in the Asset Protection Scheme, we are concerned about the need for greater clarity over the possible impact on the public purse, and urge the Government to complete the due diligence on assets in the scheme as quickly as possible, to make public the proportion of assets, by value, in each category covered by the scheme, and to disclose as soon as possible the mechanism for determining and the projected timeline for the crystallisation of any losses.

Insurance scheme versus 'bad' bank

173. The establishment of the APS has been seen in some quarters as a precursor to the creation of a 'bad' bank whilst others have viewed the APS as an alternative to such an institution. Stephen Hester explained the difference between the two:

insurance schemes ... 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.³⁵⁴

Mr Hester went on to outline the pros and cons of a 'bad' bank solution: "the advantage of that [bad bank solution] 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".³⁵⁵ The disadvantage was "it is more complex to agree the pricing than a simple insurance policy and has a more immediate burden on the taxpayer". Weighing up the alternatives, Mr Hester concluded that he did not think there was a "right or a wrong answer".³⁵⁶

174. Professor Buiter and Dr Danielsson discussed the merits of a 'bad' bank versus guarantee scheme solution, albeit prior to the Government's January 2009 announcement that it would establish an asset protection scheme to guarantee so-called 'toxic' assets. Both stressed the difficulties of valuing such assets, with Professor Buiter insisting:

I think that one wants these assets either off the books or ring-fenced on the books in such a way that they can be dealt with, their true value, or lack of it, is, revealed, that the remaining uncertainty is taken away and then that the state, if it is the only one who can carry that load, can take them on its books and try to make in the long run as much money out of them as it can. They may have to be held to maturity.³⁵⁷

175. Professor Buiter thought that if the Government went down the 'bad' bank path, then it should price its offer "quite aggressively" at a level which was higher than the banks could receive in the marketplace, but lower than "the best estimate of the present value of future

354 Q 2016

355 *Ibid.*

356 Q 2016

357 Q 697

cash flows at a reasonable interest rate”.³⁵⁸ Dr Danielsson noted that the eventual cost to the taxpayer of purchasing toxic assets might not be as high as many people thought and that “for a lot of these assets the government would not be losing that much money”.³⁵⁹

176. Lord Turner suggested that the APS could be either a precursor or an alternative to a ‘bad’ bank, and maintained that the difficulties of predicting developments in the macro economy meant that it was wise not to rule out any option.³⁶⁰ He said that at the present moment, however, the authorities considered it to be an alternative to a “straight bad bank approach”.³⁶¹ Lord Turner then went on to point out that:

bad banks work best when there is a very clearly definable set of assets. If you go back to the Swedish bad bank experience of the 1990s, the Swedish banks had made some very bad lending in particularly commercial real estate, but a lot of their lending to the broad Swedish economy and caucus was perfectly okay. There was an environment where you could with quite a high degree of certainty say, “This is bad and this is good”. I think we are in a more complicated situation at the moment. As we go into a recession we are likely to see, unfortunately, bad assets spread throughout the broad mass of SME lending. That is always what happens in a recession and that makes it more complicated.³⁶²

The Governor also conceded the possibility that a split “between good bank/bad bank is certainly a feasible option down the road”. He played down the differences between the options, arguing that the differences between establishing a ‘bad’ bank and insuring assets was “a matter of degree”; and that the two concepts were “not qualitatively different”.³⁶³ He did, however, express some reservations about ‘bad’ banks from the point of view of the “taxpayer rushing in to buy assets without knowing what the price is” saying that this was one reason why the authorities had to wait until the process of examining the assets was complete before deciding whether to move towards the creation of a ‘bad’ bank.³⁶⁴ The Governor conceded that he was “attracted by a process that cleans up and restructures the bank’s balance sheet”.³⁶⁵

177. Treasury officials told us that they had built “sufficient flexibility in the Scheme through step-in rights for the Government in defined circumstances to be able to move to a bad bank concept at some point in the future”.³⁶⁶ Lord Myners refused to be drawn on whether the Government was planning to go down the ‘bad’ bank route:

358 Q 713

359 Q 714

360 Q 2287

361 *Ibid.*

362 Q 2287

363 Q 2411

364 Q 2412

365 *Ibid.*

366 Q 2760

it is difficult to speculate with any specificity at this point, but simply to say that if that made good sense for the Government it would be done³⁶⁷.

The Chancellor also declined to comment upon whether the APS was a precursor to the establishment of a bad bank, limiting his comments to saying that there was a choice between the two and that one was not necessarily better than the other.³⁶⁸

178. We are mindful of the Governor of the Bank of England's comments that identifying the toxic assets on the balance sheets of banks is a task that will take many months. Dealing with so-called toxic or bad assets is a priority if confidence in the banking sector is to be restored and a prerequisite for this is establishing a clear and comprehensive picture of exactly what is on the balance sheet of the banks. To this end, we support the due diligence on assets of banks participating in the scheme currently being conducted by the Treasury. The Government has decided to tackle this problem through the establishment of an Asset Protection Scheme, which will provide guarantees on 'toxic' assets held by banks as well as other assets they retain that may suffer losses during the economic downturn. However, it is unclear at this stage whether the APS is a precursor or an alternative to the introduction of a so-called bad bank and we would welcome clarity as to the Government's intention in this area. We note that the exact value of the assets that the taxpayer will be guaranteeing has yet to be determined and that the eventual cost to the taxpayer of this arrangement is unknown. In hindsight, there were clear signs of an impending financial crisis since the summer of 2007. We question whether more analysis should have been instituted by the regulators earlier to clarify the nature and value of assets on which banks were relying. We would welcome transparency regarding the methods used to calculate the fee charged for participation in the Asset Protection Scheme and the relationship between the fee charged and the degree of risk. It is also as yet unclear how the Office for National Statistics will classify the potential liabilities assumed.

Beyond the January 2009 package: the prospects for further bank nationalisation

179. Arguments have been advanced that the Government should embark on the wholesale nationalisation of those banks—namely RBS and the Lloyds Banking Group—which are already partly-owned by the State. We asked the chief executives of these two banks under what circumstances they could envisage such wholesale nationalisation taking place. Eric Daniels, for Lloyds, told us that:

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

367 Q 2782

368 Q 2821

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.³⁶⁹

Stephen Hester was equally confident that RBS would avoid this fate, telling us that it would not be in the public interest to nationalise RBS and that he hoped it would not happen.³⁷⁰

180. Professor Goodhart explained that “in the Swedish bank crisis the banks were taken over completely by the government with the intention of reselling them” and that he would not rule out the possibility of this also happening in the UK. His key point was that whilst temporary ownership of the banks was “not necessarily something to be refused or avoided ... the idea that the Government should go on owning the banks indefinitely would be a very bad thing”.³⁷¹ Professor Buiter appeared to welcome the prospect of wholesale nationalisation, saying that it would have simplified things if the banks had been completely nationalised which he believed the Government “could easily have done”.³⁷² One area where this may have ‘simplified’ things for Professor Buiter was with respect to his view, discussed earlier, that the “top management and boards of failing institutions should have been told to go” and which Professor Goodhart believed would be problematic given that this was a decision for shareholders, and which therefore constrained the Government’s room for manoeuvre.³⁷³

181. The Governor of the Bank of England considered the debate about whether the outright nationalisation of the banks ought to take place was a secondary issue, arguing that there was no significant difference between the situation at present, where as the majority shareholder the Government could “make its decisions accordingly”, and outright nationalisation. He believed that the present arrangement had the merit of making it clear to everybody that “nobody thinks that the Government should be involved in running these banks indefinitely and that the shares will be put back on to the private market and the banks will be back in the private sector.”³⁷⁴

369 Q 2021

370 Q 2022

371 Q 711

372 Q 719

373 Qq 718-719

374 Q 2409

5 Bank lending

182. In our January 2009 report on the Pre-Budget Report 2008, we concluded that the lack of bank lending was “the single most critical problem for the economy in the near term”.³⁷⁵ We stated there that “the Government must ensure that the availability of credit, both to households and businesses, increases quickly”, warning that should that not happen “the recovery of the economy will be placed in jeopardy”.³⁷⁶ The Bank of England provided some evidence on how far lending had been affected. In the six months to February 2009, net lending to businesses by foreign and domestic banks had fallen to £8.6 billion from £53.5 billion in the same period a year earlier.³⁷⁷ Net secured lending to individuals by foreign and domestic banks in the six months to February 2009 fell to £4.5 billion from £43.8 billion in the same period a year earlier.³⁷⁸ We have focused in this inquiry on the effects of the lack of bank lending on two constituencies, consumers and small firms, and it is to those we now turn.

Lending to consumers

183. The Council of Mortgage Lenders (CML) has characterised the current lending market as “very different” from that of 2007:

In 2008, the impact of having to manage borrower demand exceeding supply of funds has led to lenders withdrawing products, changing criteria (requiring higher deposits and better credit histories) and increasing the price of loans to more closely reflect the risks.³⁷⁹

Figures published by the Bank of England highlight the impact on consumer lending. There were 101,942 approvals secured on dwellings in February 2009, a significant reduction on February 2007, when there were 300,063 such approvals.³⁸⁰ The consumer credit growth rate has also fallen significantly, from a 12-month growth rate of 13.9% in February 2005 to 3.4% in February 2009.³⁸¹ The Bank of England’s Credit Conditions survey for the first quarter of 2009 noted that “Lenders reported that they had reduced the availability of secured credit to households in the three months to mid-March 2009”.³⁸² However, the survey also noted more hopeful signs: “A net balance of lenders reported that they were expecting a small increase in overall credit availability over the next three months”.³⁸³ The Association of Mortgage Intermediaries (AMI) argued that the

375 HC (2008–09) 27, para 17

376 *Ibid.*

377 HC (2008–09) 376, Ev 32

378 *Ibid.*, Ev 33

379 Ev 373

380 “Approvals secured on dwellings, Seasonally adjusted”, Bank of England data

381 “Consumer credit consists of credit card lending and other loans and advances”, Bank of England website, www.bankofengland.co.uk

382 Bank of England, *Credit Conditions Survey 2009 Q1*, p 2

383 *Ibid.*, page 3

contraction in mortgage lending was “caused by the loss of institutional financial liquidity and limited capital availability driving lack of funds”.³⁸⁴ Angela Knight, for the BBA, qualified this suggestion slightly by arguing that a portion of the reduction in the availability of credit would be counterbalanced by the reduced demand for borrowing, although she did accept that demand would still outstrip supply by a considerable margin.³⁸⁵ However, Ms Knight, also clearly laid out why the banks were unable to provide lending at the moment:

a bank cannot face in all directions at the same time, you cannot lend at the same price as when there was a lot of credit availability, you cannot have an increase in your capital requirements and at the same time be able to service everybody at a very fine rate.³⁸⁶

184. In our visits to Belfast, Edinburgh and Yorkshire, we were informed of the impact on consumers, and those who work in the industries that supported consumers, of the sudden withdrawal of credit by the banks. However, we heard conflicting evidence, with some describing the effects of high levels of indebtedness, while others indicated that first-time buyers would need higher levels of debt. The Governor has described this dilemma as the “paradox of policy”. He explained that “In the short-run we have to engage in measures to ensure that spending returns to more normal levels in order to prevent significant falls in output and rises in unemployment”, and therefore need to encourage borrowing by households. He went on to concede that once the immediate problem had been negotiated, then the challenge would be to raise the national savings rate, “both public and private”.³⁸⁷

185. When we first took evidence from the Chancellor in November 2008 he argued that an end to ‘irresponsible lending’ would mean that some aspiring borrowers would see their mortgage applications rejected:

of course the availability of money must be maintained and it must be at competitive rates, but that does not mean that every person who wants a loan will necessarily get a loan on the terms they want. Pretty much on a cross-party basis people did say that what we cannot do, having done all this, is to then go back into the very irresponsible lending that so many of us have been critical of.³⁸⁸

This position was echoed by lenders, such as the Yorkshire Building Society whose Chief Executive, Iain Cornish, told us that “in the short to medium term it is going to be difficult to get a mortgage”.³⁸⁹ Mr Cornish went on to question whether there would “ever be a return to 125% loan-to-value, eight times income mortgages” and asserted his belief that there should not be.³⁹⁰ It was not just lenders who were concerned about a return to

384 Ev 160 [AMI]

385 Q 841-2

386 Q 865-6

387 HC (2008-09) 376, Q 5

388 Q 12

389 Q 1595

390 *Ibid.*

previous lending levels. Peter Tutton, from Citizens Advice, also defended the contraction in lending, suggesting that “in the past perhaps credit costs in some respects have been too low, credit has been too available, people have over-borrowed and that has been one of the problems”.³⁹¹ However, others have argued for the median path. Which? accepted that an adjustment in the cost and availability of credit would occur but felt that it would be “very damaging to go from feast to famine”.³⁹² The challenge, AMI contended, was to facilitate a “return to more stable patterns of lending which support the natural desire to own a home of one's own, but protect consumers from entering into unsustainable levels of debt”.³⁹³

186. While we have received numerous submissions discussing the nature of this challenge, few have offered suggestions as to how it can be met. The Financial Inclusion Centre has proposed that more use could be made of non-profit financial institutions:

government could increase the financial resources available to non-profit lenders. Governments and other public authorities would have to develop institutional funding mechanisms and cross-subsidise third sector organisations to provide access to financial services to excluded consumers. Possible solutions could include institutional solutions such as reinventing the role of the Post Office; boosting the role of third sector organisations such as CDFIs [Community Development Finance Institutions] and credit unions; new style public-private partnerships to meet needs of excluded consumers; or even more radically, a mortgage and loans version of National Savings and Investment.³⁹⁴

Lending to small and medium sized businesses

187. Our UK visits also allowed us to meet representatives of the local business communities in Yorkshire, Scotland and Northern Ireland. They provided anecdotal evidence that lending via the banks was not as prevalent as it once had been. Alongside this, the Bank of England, in its 2009 Q1 credit conditions survey, noted that demand by small firms for both unsecured and secured credit had increased over the last three months, and that demand for credit by small firms was expected to increase further over the next three months.³⁹⁵ Mr Cave, of the Federation of Small Businesses, told us that “the figures that came out from the BBA ... demonstrate to us that overdrafts have reduced by £100 million in October and November and small businesses are having to dip into their savings to the tune of £900 million. These figures again are for October and November but the anecdotal evidence that we receive from members on a day to day basis suggests that the problems are continuing”.³⁹⁶ The banks’ perspective on the situation was described by Angela Knight. In response to complaints by businesses that they were being denied credit facilities despite having in place solid financial histories and business plans, Ms Knight

391 Q 824

392 Ev 237

393 Ev 159

394 Ev 338

395 Bank of England, *Credit Conditions Survey 2009 Q1*, pages 4-5

396 Q 804

argued that while businesses might feel that they were ‘the same’ business renewing existing facilities, banks would be concerned about the wider economic situation and that the value of assets offered as security for borrowing facilities may have dropped:

If the security has dropped in value though and the same amount of money is required by the business, then you are into a rather more risky scenario, and that risk then reflects back into the capital.³⁹⁷

188. Concerns have also been expressed to us, both during our visits and in correspondence we have received, that bank charges have been rising for business customers. We learned of large increases in charges for renegotiating existing loans or for taking on new loan facilities. The Governor of the Bank of England confirmed that the Bank’s agents had also been hearing the same complaints.³⁹⁸ While noting that such matters were for the FSA, rather than the Bank of England, he explained that the reduced difference between the borrowing and lending interest rates means that banks may be turning to charges to secure returns.³⁹⁹

189. Whilst noting some positive signs, we are very concerned about the availability and terms of credit to the small business sector, and the slow movement on this issue by the banks. We regret the reports of sharp increases in bank charges and arrangement fees which can often be more damaging to businesses than higher interest rates. We deplore the behaviour of a number of those banks who have received so much public money and behaved in such an insensitive manner particularly to established customers. We ask the Lending Panel to set up a unit to monitor and investigate such practices, which seem to work against the letter and the spirit of the signed agreement. We invite the banks and Government to report back to us on progress in this area on a quarterly basis.

Government intervention

Agreements with the banks

190. Given the significant support extended to the banking system by the Government, we explored why the banks still appeared to be reluctant to lend. Aside from its general package of measures to promote financial stability, the Government has entered into two sets of agreements with Lloyds Banking Group and RBS, with the express purpose of increasing lending.

191. The first of these were agreed at the time of the recapitalisations, and formed part of the package relating to the placing and open offer agreements needed for the recapitalisation. The agreement between RBS and HM Treasury set out the following detailed conditions on mortgage and bank lending to SMEs:

³⁹⁷ Q 853

³⁹⁸ HC (2008-09) 376, Q 33

³⁹⁹ *Ibid.*, Q 6

- On lending for mortgages, RBS made a commitment immediately to restore and maintain the availability and active marketing of competitively priced mortgage lending over the next three years at a level at least equivalent to that of 2007. It also agreed to make available increased sums for the next 12 months “for shared equity/ shared ownership schemes” and “to support ongoing expansion of financial capability initiatives”.
- On support for SMEs, RBS agreed to “restore and maintain availability and active marketing of competitively priced lending to SMEs at a level at least equivalent to that of 2007”. It also agreed to publish an annual report on “overall lending to SMEs; overdraft facilities and loans to SMEs: volumes, value and rates; foreclosures of debt finance to SMEs; appropriate lending of Small Firms Loan Guarantee Scheme; Application and use of EIB global loan facility to secure additional liquidity specifically for SME lending”.⁴⁰⁰
- RBS agreed to adopt a policy of “transparent public reporting on both SME lending and Mortgages as agreed with HMG”.⁴⁰¹
- Finally to satisfy EU Commission state aid requirements, RBS’s annual lending growth would be limited to the higher of the average annual growth rate in UK banks outstanding assets, and average annual growth rate of UK GDP, over the required period”.⁴⁰²

The agreement signed between LloydsTSB and HM Treasury contained a very similar set of conditions, except the sum in support of shared equity /shared ownership schemes was “tentatively” set at £15m–£20m, while the sum in the support of financial capability initiatives was “tentatively” set at £3m.⁴⁰³

192. The second set of lending targets was agreed when Lloyds Banking Group and RBS agreed in principle to enter the Asset Protection Scheme. The conditions in lending were now set out with quantitative figures for the expected lending:

- On 26 February 2009, the Treasury announced that agreement in principle had been reached with RBS over its access to the Asset Protection Scheme, and that in return, RBS had made 2009 lending commitments totalling £25 billion, which would comprise £9 billion of mortgage lending and £16 billion of business lending.⁴⁰⁴
- On 7 March 2009, the Treasury announced a similar agreement in principle with Lloyds Banking Group: “Lloyds will make additional lending commitments totalling £3bn of mortgage lending and £11bn of business lending over the next 12 months. A

400 Placing and open offer agreement between The Royal Bank of Scotland Group Plc, UBS Limited, Merrill Lynch International and The Commissioners of Her Majesty’s Treasury, Schedule 6, 13 October 2008

401 *Ibid.*

402 *Ibid.*

403 *Ibid.*

404 “Asset Protection Scheme - agreement with Lloyds”, HM Treasury press release, 23/09 , 7 March 2009

similar lending commitment has been made in respect of the subsequent 12 months but this will be reviewed to ensure it reflects economic circumstances at that time.⁴⁰⁵

193. However, despite these assurances, there was some doubt, expressed to us during our visits across the country, as to whether these banks were achieving these lending targets. But when we discussed the first set of commitments with the Lloyds Banking Group and RBS, they suggested that they were meeting their targets. Mr Hester for RBS told us “As at the end of 2008 our lending in those categories was more than 10% higher than the 2007 levels”.⁴⁰⁶ Mr Daniels for Lloyds Banking Group similarly noted:

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 2007.⁴⁰⁷

John Varley for Barclays, though not a party to these agreements, told us that “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”.⁴⁰⁸ The Governor of the Bank of England though seemed more sceptical of whether the targets in the first set of agreements were met: “As far as I know nothing happened until the Asset Protection Scheme came in”.⁴⁰⁹ He went on to say that “the lending agreements need to be specified in quantitative form so they can be monitored”.⁴¹⁰

Northern Rock

194. On 23 February 2009, the Treasury announced that Northern Rock would “increase mortgage lending by up to £14 billion over the next two years”.⁴¹¹ This increase would see “around £5 billion of new mortgage lending for 2009 and between £3 [billion] and £9 billion from 2010 onwards, subject to market demand”.⁴¹²

Other lending support programmes

195. Two schemes were designed to support banks, rather than directly alter patterns of lending. The Working Capital Scheme has the aim of providing “banks with guarantees covering 50 per cent of the risk on existing and new working capital portfolios worth up to £20 billion”.⁴¹³ The Government suggested this would assist firms in two ways. It would

405 *Ibid.*

406 Q 1962

407 *Ibid.*

408 Q 1919

409 HC (2008-09) 376, Q 88

410 *Ibid.*, Q 91

411 “Northern Rock”, HM Treasury press release, 15/09, 23 February 2009

412 *Ibid.*

413 Department for Business Enterprise and Regulatory Reform, *Working Capital Scheme Factsheet*, 14 January 2009

guarantee £20 billion worth of working capital credit lines for companies, and would free up capital “which the banks must use for new lending as a condition of this scheme”.⁴¹⁴ In addition, on 30 October 2008, the Government announced that small and medium-sized businesses stood to benefit from up to £4 billion in loans from the European Investment Bank over the next four years.⁴¹⁵ These loans would be made available through the banking system, and not directly to firms.⁴¹⁶

196. As well as these programmes, small business support is also provided by the Enterprise Finance Guarantee scheme, which replaced the Small Firms Loan Guarantee scheme.⁴¹⁷ The Department of Business, Enterprise and Regulatory Reform provided the following guidance on the scope of the Scheme:

This £1.3bn scheme will support bank lending, of 3 months to 10 year maturity, to UK businesses with a turnover of up to £25 million who are currently not easily able to access the finance they need. It will enable them to secure loans of between £1,000 and £1 million through the Government guarantee and is available up to 31 March 2010.⁴¹⁸

Mr Cave, for the Federation of Small Businesses, acknowledged that the Government had taken some steps towards supporting small business:

Of the announcements today the key one is obviously the £1.3 billion finance scheme for small businesses, which we welcome. We proposed a very similar scheme last October and it is important to point out that since last October when it was first proposed to now over 6,000 businesses have closed their doors, so we would have liked to have seen this come on tap much sooner. However, it is better late than never and we believe that it will make a real difference.⁴¹⁹

On our visits around the UK we heard anecdotal evidence that the Enterprise Finance Guarantee was very difficult to operate because banks were constrained to offer the facility only to ‘viable’ businesses but had been given no coherent guidance on how to assess the viability of a business facing a sudden contraction in its order book which may continue for an indeterminate period.

197. After announcing in the Pre-Budget Report 2008 that a Lending Panel would be formed, on 25 November 2009, the Chancellor announced that:

A Lending Panel has been established to monitor lending to both businesses and households, and to promote best practice across the industry in dealing with borrowers facing financial difficulties. The Lending Panel will report to the

414 *Ibid.*

415 “Extra support for small firms in the UK from the European Investment Bank”, HM Treasury press release, 30 October 2008

416 www.realhelpnow.gov.uk, February 2009

417 Department for Business Enterprise and Regulatory Reform, *Enterprise Finance Guarantee*, www.berr.gov.uk

418 *Ibid.*

419 Q 805

Chancellor of the Exchequer and the Secretary of State, BERR. It will meet monthly, and will comprise the Government, lenders, consumer, debt advice and trade bodies, and regulators and the Bank of England.⁴²⁰

Missing links?

198. Two additional causes for the drop in lending were suggested us. Paul Thurston, Managing Director for the UK for HSBC, explained that “clearly some of the foreign banks ... have pulled out of the market” and that as well as this “some of the specialised mortgage providers have pulled out of the market”.⁴²¹ Stephen Hester, Group Chief Executive, RBS, argued that part of the difficulty was that even if the major banks extended their lending, a gap would remain due to the withdrawal of international banks from the UK mortgage market:

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.⁴²²

199. Such a reduction in foreign lenders may also be due to the support operations of various countries prioritising lending in their own markets. However, the Governor of the Bank of England provided more detail as to the effect of the potential loss of the foreign banks. For consumers, he seemed to consider there to be a small effect: “Most of the foreign banks did not lend in the mortgage market, but the Irish banks did and there has been some withdrawal of mortgage lending from Irish banks”.⁴²³ In fact, he thought “By and large the big reduction in capacity in the mortgage lending market was through the withdrawal of Northern Rock and Bradford & Bingley when they exited the market”.⁴²⁴ For corporate lending, Paul Tucker, Deputy Governor of the Bank of England for Financial Stability, told us that “a lot of lending by overseas banks would have been for takeovers rather than for working capital finance or real investment”.⁴²⁵ It was Mr Tucker’s “broad guess” that “in terms of real economic activity there is a greater dependency on credit from the domestic banking system than there is on the overseas banking system”.⁴²⁶ Further evidence from the Bank of England provided more detail on the impact of the loss of the foreign lenders: “In the six months to February 2009, net lending to businesses by foreign banks fell to £1.4bn from £21.1bn in the same period a year earlier, whereas net lending by domestic lenders fell to £7.2bn from £32.4bn in the same period a year earlier”.⁴²⁷ However,

420 “Statement on Banks and Building Societies”, HM Treasury Press Release, 126/08, 25 November 2008

421 Q 1965

422 Q 1973

423 HC (2008-09) 376, Q 79

424 *Ibid.*

425 HC (2008-09) 376, Q 80

426 *Ibid.*

427 HC (2008-09) 376, Ev 32

the Bank of England noted that in the mortgage market “The contribution of foreign lenders to the growth in mortgage lending has always been relatively modest”.⁴²⁸ It stated that “In the six months to February 2009, net secured lending to individuals by foreign banks fell to -£3.7bn from £5.7bn in the same period a year earlier, whereas net lending by domestic lenders fell to £8.2bn from £38.1bn in the same period a year earlier”.⁴²⁹

200. Another aspect of the crisis has been the reduction in lending by non-bank specialist lenders. In its submission to us, Paragon mortgages told us “there has been a general lack of support for the non-bank lenders since the economic downturn has taken hold”.⁴³⁰ This lack of support for specialist non-bank lenders meant that while there had been a “very significant amount of support” to the banks, “a large and very important part of the mortgage market has been left with no liquidity support whatsoever”.⁴³¹ Mr Tucker appeared concerned about the impact of the withdrawal of specialist lenders from the market: “The fact that they have withdrawn in this crisis has plainly made the crisis a lot worse, but I would not expect them to re-enter for quite a while”.⁴³² He noted though that “We can build a system for underpinning the banking system with difficulty but more readily than we can build a system for underpinning essentially unregulated intermediaries in credit”.⁴³³

Conclusions

201. **There are currently a number of Government schemes aimed at encouraging lending by the banks. However, it is difficult to form an overall picture of how effective those efforts are, and how well they are working together. We recommend that the Government, via the Lending Panel, ensure that there is published a clear overall strategy, with each of the schemes outlined, indicating its aim and progress to date. At present, the approach seems to be piecemeal and disjointed. The Lending Panel has not provided detailed information on how the lending level targets set when negotiating the recapitalisation and asset protection schemes have been met. The relevant data should be published. Meanwhile there is an unresolved inconsistency between, on the one hand bankers’ assurances that they are increasing their lending and, on the other hand the widespread complaints of business that credit is difficult to obtain and increasingly expensive. This information should be published now, and on a quarterly basis in future.**

202. **We are concerned about the arrangements for monitoring lending levels, which reverted from UKFI to the Treasury with the announcement of the January 2009 package. We feel that annual reporting of the lending levels, as announced by the**

428 HC (2008-09) 376, Ev 33

429 *Ibid.*

430 Ev 173

431 *Ibid.*

432 HC (2008-09) 376, Q 112

433 *Ibid.*

Government to Parliament, is inadequate, and recommend that the quarterly figures reported to the Treasury by the banks should be made public.

6 UKFI

Introduction to UKFI

203. On 13 October 2008 the Chancellor announced that he would be creating a new “arm’s length” body to manage the Government’s shareholdings in UK banks. This would be done “on a professional and wholly commercial basis”.⁴³⁴ The Chancellor announced on 3 November 2008 that this body would be called UK Financial Investments Limited (UKFI).⁴³⁵ UKFI is wholly owned by the Government and has the overarching objective to “protect and create value for the taxpayer as shareholder with due regard to the maintenance of financial stability and in a way that promotes competition”. This objective was qualified by a number of considerations binding UKFI in its operation:

Consistent with HM Treasury’s stated aim that it should not be a permanent investor in UK financial institutions, maximising sustainable value for the taxpayer, taking account of risk;

maintaining financial stability by having due regard to the impact of its value realisation decisions; and

promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions.⁴³⁶

204. UKFI currently manages the Government’s investments in RBS and Lloyds Banking Group. At the time of this Report’s agreement, these investments comprised holdings in RBS of £5 billion in preference shares and 57.9% of the company’s ordinary shares, and holdings in Lloyds comprising £4 billion in preference shares and 43.4% of the company’s ordinary shares. UKFI will also manage investments in Northern Rock and Bradford & Bingley once European Commission approval has been obtained for their respective business plans.⁴³⁷

205. Glen Moreno, UKFI’s Acting Chairman, informed us that UKFI was a very small company. It currently employed 12 people, which would rise to a complement of 16 when fully staffed.⁴³⁸ He had been “extraordinarily impressed” with both the staff seconded from the Treasury and hired from the City.⁴³⁹ These staff operated out of two rooms in the Treasury’s Whitehall building, the main room being “smaller than the average bank CEO’s office”.⁴⁴⁰ UKFI’s style was not flashy—“people work literally adjacent to each other at work

434 Hansard, 13 October 2008, column 544

435 Letter from the Chancellor to the Chairman of the Treasury Committee, 3 November 2008

436 UK Financial Investments Ltd, *Shareholder relationship framework document*, clause 3

437 *Ibid.*, clause 2.2

438 Q 2510

439 Q 2516

440 Q 2510

stations without any dividers between us, and that is fine; I think that is a healthy environment”.⁴⁴¹

206. Mr Moreno believed that UKFI offered the shareholder real value for money, and was not going to be a “big, rich quango”. His Chief Executive, John Kingman estimated that the cost of running UKFI, when it was fully up to speed, would amount to “lowish single-figure millions a year”.⁴⁴² Costs were being kept to a minimum since central Treasury resources were being shared:

The Treasury happen to have offered us an extremely reasonable deal [on rent]. There is actually a serious economy point which is that we are a very small company, we do not want to have our own overheads, such as an HR person or an IT person, a press person and so on, so we are to some extent, as it were, working on the back of Treasury systems.⁴⁴³

207. In response to a parliamentary written question from Graham Brady MP on 29 January 2009, the Treasury announced that UKFI’s Board would propose a budget by the end of February 2009, “appropriate to ensure the fulfilment of UKFI’s remit”.⁴⁴⁴ Mr Kingman told us that UKFI had made such a proposal to the Treasury and that negotiations were ongoing.⁴⁴⁵ He hoped that the budget would be agreed prior to UKFI’s first Annual Report and Accounts being published in the summer of 2009.⁴⁴⁶ Mr Moreno agreed to provide us with UKFI’s Business Plan and Budget as soon as it was agreed with the Treasury.⁴⁴⁷

208. Mr Kingman did not know how much UKFI had spent to date, although he said that the Treasury reviewed UKFI’s expenditure on a monthly basis.⁴⁴⁸ In a subsequent letter, we were informed that between 3 November 2008 and the end of February 2009 UKFI spent £1.057 million.⁴⁴⁹

209. Mr Moreno told us that there were two phases to UKFI’s involvement in the banking sector. The first phase was assisting in financial stability, through both the bank recapitalisations and the Asset Protection Scheme.⁴⁵⁰ As part of this first phase, UKFI had been involved in intensive discussions with Sir Philip Hampton, the new Chairman of RBS, about reshaping the Board, and, with Stephen Hester, the new Chief Executive, about realigning the company’s strategy. Mr Kingman said that he was supportive of the new

441 Q 2516

442 Q 2474

443 Q 2533

444 Q 2502

445 Q 2506-7

446 Q 2505

447 Q 2511

448 Q 2521

449 Ev 594

450 Q 2573

strategy developed by Mr Hester, and would continue to be closely involved in discussions on the many issues yet to be resolved.⁴⁵¹

210. Now that initial negotiations between the Treasury and RBS and Lloyds had concluded, UKFI would be turning its attention to the second phase, which was the “classic role of an institutional investor”. The aim here, according to Mr Moreno, was to get the taxpayers’ money back over the next several years. Details on how this would be achieved would be published in an “investment mandate” for UKFI, which was yet to be agreed by the Treasury. Mr Kingman said that “it would be good to get the investment mandate in place expeditiously”.⁴⁵² Given its commercial sensitivity, neither the Treasury, nor UKFI, envisaged that this document would be published.⁴⁵³

211. UKFI has pledged to operate like any other active, engaged shareholder, operating on a commercial basis and at arm’s length from Government. It will follow in full the Institutional Shareholders’ Committee’s Statement of Principles, which covers issues such as the monitoring of board performance, intervention with a company’s board, voting and evaluation and reporting of performance to clients (in this case, HM Treasury).⁴⁵⁴

212. UKFI is managing billions of pounds of taxpayer money but at this stage too little of its activities are in the public domain. UKFI’s website, for example, is almost devoid of content.⁴⁵⁵ Its Framework Document was published on 2 March 2009, four months after UKFI was set up, and the Investment Mandate is still not in place. We urge the Treasury to complete this document expeditiously, and to publish it. We consider it important that the public, the markets and Parliament understands the full details of UKFI’s objectives with respect to its investee banks. The Government must publish a strategy for UKFI addressing how it will use its control of the investee companies, and what role it envisages for UKFI in promoting change within the banking sector more generally. We recommend that this should be done within the next three months. We do not think it is in the national interest for UKFI to remain so enigmatic a body.

UKFI as shareholder

213. The directors of banks in which UKFI holds shares have a responsibility to manage their companies in the best interests of all their shareholders, not just UKFI. Mr Kingman confirmed that he expected these directors to have “robust views” if they felt that UKFI was making demands that were inconsistent with the wishes of other shareholders. He commented that it was very important that UKFI should have a lot of dialogue with other institutional shareholders. There had already been some, but UKFI had been constrained by the fact that it had been an ‘insider’ in drawing up the new RBS strategy, so was unable to discuss that with other institutional investors. A series of meetings with all the large

451 Q 2579

452 Q 2573-4

453 UK Financial Investments Ltd, *Shareholder relationship framework document*, clause 4.7

454 UKFI document, page 9

455 www.ukfi.gov.uk

investors in both RBS and Lloyds Banking Group had been set up and Mr Kingman said that “we very much want to hear their perspective because they have been studying these banks for a lot longer than we have”.⁴⁵⁶

214. Mr Hester characterised the approach of UKFI towards RBS as one of a “very engaged institutional shareholder in relation to what I will call the strategic and shareholder value type issues”, but added that UKFI did have “other mandates that are not about shareholder value ... which are a little more political”. One of these issues was pay. Mr Kingman argued that it was “very important” that UKFI should discuss remuneration policy with the banks, but did not accept that this was for political reasons, but rather because any shareholder would have such concerns: “one of the lessons of what went wrong in these banks is that the incentives were wrong in these banks and I think as shareholder we should really care about that”.⁴⁵⁷

215. RBS was committed to reviewing fundamentally its remuneration policy, with the strong support of UKFI. Ultimately, decisions on remuneration would be taken by the RBS Board, but the Board would need to take into account the views of UKFI alongside other shareholders. In Mr Kingman’s view, getting the incentives right did not preclude the payment of “quite large sums for serious people to work in these banks” where that was necessary.⁴⁵⁸ Mr Hester was comfortable with that arrangement, but explained that if there were to be a difference between the views of UKFI and other shareholders, then “the Board would need to take that into account and ... probably make that issue public and up for more debate”.⁴⁵⁹

216. Mr Kingman argued that reforms made to remuneration at RBS (including 100% deferral, significant potential for claw back and payment in capital rather than cash) constituted the “most radical shift in the approach to investment banking remuneration anywhere in the world”. He expected the banks in receipt of public investment to be at the forefront of changing remuneration practices in the future.⁴⁶⁰

217. In owning a majority stake in both RBS and Lloyds Banking Group, UKFI is in a strong position to influence banking remuneration structures across the entire banking sector, and should use this opportunity to fundamentally change the bonus culture provided by current banking remuneration practices. In a forthcoming report we will discuss in detail the contribution of remuneration practices to the banking crisis and how banking pay could be better structured.

456 Q 2636

457 Qq 2586 and 2618

458 Q 2618

459 Q 1926

460 Q 2619

Arm's length?

218. The nature of UKFI's engagement with its investee banks is clearly set out in the Framework Document. UKFI has been set up to operate as an institutional shareholder, rather than to enforce the Government's will with respect to banks. For example, UKFI will play no role in enforcing lending agreements negotiated by the Treasury with each of RBS and Lloyds.⁴⁶¹ Compliance with these, and any other subsequent agreements will be monitored by the Treasury.

219. Mr Kingman told us that the Framework Agreement made it very clear that UKFI was "to operate commercially, that we are to use our discretion to use all the functions of a shareholder, so voting, interaction with the boards and so on, at arm's length from the Treasury".⁴⁶² This was part of the philosophy underpinning the Government's belief that the best way to return the banks to the private sector "was for them to be run commercially by proper independent boards" and not for the Government or indeed for UKFI to be running the banks. He saw UKFI's role as managing the shareholdings, "and I do see a very important part of that as having all the dialogue you would expect a serious shareholder to have around management, strategy, performance, capital, risk management, ... but we are not running the banks".⁴⁶³

220. UKFI is accommodated within HM Treasury's building, and shares some of the Treasury's support services, in order to keep costs low. Many of the staff are secondees from the Treasury, including the Chief Executive John Kingman. These arrangements cast doubt over the extent to which UKFI is indeed at "arm's length" from the Government. The Chancellor told us he understood these concerns, but argued that if UKFI had spent more money on offices and staff then it would be criticised for not achieving potential economies of scale with the Treasury. He did not rule out UKFI moving out of the Treasury in future.⁴⁶⁴

221. Despite UKFI being at "arm's length", the Government has taken a power of direction that can be invoked if UKFI acted in a way fundamentally at odds with the Government. UKFI's Framework Document states that the Treasury can give UKFI directions of a specific nature and that the board of UKFI "will comply with such directions or resign".⁴⁶⁵ Mr Kingman said that this would only occur in abnormal circumstances: "If [the Government] thinks that UKFI has in some sense lost its senses and is doing something that it fundamentally disagrees with, it can overrule us and the board of UKFI would have to decide how it responded to that direction. I would see directions as being an extremely unusual event".⁴⁶⁶

461 UKFI did originally have responsibility for monitoring compliance with lending agreements, but this responsibility was taken on by HM treasury following the January negotiations on the Asset Protection Scheme.

462 Q 2568

463 Q 2576

464 Q 2849

465 UK Financial Investments Ltd, *Shareholder relationship framework document*, clause 9.26

466 Q 2632

222. It is right that the Government's investments in UK banks should be managed at arm's length and it is important to retain a clear division of responsibility between UKFI's role as an institutional investor, and any other public policy objectives that the Government may pursue. However, we think it important that "arm's length" in this instance is clearly defined so that what is appropriate behaviour can be clearly discerned. Certain aspects of UKFI's institutional arrangements do lead us to wonder just how "arm's length" UKFI actually is from the Treasury: it shares a building and support staff such as IT and HR professionals, while the Chief Executive and several other staff are Treasury secondees. Whilst we acknowledge the cost savings that might be made through the collocation of UKFI with the Treasury, the effectiveness and independence of UKFI should not be compromised for the sake of relatively inconsequential sums of money, especially bearing in mind the onerous responsibility placed on UKFI. To this end, we recommend that UKFI consider moving out of the Treasury building, even if that means elsewhere on the Government estate. The Treasury has constrained UKFI's discretion by introducing a power of direction to be used if UKFI strays too far from the Treasury's wishes. The existence of this power, even if it is a nuclear option, undermines the "arms length" nature of UKFI's engagement with the investee companies. We invite the Treasury to set out clearly the precise circumstances in which it envisages this power being used.

223. Given the importance of the task entrusted to it and the vast sums of public money involved, we believe that UKFI should be established, at the earliest opportunity on a proper statutory basis. While the current ad hoc administrative arrangements persist we have no confidence that UKFI will have the real operational independence that is necessary.

Return of investee banks to the private sector

224. The Chancellor confirmed to us that the Government's objective was to return the investee banks to private sector ownership. He accepted the need for "a clear objective, a clear plan ... to take the banks off our books". However, he warned that any exit strategy would need to be consistent with ensuring economic recovery.⁴⁶⁷

225. According to UKFI, much of its future focus will be on formulating and implementing a strategy for selling its investments over time in an orderly way, consistent with the Government's firm view that it has no wish to be a permanent investor in UK financial institutions.⁴⁶⁸ Professor Goodhart was clear that the most appropriate way to extricate the taxpayer from ownership of banks was a straightforward privatisation, once the crisis had passed.⁴⁶⁹ Andrew Crockett explained that "the goal should be to re-establish normal financial conditions as soon as possible, and return partially nationalized institutions to full private ownership as soon as their condition warrants".⁴⁷⁰ The Investment Management

467 Q2878

468 UK Financial Investments Ltd, *An introduction: what we do*, page 10

469 Qq 720-1

470 Ev 297

Association (IMA) listed several prerequisites for successful disposal of UKFI's stakes in banks:

- investor confidence that the banks in question have fully recognised losses on their balance sheets, and that the process of recapitalisation has run its course;
- confidence that the banks are operating on a fully commercial footing;
- sale at a price that investors consider to offer long-term value.⁴⁷¹

226. Mr Hester believed that returning RBS to “standalone health”, and returning it to the private sector would be a “three to five year process”, depending on the length of the economic downturn.⁴⁷² In order to get to that position, RBS would be following different strategies in different parts of its group 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.⁴⁷³

227. Mr Kingman nuanced Mr Hester's timescale: “What I understood him to say and what he said to me is that he sees that as the timescale for the full turnaround of the bank”, which was not necessarily the same as the timescale for exit. The exit, said Mr Kingman, would depend very much on the return of investor confidence, “which could well precede the full flowering of everything that Stephen is trying to deliver”, but he cautioned that it could also take longer than three to five years. Whatever the timeline, Mr Kingman thought it more likely that privatisation would happen through a series of transactions over time, “rather than one big-bang simply because the scale of our investment is so large”.⁴⁷⁴

228. Eric Daniels, the Chief Executive of Lloyds told us that he “certainly hoped” that his firm would have repaid taxpayer support in less time than the three-to-five-year period that RBS was planning.⁴⁷⁵

229. We appreciate that UKFI has many urgent priorities to consider at the moment, but shaping an exit strategy must be one of them. We think it vital for investor confidence that, even at this early stage of ownership, preconditions for UKFI's exit should be outlined, and a strategy for achieving exit devised. It is clear that setting out an exit strategy has advantages and disadvantages for banking system stability and UK economic recovery. The taxpayers must be satisfied that any exit strategy will maximise the direct financial benefits and minimise the risks to them. This precondition for any exit from the results of recapitalisation must be clearly set out. The existence of an exit

471 Ev 232

472 Q 1997

473 Q 2003

474 Q 2610

475 Q 2001

strategy would greatly improve the clarity of UKFI's mission, and enable more effective scrutiny of UKFI's performance. We recommend that the Treasury provides details of an exit strategy for the taxpayer's investment in the banking sector. This strategy should include an analysis of the pros and cons of selling the Government's stake in tranches rather than as a whole.

7 The future of the banking sector

Introduction

230. Some elements of retail banking fulfil an important function in most people's lives. The Financial Services Consumer Panel likened this aspect of banking to a "utility", in much the same way as domestic services such as water and power:

To buy food consumers need either cash dispensed by banks and post offices or payment systems such as debit and credit cards. We are steadily moving towards a world where cash transactions will be replaced by electronic payment using devices like Oyster cards and mobile phones. These need banking facilities to operate. In this world where the majority of consumer transactions will be electronic, continuity of service from the banking system is central to the functioning of the economy. Any disruption is likely to be costly both for consumers by, for example, missing bill payments on credit cards or mortgages and for cash flow in the wider economy.⁴⁷⁶

The BBA agreed that banking services were "central to the financial wellbeing of many people", but rejected the notion that they should be viewed as a "utility", seeing in this term "connotations of standardisation that would stifle innovation".⁴⁷⁷ Mr Hester, for RBS, suggested that the public still valued the everyday services provided by banks, but the public image of banking had been tarnished by the crisis

there is clearly, at the moment, a difference which we have to get away from between the public's [negative] view of banks as institutions ... and the public's day-to-day experience of us in terms of our services; and every day each one of the [banks] 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.⁴⁷⁸

231. Over the last ten years substantial profits from the banking industry have accrued to shareholders and senior management, but it is the taxpayer who has been called on to rescue the banks that have failed. The utility of banking, and the special importance of the sector to all other industries, and individuals, in the economy means it is extremely difficult for governments to permit a failing bank actually to go bankrupt. This is particularly true of the very large UK retail banks such as RBS, Lloyds Banking Group, Barclays and HSBC—the bankruptcy of one of these institutions would have catastrophic impacts on depositors and others. Several of our witnesses doubted whether it was therefore appropriate for retail banks to indulge in "riskier" investment banking activities. Nomura, a 'pure' investment bank⁴⁷⁹, observed that "by co-mingling risky investment banking

476 Ev 269

477 Ev 318

478 Q 1096

479 Nomura is not authorised to accept retail deposits.

activities with the traditional, less risky, lending activities of commercial banks, depositors may be exposed to undue risks". The need to protect depositors' interests, in Nomura's view, would result in "asymmetric treatment of banking profit and loss, with losses being socialised while profits remain in the private sector" which led to a public subsidy of commercial banks' investment banking activities, ultimately damaging both the public purse and independent investment banks.⁴⁸⁰ The IMA stressed to us the importance in a market economy of businesses being able to fail:

Without the knowledge that mismanagement can lead to failure, executive management face no moral hazard. If risks may be taken for short term gain, secure in the knowledge that the public sector will step in to rescue the business, there is an unacceptable mismatch between the risk and reward faced by the institution and by the taxpayer.⁴⁸¹

232. But Andrew Crockett, former General Manager of the Bank of International Settlements, was not confident that such market discipline could be applied to banks. Instead, he argued, the "undeniable" moral hazard issues raised by public intervention to prevent banking collapses could be minimised through making sure that the owners and managers of financial institutions were "suitably penalised for decision making lapses", and by ensuring that regulatory discipline replaced, and mimicked, as far as possible, the market disciplines that would apply in a well-functioning system without government guarantees.⁴⁸²

Investment banks

233. The term 'investment bank' can describe organisations undertaking a very broad range of activities, including the provision of advice, the broking of transactions, asset management and principal trading activity.⁴⁸³ Each of these activities is important to the functioning of liquid wholesale markets and occurs both within the large commercial banks and within the more bespoke institutions to which the term, investment bank is usually applied.⁴⁸⁴

234. Traditionally, banks either engaged in commercial (or retail) banking or investment banking. In commercial banking, the institution collects deposits from clients and gives direct loans to businesses and individuals. Through investment banking, an institution generates funds in two different ways. It may draw on public funds through the capital market by selling stock in its company, and it may also seek out venture capital or private equity in exchange for a stake in its company. An investment banking firm may also undertake consulting work. Investment bankers may, for example, give companies advice on mergers and acquisitions. They track the market in order to give advice on when to

480 Ev 624

481 Ev 232

482 Ev 297

483 This is where the bank risks its own capital.

484 Ev 721

make public offerings and how best to manage the business' public assets. Some of the consultative activities investment banking firms engage in overlap with those of a private brokerage, as they will often give buy-and-sell advice to the companies they represent.⁴⁸⁵

235. The line between investment banking and other forms of banking has become harder to draw in recent years, as deregulation enabled banking institutions to move into more sectors. Goldman Sachs pointed out that whilst there were differences in individual financial firms' business models, the businesses of virtually all large, integrated financial intermediaries overlapped. Their core activities include classic financial intermediation, lending, market making, advisory services and underwriting securities. Many commercial banks engage in the investment banking business. An important distinction between investment banks and most of the commercial banks is that investment banks' business would be generated predominantly in the wholesale/institutional markets, whereas the large universal and commercial banks would also have a large retail businesses and client base.⁴⁸⁶

236. Nomura International believed that investment and commercial banks both had fundamental economic functions. Investment banks supported economic growth by supporting corporate change and development and by contributing to liquidity in the capital markets:

- through the provision of merchant banking activities they provide important financing for large scale projects that may not be considered by commercial banks.
- through merger and acquisitions and advisory activities, investment banks help clients achieve their strategic goals.
- through fixed income and equity businesses, investment banks support liquidity in the capital markets by matching and providing financing for buyers and sellers.⁴⁸⁷

237. In September 2008, the Federal Reserve allowed the investment banks Morgan Stanley and Goldman Sachs to convert into traditional bank holding companies. The move was designed to help two of Wall Street's most prestigious institutions avoid the fate of Bear Stearns by providing them broader access to federal money and the ability to build a stable base of deposits.⁴⁸⁸ This change led one commentator to ponder whether Wall Street as "a coterie of independent brokerage firms that buy and sell securities, advise clients and are less regulated than old-fashioned banks", would cease to exist.⁴⁸⁹ In allowing the conversion of the two banks, the Federal Reserve, not only secured the banks against a Lehman-style collapse, they also brought the two banks under their strict regulatory

485 Ev 605-6

486 *Ibid.*

487 Ev 620-1

488 "Wall Street in crisis: Mitsubishi to buy stake in Morgan Stanley", www.guardian.co.uk, 22 September 2008

489 "End of Traditional Investment Banking, as Storied Firms Face Closer Supervision and Stringent New Capital Requirements", *Wall Street Journal*, 22 September 2008

oversight.⁴⁹⁰ The rules set by the Federal Reserve limited opportunities for large profits from speculation on the price of oil and other similar investments.⁴⁹¹

Narrow banks

238. Following the Great Crash of 1929, the US Congress passed the 1933 Glass-Steagall Act which, among other measures, prohibited a bank holding company (a retail bank) from owning other financial institutions (such as investment banks).⁴⁹² This provision was repealed in 1999. Some witnesses argued that a similar approach to the rigid separation of retail banking from investment banking should be adopted in the UK, in order to prevent the “utility” functions of a bank becoming contaminated with “riskier” investment banking practices. Jon Moulton of Alchemy Partners argued that banks had become too complex, and that the only way in which banks could regain the trust of their customers was by becoming much simpler entities: “We need to have banks which are simple, manageable, comprehensible, the so-called narrow bank”.⁴⁹³ Academics from the University of Manchester echoed these comments, comparing the public’s expectation that retail banks should “serve depositors by safekeeping money and organising payments as well as serving borrowers by providing loans for firms and households” with “opaque, risky, innovative, hard to control” investment banking.⁴⁹⁴

239. RBS admitted that there was a “potential conflict” between traditional banking management structures and those found in modern investment banking, and “careful thought needed to be given as to how to insulate deposit taking from riskier banking activities”. But it did not consider the Glass-Steagall approach to be an ideal model, arguing that it would be difficult to define those activities which can be simply classified as investment banking:

There are a wide range of functions essential to the provision of finance to large corporates which means that global banks involved in deposit taking and extending credit are also naturally involved in complex treasury and market activities. For example, investing in corporate bonds and foreign exchange are legitimate retail banking activities”.⁴⁹⁵

RBS explained that one could, in principle, run a pure retail bank without investment banking activities, but it was much harder to divorce an established commercial and corporate banking franchise from these capabilities. From the RBS point of view, the important issue was not so much about the separation of activities, but about “the amount

490 “End of Traditional Investment Banking, as Storied Firms Face Closer Supervision and Stringent New Capital Requirements”, *Wall Street Journal*, 22 September 2008

491 “Wall Street in crisis: Mitsubishi to buy stake in Morgan Stanley”, www.guardian.co.uk, 22 September 2008

492 In the United States, a bank holding company, as provided by the Bank Holding Company Act of 1956, is broadly defined as any company that has control over a bank.

493 Q 737

494 Ev 188

495 Ev 655

of risk taking relative to capital and the quality of risk management within individual organisations.”⁴⁹⁶

240. Written evidence from the banks was strongly in favour of retaining the universal banking model. Barclays argued that the universal model meant that customers had access to a wider range of services through a single relationship than could be provided by a narrow bank. For example, its mid-market commercial customers were able to access Barclays Capital investment banking products that were once available only to large corporate firms. In Barclays’ view, the universal banking model helped diversify risks across sectors and countries and therefore reduced systemic risks. Barclays further observed that it obtained “significant synergies” from housing different banking operations under one roof in terms of risk management and effective use of capital.⁴⁹⁷ The BBA saw no grounds for an enforced separation of investment banking from retail banking, pointing also to synergies between different financial services, the practical difficulties of separating out such activities and imposing a clear dividing line between the two, and the need for UK financial services firms to remain globally competitive. Furthermore, the BBA argued that non-hybrid retail banks such as Northern Rock and Bradford & Bingley, and investment banks including Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs and Morgan Stanley had suffered more than universal banks. Allowing banks to diversify, argued the BBA, therefore offered the banking industry the potential to reduce risk, rather than increase it.⁴⁹⁸

241. The Governor’s instincts were that the narrow bank idea was “very attractive” but he did not think a separation of narrow and wider banks was sustainable in practice. He explained that an intensively-regulated narrow bank would not be able to offer returns as high as its loosely-regulated wider bank competitors, and many depositors would be tempted into switching their deposits to a wider bank. Wider banks would then expand much more rapidly than the narrow banking sector, and would become so big that, in a crisis, the Government would be forced to step in anyway.⁴⁹⁹ Lord Turner commented that it would be a “delusion” to believe a system could be developed in which “casino” banks were sufficiently non-systemic that they could fail without being rescued. Lord Turner was unconvinced about not only the feasibility, but also the desirability of forcibly separating investment banking activity from retail banking:

we cannot ... go all the way back to a clearing bank of the 1950s and ... the merchant banks of the 1950s, because I think we have to live with the reality that that extreme separation existed in a world of fixed exchange rates, capital control, very limited global cross-border operation of corporates who needed to be serviced by banks, much smaller international trade and capital flows... , and I think that that account ... really does not deal with banks which ... like HSBC or Standard Chartered, are inherently global banks which have done better than most at avoiding some of the

496 Ev 663

497 Ev 720

498 Ev 318-9

499 Q 2401

problems. They are deeply involved in this process of lubricating a global economy in a world of floating exchange rates and which, in order to do that, cannot be entirely away from things that happen in trading rooms, markets that need to be made, derivative products that are legitimately offered.⁵⁰⁰

242. Andrew Crockett accepted that banking had utility aspects and therefore warranted regulation and protection, but he said that the synergies between the basic utility of providing a secure payment system and that of providing other financial services were “substantial”. Rather than separate out the different aspects of banking into different entities, he suggested that the “utility” function be protected by more effective regulation. He made the important point that when large financial institutions got into trouble and created a risk of losses to customers, public sector assistance was almost always provided, regardless of the nature of the bank. In his view it was “best to accept this as a fact of life and regulate all financial institutions accordingly”.⁵⁰¹

243. For the FSA, Hector Sants commented that what mattered was ensuring that risk in a bank was well managed. Part of risk management involves diversifying operations, so “we do need to be careful, when we are in this narrow banking debate, that we do not suddenly create a new risk which is lack of diversity”. He added that what were needed were institutions which well managed, and, if the risks became too complex, “then the regulator should narrow that”.⁵⁰²

244. The BBA argued that rather than legislate to force banks to choose between retail and investment banking, the solution lay in banks placing greater emphasis on achieving steady income:

Banks are unlikely to return to highly leveraged business models as impairment will bite away at the bottom line. Instead of relying upon higher-risk and less steady sources of income, lower-risk and steadier sources of income, for example deposit accounts, and fee-based services such as custody and fund management, will become more prominent. Banks will need a full suite of cards, and a wider range of products and services, and geographical exposure. It is fair to say that banks have reached a point of no return. A structural change is taking place and a new legal order is evolving. The lesson is how to ensure that controls are inherent in their models.⁵⁰³

Lord Turner told us that the changes being made by the FSA and international bodies on increasing capital requirements for trading books, different approaches to credit rating agencies, tighter control of risk, would probably result in many banks “which de facto look like ... narrow banks”.⁵⁰⁴ He predicted that many British banks would in future refrain from conducting proprietary trading, and those that continued to, would receive much

500 Q 2228

501 Ev 297

502 Q 2236

503 Ev 319

504 Q 2229

more attention from the FSA. Although proprietary trading would reduce, some large complex financial institutions would continue to perform investment banking activities such as making markets in government bonds, providing forward foreign exchange cover, and foreign exchange swaps, for example.⁵⁰⁵

245. The rebuilding of consumer trust is closely wound up in depositors having faith in the safety of their deposits, and the stability of payment systems and other utility aspects of banking. In our view, depositor reassurance can in the short term best be provided through improving and strengthening the regulatory regime for all types of bank. We do not lightly dismiss the Governor of the Bank of England’s instinct that a separation of retail from investment banking functions is “very attractive”. We believe that this is a live issue which requires further debate, and one to which we will return.

Trading of financial instruments

246. Even those of our witnesses who criticised complexity in the banks argued that securitisation and the trading of financial instruments had brought benefits. For example, Professor Buiter assured us that securitisation was “a wonderful invention to make the illiquid liquid and the non-tradable tradable”.⁵⁰⁶ Which? argued that an “entire rejection [of securitisation] ... would lead to a substantial contraction in the availability of mortgages, with significant negative implications for consumers”⁵⁰⁷ and Dr Danielsson told us “securitisation is something that we would sorely miss if we did not have it”.⁵⁰⁸

247. While some, such as Lord Turner, have argued that the market response to the current crisis will naturally extinguish the less positive aspects of securitisation, the general consensus amongst witnesses appeared to be that some regulatory reform is required to provide a long-term solution.⁵⁰⁹ With regard to the nature of such reform, two specific developments were discussed by the witnesses we heard from: the requirement for banks to have more ‘skin in the game’ and the requirement for more instruments to be traded on exchanges.

248. Richard Lambert, Director General of the CBI, argued that banks engaging in securitisation should have more “skin in the game”.⁵¹⁰ In simple terms this would be a requirement that banks retained a portion of the products they were distributing. This would, Mr Lambert argued, give them a “continuing interest in the risk that they were originating going forward”.⁵¹¹ This proposal was supported by many of our other witnesses including Jon Moulton of Alchemy Partners who asserted that banks “have to be part

505 Q 2235

506 Q 698

507 Ev 237

508 Q 698

509 Q 2180

510 Q 736

511 Q 736

principal, not just agent[s] taking a fee and waving goodbye”⁵¹² and Will Hutton who echoed the view that the originating banks must not be allowed to “walk away”.⁵¹³ Professor Buiter agreed that “we need to force the originator to hold onto a sizable chunk of the first-loss or equity tranche of the securitised commodities” since this approach “keeps the incentive for gathering the information and monitoring the relationship intact”.⁵¹⁴

249. We acknowledge that the toxic shock that major financial institutions have been exposed to by securitisation is likely to result in changed business practices. We expect that one such change will see banks returning to the practice of keeping a greater portion of the loans they originate on their own balance sheets. But we also believe that a regulatory response may be required and recommend that the FSA coordinate efforts with its international counterparts to require that those undertaking securitisation retain a tranche of the commodities they trade.

250. A second change to the operation of the financial markets was proposed by Dr Danielsson. He argued that the ‘over-the-counter’ nature of many securitised products had caused many problems. He raised two specific objections to over-the-counter products. First that “there is no way to figure out what exactly is an appropriate market price for these instruments” and secondly that “when there is a problem there is no way to add up all the exposures of the entities”.⁵¹⁵ As a solution, Dr Danielsson suggested that regulation should make these instruments more transparent and require them to be traded on exchanges:

in the future we need to keep those instruments, they are useful, but they do need to be traded on an exchange so that they are transparent, we understand the risk, and any buyers get an appropriate price and can dispose of them if need be”.⁵¹⁶

251. For Dr Danielsson the principle advantage of trading complex instruments through an exchange would be that “you could immediately figure out what exactly is the exposure of an individual institution”. The need for this transparency was exemplified by Lehman Brothers:

when they went under they had a few hundred billion dollars worth of CDSs [credit default swaps] and the problem is nobody really knew what was the net exposure of Lehman’s. After they defaulted you could finally sit down and do the calculation. They figured out that the net exposure of Lehman was \$6 billion, a lot smaller than anybody suspected. If these instruments had been traded on an exchange, that would have been known prior to the default of Lehman’s so they might still be alive.⁵¹⁷

512 Q 736

513 Q 736

514 Q 698

515 *Ibid.*

516 *Ibid.*

517 *Ibid.*

252. When challenged to explain why his call for an end to over-the-counter trading had not been successful previously, Dr Danielsson thought that this was because “complexity is profitable”.⁵¹⁸ He told us that the banks had lobbied “very strenuously” against change, suggesting that because “products were so complicated the banks had all the cards ... the regulator was in a very difficult position to resist”.⁵¹⁹

253. Andrew Crockett opposed an outright ban on over-the-counter trades between “knowledgeable wholesale counterparties” because to impose such prohibitions could, in his view, “impair institutions’ ability to manage risk”.⁵²⁰ He also warned against equating over-the-counter with complexity:

There is not a one-to-one correspondence between complexity and trading venue (ie, “over the counter” (OTC) or exchange-traded). While truly complex products are almost invariably traded over the counter, simpler products can be traded both OTC and on exchanges. The choice of whether to trade these products on an exchange or over the counter is driven by which platform offers the best liquidity, and it is not necessarily desirable to force all trading onto an exchange.⁵²¹

254. For Mr Crockett it was the “clearing aspect, not the trading venue, which offers the possibility of reducing systemic risk”. This focus was echoed by Lord Turner who agreed with Dr Danielsson that over-the-counter trading brought risks but also suggested that the focus of his concern was the absence of clearing houses:

if you do not have a central clearing house and a central counterparty, there is a massive accumulation of gross claims of the different counterparties among one another which can make it very difficult to see where risk lies and which can create great complexity if you do have a failure of institution.⁵²²

255. He informed us that the FSA was interested in increasing the amount of credit default swap trading going through clearing systems and central counterparties and that it was “deeply involved in discussions with the Federal Reserve in the US and the EU Commission about how we progress this issue”.⁵²³ He also argued that there was a limit to what could be traded on an exchange:

It is important to realise that about 75% or so of the CDS market is probably not of a sufficiently standardised form that it would be possible to put into a central counterparty clearing arrangement, because these are bespoke and therefore are, almost by definition, over-the-counter products. However, in that segment where we

518 Q 701

519 Q 702

520 Ev 295

521 *Ibid.*

522 Q 63

523 Q 2185

can make progress there is a clear belief that we should try to do so and we are trying to drive that.⁵²⁴

256. The Governor of the Bank of England's position was similar to the of Lord Turner. He told us that he did not think that trading on exchanges was the most important issue, because "there are many instruments that it would be desirable for people to be able to transact if they wanted to but do not generate enough business to justify an exchange".⁵²⁵ The key issue, he argued, was that clearing houses should be used in order to increase information and transparency:

What does matter is a clearing house so that we actually have a register of how many transactions there are, a method of ensuring that those who engage in liabilities on one side are clearly matched on the other side. One of the problems of Lehman Brothers failing, and it still is going to take many months to sort out the details of many of those contracts, was a most extraordinary outcome really that all these contracts were not done through clearing houses in a way that would enable the counterparties to get out of it. I think clearing houses rather than exchanges is the key from our point of view".⁵²⁶

257. The importance of the role of clearing houses was supported by Paul Tucker, Deputy Governor of the Bank of England for Financial Stability, who argued that these bodies could "ensure common margin standards, common valuations and greater transparency". Mr Tucker did warn that central clearing houses "bring all the risk into one place and, therefore ... if one of them gets into trouble, and perhaps over history two have got into trouble, capital markets more or less shut down",⁵²⁷ but overall he supported the idea that "credit default swaps should be cleared through a central counterparty, a central clearing house". Mr Tucker also noted that "there is potentially a role for exchanges as well ... Exchanges can do something [clearing houses don't] ... For the most vanilla instruments they can preserve a little bit greater liquidity."⁵²⁸

258. We are concerned about the lack of transparency inherent in over-the-counter trading. One of the many reasons why "toxic" assets had such a devastating impact was that institutions had only a shaky grasp on where they were, what they comprised and what their value was. Their judgment was further clouded by the strong correlation between complexity and profitability. Looking to the future it is desirable that such obscurity is avoided. We recommend that the FSA takes steps to encourage trading through clearing houses and where appropriate on exchanges. The international nature of finance means that unilateral action by the UK would be ineffective. Nevertheless, the UK's central role in world finance makes it a key player in moving forward this agenda.

524 *Ibid.*

525 Q 2368

526 *Ibid.*

527 *Ibid.*

528 *Ibid.*

Competition in the banking sector

259. The Department for Business, Enterprise and Regulatory Reform’s website is just one of the places in which the Government has stated its commitment to nurturing efficient competition and espoused its benefits:

Competitive markets provide the best means of ensuring that the economy’s resources are put to their best use by encouraging enterprise and efficiency, and widening choice. Where markets work well, they provide strong incentives for good performance—encouraging firms to improve productivity, to reduce prices and to innovate; whilst rewarding consumers with lower prices, higher quality, and wider choice.⁵²⁹

260. When assessing the future landscape of the banking sector, the change in the competition conditions cannot be ignored. In this section we will examine two factors which have contributed to this shift: the consolidation in the banking sector and Government intervention. We will also review the competition implications of the Lloyds-HBOS merger.

261. In the Pre-Budget Report 2008, the Government set out some of the primary examples of consolidation in the UK banking sector:

- the transfer of the deposit books of Bradford & Bingley and the two Icelandic subsidiaries to Abbey National plc and ING respectively;
- the takeover of Alliance & Leicester by the Spanish bank Santander;
- the merger between Lloyds TSB and HBOS;
- the planned mergers of a number of UK building societies: Catholic and Chelsea Building Societies; Cheshire, Derbyshire and Nationwide Building Societies; Barnsley and Yorkshire Building Societies; and Scarborough and Skipton Building Societies.⁵³⁰

In addition to this list, as we have seen, many foreign banks and specialist lenders have pulled out of the market.

262. The Association of Mortgage Intermediaries was amongst those who expressed concern about “the potential for decreased competition arising from the concentration in mortgage lending”.⁵³¹ Which? argued that these developments had occurred in a market which already had a “poor record of delivering effective competition for the benefit of consumers”.⁵³²

529 Department for Business Enterprise & Regulatory Reform, *Competition Matters*, www.berr.gov.uk

530 HM Government, *Pre-Budget Report 2008*, Cm 7484, para 3.37

531 Ev 158

532 Ev 90

We have long-standing concerns about the lack of effective competition in the retail banking sector which has been dominated by the ‘Big Five’ of Lloyds TSB, HSBC, Barclays, RBS/Natwest and HBoS.⁵³³

263. It was against this backdrop, that Which?’s Personal Finances Campaign Manager, Doug Taylor, warned that the potential for competition to get worse was “absolutely clear”.⁵³⁴ He expressed particular concern that “as the market contracts and availability disappears [changing mortgage providers] is going to be more difficult”.⁵³⁵

264. Presenting the perspective of the banks Angela Knight of the BBA accepted that the banking sector was “now much narrower for practical purposes than it was a year ago”. She went on to acknowledge that this made banking a “difficult market”, but maintained that there was “still a lot of choice” and rejected any suggestion that there was a lack of competition.⁵³⁶ Similarly, Lord Turner, Chairman of the FSA, argued that it was “not clear that [the] banking system [was becoming] so concentrated that there cannot be reasonable competition”. As evidence he pointing to the existence of “quite a few players” such as Nationwide and Abbey Santander. While emphasising that it is the Office of Fair Trading rather than the FSA which holds primary responsibility for competition issues, Lord Turner acknowledged that “we will all jointly have to look” at the situation.⁵³⁷

265. The Government has undertaken a number of unprecedented interventions in the UK banking sector. Direct interventions, including the full and part nationalisations and the sanctioning of the Lloyds-HBOS merger have been widely scrutinised. The Building Societies Association have argued that Government activity has also indirectly had an impact:

there is going to be more intense competition from National Savings over the next year or so. The target for National Savings’ inflow has been increased from £4 billion to £11 billion and that is going to have a significant impact on building societies in the very low interest rate environment we are in.⁵³⁸

266. In its written submission, Which? identified two ways in which state intervention could affect competition. First, “the potential for ‘unfair’ competition, with a publicly backed bank seeking to exploit greater wholesale purchasing power and possibly improved confidence of consumers due to secure deposits, leveraging this into aggressive growth of market share”. Secondly, “weakening of the ‘competitive fringe’, where banks are forced to merge and/or reduce the range and value of their commercial offerings despite public ownership”.⁵³⁹

533 Ev 243

534 Q 826

535 *Ibid.*

536 Q 888

537 Q 32

538 Q 1576

539 Ev 91

267. Angela Knight suggested that “great care” would need to be taken to ensure that Government intervention in the banking sector did not lead to “permanent distortion of the market”.⁵⁴⁰ It is evident that the Government has taken action to minimise the impact on competition of its interventions. For example, Northern Rock has published a “competition framework” in which it makes a number of commitments designed to minimise the benefit it gains from Government ownership.⁵⁴¹

268. Despite the Government’s efforts, Iain Cornish, of Yorkshire Building Society, was not alone in expressing concern that the perceived safety of government-owned banks in the otherwise volatile market was distorting the market:⁵⁴²

I would describe it as a trickle rather than a flood but it is very galling when you see [savers] money going back to Northern Rock because they are perceived to be more guaranteed than we are, or going back to Irish banks where there is a different guarantee.⁵⁴³

Lloyds-HBOS merger

269. On 18 September 2008 Lloyds TSB announced that it had reached an agreement on the terms of a ‘recommended acquisition’ of HBOS.⁵⁴⁴ In its report on the merger proposal, the Office of Fair Trading (OFT) concluded that there was a realistic prospect of a “substantial lessening of competition” in the banking sector.⁵⁴⁵ The report detailed concerns regarding personal current accounts, mortgages and small and medium size enterprise banking.⁵⁴⁶ It noted that “the merger will remove a firm, HBOS, that was (at least until less than two months ago) a major driver of competition in the market, and strengthen the current market leader, Lloyds”.⁵⁴⁷ The OFT report concluded that, based on 2007 market share figures, the combined entity would have a 33% share of the personal current account market and 20–30% of the SME and mortgage markets.⁵⁴⁸ If carried through to the present day, such percentages would make the Lloyds Banking Group the largest participant in the personal current account and mortgage markets and the second largest in the SME market.⁵⁴⁹

540 Q 856

541 Ev 78

542 Ev 345

543 Q 1575

544 “Recommended acquisition of HBOS plc by Lloyds TSB Group plc to be implemented by means of a scheme of arrangement under sections 895 to 899 of the Companies Act 2006”, Regulatory Announcement by Lloyds TSB, 18 September 2008

545 Office of Fair Trading, Anticipated acquisition by Lloyds TSB plc of HBOS plc - Report to the Secretary of State for Business Enterprise and Regulatory Reform, 24 October 2008, p 59

546 *Ibid.*, p 5

547 *Ibid.*

548 *Ibid.*, pp 31, 47, 54

549 *Ibid.*

270. On the same day that the OFT published its report, a new order made under the Enterprise Act 2002, came into force. Under the Enterprise Act 2002, the Business and Enterprise Secretary of State has the power to “give a notice to the Office of Fair Trading if he believes that it is or may be the case that one or more than one public interest consideration is relevant to a consideration of the relevant merger situation”.⁵⁵⁰ The new order, ‘public interest considerations’ were extended explicitly include the maintenance of UK financial stability.⁵⁵¹ It was this new power which the Business and Enterprise Secretary of State employed on 31 October 2008 when he decided that the merger of the HBOS and Lloyds was in the public interest and should be allowed to proceed despite the competition concerns.⁵⁵²

271. A number of submissions we received raised concerns regarding the merger of Lloyds and HBOS. Doug Taylor of Which? argued that the enlarged Lloyds Banking Group posed additional challenges to competition,⁵⁵³ while Cooperative Financial Services suggested that the merger brought “long-term risks to the effective operation of key UK banking markets”.⁵⁵⁴ Despite these concerns, many of those who raised objections also acknowledged that the Government’s actions were appropriate. For example, Mr Thurston, UK Managing Director of HSBC, told us “I think it was the right decision to put aside the competition rules at a time of crisis”.⁵⁵⁵

272. It is widely accepted that the Government has been obliged to intervene very heavily in the banking sector to ensure its survival and maintain economic stability. In doing so, competition concerns have not been a priority. However the benefit of free competition in this area remains important and we recommend that the Government address this issue during the next two years.

Rebuilding confidence in the banking sector

273. Invited to describe the current situation, Lord Turner characterised it as “the biggest collapse of confidence in the money markets which had occurred since 1914”.⁵⁵⁶ Building on this theme, the Governor of the Bank of England told us that the events of the past 18 months had led to a bilateral loss of confidence: first in the banking sector and second in the economy as a whole:

The developments since last September/October have demonstrated the extraordinarily damaging consequences of a loss of confidence. We have seen this in two quite distinct areas ... The first is a lack of confidence in the banking system which became extreme in the difficult days of mid-September to early October last

550 The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008, (S1 2008/2645)

551 *Ibid.*

552 HM Government, *Pre-Budget Report 2008*, Cm 7484, para 3.37

553 Q 826

554 Ev 245

555 Q 1989

556 Q 10

year. The other is lack of confidence in the world economy, which fell off a cliff in October/November last year.⁵⁵⁷

274. Much of the analysis of the loss of confidence in the banking system has concentrated on the loss of inter-bank confidence and the resulting liquidity problems. In this section we will consider the other component of declining confidence in banks: the loss of consumer confidence.

275. The decline in confidence in banks was demonstrated most vividly by the ‘run’ on Northern Rock in September 2007: between 14–17 September 2007, £4.6 billion—20% of Northern Rock’s retail deposits—was withdrawn from its branches.⁵⁵⁸ Press interviews with those who were withdrawing their money from Northern Rock, and more recently from Bradford & Bingley, reported that they were withdrawing funds because they no longer trusted the banks to keep their money safe.⁵⁵⁹ While these cases provide dramatic illustrations of what happens when the public loses confidence in an individual bank, what is perhaps more concerning is the less sensational, but more pervasive, mistrust of banks which is evident in the submissions we have received.

276. The evidence submitted to us suggests that this lack of trust has been created and fed by a number of elements, including the:

- perceived “catastrophic lack of competence and ability” demonstrated by bank executives;⁵⁶⁰
- contrast between the high levels of remuneration within failing banks and the financial hardship faced by many taxpayers;⁵⁶¹
- banks’ treatment of customers in default on their mortgages;⁵⁶²
- perceived ‘unfair’ charges imposed by banks on customers;⁵⁶³
- alleged mis-selling of financial products to customers who cannot afford them;⁵⁶⁴ and
- apparent unwillingness of lenders to continue to serve even financial stable customers who have already obtained high LTV [loan to value] mortgages.⁵⁶⁵

277. When they came before us, the banks appeared to acknowledge that confidence had been destroyed: Paul Thurston of HSBC accepted that “trust has been put under duress

557 Q 2321

558 National Audit Office, *The Nationalisation of Northern Rock*, p15

559 “They gambled our cash and the town’s heritage. They made fortunes but destroyed the business”, *The Times*, 30 September 2008

560 Ev 286 [G W Carleton]

561 Ev 100 [Which?]

562 Ev 86 [Shelter]

563 Ev 252 [Which?]

564 *Ibid.*

565 Ev 93 [Which?]

and has been tarnished”.⁵⁶⁶ The banks also recognised that they needed to act decisively to rebuild this confidence: Mr Thurston acknowledged that the banks must rebuild trust by “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”.⁵⁶⁷ Stephen Hester of RBS told us that he believed that the banks had a duty to persuade the public that they were worthy recipients of taxpayers money:

the price of government support must be to build confidence on behalf of government that we are proper stewards of the support ... We have to explain ourselves and build and rebuild confidence.⁵⁶⁸

278. In its February 2009 Inflation Report, the Bank of England suggested that as a consequence of the decline in money flowing from foreign lenders, “in the longer term, banks are likely to increase their reliance on retail deposits”.⁵⁶⁹ It is self-evident that this increase will not be achieved if consumer confidence in the banks does not improve.

279. In attempting to rebuild this confidence, the Financial Services Consumer Panel amongst others has argued that more attention must be paid to savers.⁵⁷⁰ In its submission the Panel noted that the introduction of lower interest rates in a still inflationary climate had left many savers with falling income levels and indeed that “most instant access savers are losing money every day”.⁵⁷¹ A more pejorative tone was taken by Doug Taylor, from Which?, who told us that “banks have wanted to have their cake and eat it recently by passing on the base rate cuts to savers but not necessarily passing the benefits of that to borrowers”.⁵⁷² This is a charge which banks have resisted, arguing in their written evidence to us that they had passed on cuts to both savers and borrowers where possible.⁵⁷³

280. The Bank of England has reported that the flow of deposits from households and companies to UK banks has recently been “weak”.⁵⁷⁴ Commenting on this, the Governor of the Bank of England argued that lower saving levels were not undesirable in the short term because “if we all started to save now, we would be worse off”.⁵⁷⁵ The Governor’s message to consumers was a “complicated but crucial” one, which exposed what he described as the “paradox of policy”:⁵⁷⁶

Everything that we are doing now in order to stop the downturn and to get back to normal is absolutely opposite to everything that we know we should do in the long

566 Q 2134

567 Q 2134

568 Q 2006

569 Bank of England, *Inflation Report February 2009*, p 11

570 Ev 345 [Cooperative Financial Services]

571 Ev 271

572 Q 784

573 Ev 733 [Lloyds]

574 Bank of England, *Inflation Report February 2009*, p 11

575 Q 2392

576 *Ibid.*

term. That does not mean to say it is wrong. It means to say we have to explain to people why it is that collectively, if we all started to save now, we would be worse off in the short run. It is important that we get the economy back on track again and then, at that point, we can turn to implementing the moral messages about the need to save.⁵⁷⁷

In the long run we will all, as a nation, need to save more. We need to reduce our borrowing, but if we now move to that position too quickly, we will merely exacerbate the speed of the downturn.⁵⁷⁸

Angela Knight for the BBA suggested that the challenge of communicating this message remained pressing because “at the moment half the time [people] do not know what to believe”.⁵⁷⁹

281. Paul Tucker, Deputy Governor of the Bank of England for Financial Stability, told us that “once confidence has been fractured in the way that it was in October it is not going to be healed and restored overnight”.⁵⁸⁰ Indeed, the witnesses we heard from declined to offer any quick solutions. They did however, offer some general messages to the banks regarding the potential for better treatment of customers, particularly those in financial difficulty.⁵⁸¹ As we noted above, the banks appear to accept that they must do more to support customers and win back the public's trust.⁵⁸²

282. Some banks' management and boards have failed their shareholders and created concerns for their customers and this failure has had devastating consequences for the UK's private and public finances. The consequences of this are being felt by individuals and households around the UK, and by UK businesses. Enormous effort will be needed on the part of financial institutions to restore public confidence in them. Moreover such is the sophistication of current (and no doubt future) banking operations that a different intensity of supervision may be needed to protect lenders, investors and other participants. We look forward to contributing to discussions on this issue.

577 Q 2392

578 Q 2394

579 Q 866

580 30 April 2009, HC 376-i, Q 70

581 Q 788, Ev 88 [Unite]

582 Q 1948, Q 1962

Annex: Committee visits in conjunction with this inquiry

283. The Committee undertook visits to Belfast (2 March) and Edinburgh, Halifax and Leeds (9–10 March). We met a wide range of members of the public, representatives of consumer groups, and representatives of the business sector in each centre. We also met Members of the Northern Ireland Assembly in Belfast. Key points are summarised below.

284. In Belfast:

- businesses were finding it hard to persuade banks to lend to them. Businesses which had hitherto had access to lending were now finding those sources were drying up;
- repossession rates were rising and Citizens Advice were having to deal with a surge of inquiries from those worried about debts;
- members of the Presbyterian Mutual Society faced uncertainty and worry over losses they had incurred as a result of the Society's collapse;
- knowledge of the various support schemes put forward by the Government was patchy.

285. In Edinburgh:

- there were fears that various aspects of the banking crisis RBS would impact negatively on jobs in the financial sector in Scotland; and
- a large rise in enquiries to Citizens Advice over consumer debt, rental and mortgage issues;

286. In Halifax there was:

- a feeling of betrayal that a town whose history was closely entwined with the growth of the building society was now reduced to a state of nervous anxiety;
- resentment at the greed and short-sightedness of HBOS management;
- a lack of information about future employment prospects;

287. In Leeds:

- concern was expressed about the visibility of the Government's schemes to support businesses during the financial crisis. Questions were also raised as to how the schemes interacted;
- concern was expressed that the banks themselves were in turmoil, as staff within the banks were unsure about their own jobs. Recent experience suggested that bank staff on the high street had been “deskilled”;

- there was a discussion of the reduction in house building, and the potential for skills to be lost in the construction industry, which would affect the ability to resume building in the future; and
- local anxieties were expressed as to whether there would be redundancies in Leeds.

Conclusions and recommendations

How did we get here?

1. We acknowledge the international aspects of the present crisis, and welcome the call from the Governor of the Bank of England and others for reform to the design of the international financial architecture. We will consider such reforms in our inquiry into the international context of the banking crisis. Governments, politicians, regulators and central bankers in the UK and across the world share a responsibility for sustaining the illusion that banking growth and profitability would continue for the foreseeable future. A culture of easy reward, illustrated by risky lending of credit and capital, has been underpinned by an assumption of continuous expansion in banking accompanied by an expectation of ever bigger bankers' rewards. (Paragraph 17)
2. To date, building societies have generally been shown to have operated a safer business model. Certain features of the building society model, including the comparatively low reliance on wholesale funding and the focus on the protection of members rather than the service of shareholders, have left building societies better equipped to defend against the shockwaves of the current crisis. We heard evidence that establishing new building societies was now harder than it was when the Ecology Building Society was started in 1981. The Government should examine, with the sector, whether any legislative or regulatory changes are required to facilitate building society start-ups and remutualisation. (Paragraph 63)
3. We note that risk and complexity within the banking sector has increased dramatically over the last twenty years. The widespread—but at sometimes misguided—belief that risk was being dispersed and 'managed' led many banks to increase the complexity of their operations and their overall risk exposure. This was manifestly a false premise. Indeed one of the factors that is key to understanding the banking crisis is that some forms of securitisation, far from mitigating risk, actually obscured it. (Paragraph 82)
4. We note that the financial sector has significantly increased its leverage over the last two decades, and those firms that showed the greatest appetite for rapid growth, particularly in the last five years, through leverage are amongst the heaviest casualties. Increased debt simply led to increased risk. We will consider potential measures to control leverage in our forthcoming report on public regulation. (Paragraph 83)
5. The origins of the banking crisis were many and varied, including low real interest rates, a search for yield, apparent excess liquidity and a misplaced faith in financial innovation. These ingredients combined to create an environment rich in over-confidence, over-optimism and the stifling of contrary opinions. Notwithstanding this febrile environment, some of the banks have been the principal authors of their own demise. The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed. Bankers have made an astonishing mess of the financial system. However, this was a failure not only within

individual banks but also of the supervisory system designed to protect the public from systemic risk. (Paragraph 84)

6. Bankers complicated banking to the point where the location of risk was obscured, abandoned time-honoured principles of prudent lending and failed to manage their funding requirements appropriately. There were major failures in the modelling, procedures and structures for risk management, which we will address more fully in our future report. They did this in a reckless environment, and one in which their corporate governance was often totally ineffective. Whilst we would hope that the nature of banking, and bankers, would change in response to the crisis, and no doubt bankers will be chastened by recent experience for a short while, the responsibility falls to the financial regulator, the FSA, to create a more durable framework for stable finance. We will address the FSA's task in our forthcoming report. (Paragraph 85)
7. The FSCS deserves praise for the way in which it fundamentally increased its response to the unprecedented compensation claims arising from the default of five banks in just a few months. We are particularly impressed with the variety of innovative solutions deployed by the FSCS to suit the particular challenges facing them. (Paragraph 88)
8. We think that there should be a limit to the level of deposit protection offered by the FSCS to mirror arrangements in Europe in order to avoid a competitive disadvantage for UK banks. Once financial stability has returned and there has been clear communication about the scope of protection, it should be made clear that the new £50,000 limit will be applied. This would reintroduce the depositor's obligation to consider matters other than the bald interest rate in choosing where to locate their investments, and thus ensure that the banks had a disincentive to be reckless. The FSA should think now about a strategy for shifting the expectations of the banking consumer from one of total protection, to a partial protection basis. This strategy should be developed sufficiently to be readily deployed by the time that immediate concerns about bank safety have been calmed. One measure we would like to see adopted would be a requirement for all savings institutions to publish all relevant documentation and advertising, and also within branches, notice of the £50,000 deposit ceiling. We renew our recent recommendation that the FSA should carry on its website a list of all banking products covered by the deposit protection scheme. (Paragraph 90)
9. We also think that financial institutions must make clear to their customers where they are subsidiaries of other institutions where this is relevant in terms of deposit protection. Ideally, we would like to see each brand holding a separate banking licence. (Paragraph 91)
10. We are very sympathetic to the plight of building societies in funding more than their share of the FSCS burden and call on the FSA to review the situation with urgency. It is entirely inappropriate that institutions that are recognised as having a safer funding model, indeed have such a funding model enshrined in legislation in order to protect their depositors, should be required to contribute more to the industry's insurance scheme than competitors with funding models that have failed in the current crisis. The principle seems to have been that the riskier the business

model, the less that is paid. The absurdity of this serves to reinforce our previous recommendation that levies be charged according to risk, and we renew that recommendation in this Report. (Paragraph 96)

What has been the Government response?

11. The Government's initial policy of requiring Northern Rock to run down its loan book immediately after nationalisation stood in clear contradiction to its public exhortations to other banks to increase lending levels to small firms and individuals. Given the economic downturn and the need to maintain overall lending levels, we welcome the Government's decision to reverse this policy and allow Northern Rock to expand lending. We ask the Government to set out how this change of policy will also change the timescale over which the taxpayer loans to Northern Rock will be fully repaid and, in turn, the timescale over which a new ownership structure, whether by trade sale, privatisation or remutualisation, could be achieved. (Paragraph 111)
12. We are concerned that Northern Rock is suffering a 'first starter' disadvantage because it was one of the first European banks to request public funds. Northern Rock is paying a relatively high rate of interest on its Government loans whilst banks which have subsequently entered public ownership are paying lower charges in comparable circumstances. We recommend that the Government ensures consistent rates on loans made to banks in receipt of public funds or explains the justification for continuing discrepancies in such rates. (Paragraph 112)
13. We strongly recommend that the Government assesses the impact on the buy-to-let mortgage market of its share of that market, and how it proposes to use the influence it has. (Paragraph 119)
14. The merger between Lloyds and HBOS has been described in some quarters as a 'shotgun wedding'. Lloyds Group Chief Executive Eric Daniels conceded that the merger proceeded swiftly on the basis of relatively little due diligence and that the Government was involved to the extent that it offered to waive the competition rules. We also note that the merger may have prevented the collapse of HBOS with the consequent loss of many thousands of jobs and also avoided the outright nationalisation of the company. Nevertheless, from the evidence we received, if the merger has had injurious consequences for Lloyds TSB we consider that the responsibility for this lies primarily with the Lloyds Board. (Paragraph 128)
15. Bank recapitalisation was necessary to maintain confidence in the UK banking sector. Given prevailing market conditions it was clear that some UK banks would have collapsed without taxpayer support. We therefore support the decision to implement a recapitalisation programme and the Government's support in return for stakes in banks that were unable to raise additional capital through the private sector. The unavoidable speed of implementation did, however, mean that the implications for both banks and Government were neither fully understood nor worked out. (Paragraph 146)

16. We welcome the fact that the Government has attached conditions to those banks in receipt of public funds for the purpose of recapitalisation. This is despite the fact that such conditionality may have discouraged other banks from applying for Government support. It is important that Government intervention does not undercut the competitive position of sound banks. Such conditionality should help provide assurances to the public that the banks face a quid pro quo in return for Government money and have not received a cost-free bail-out. The Government's priority now must be to ensure that these conditions—in particular those relating to remuneration and lending levels—are adhered to. We will consider remuneration policy in the part-nationalised banks in a later report. (Paragraph 154)
17. That said, we are concerned about the contradictions of the Government's objectives for the banking sector especially with regard to the part-nationalised banks. For example, there is an inherent conflict between ensuring that the banks maintain high capital ratios, protecting the taxpayer interest and wanting the banks to increase lending levels. This tension was demonstrated by the Government's initial decision to charge a 12% coupon on its preference shares which may have adversely impacted on the ability of the part-nationalised banks to increase lending levels. To this end, there is a pressing need for the Government to clarify its strategic objectives and priorities with respect to the part-nationalised banks as well as towards other banks who are also facing conflicting pressures from Government. (Paragraph 155)

The January 2009 package

18. Whilst welcoming the approach taken in the Asset Protection Scheme, we are concerned about the need for greater clarity over the possible impact on the public purse, and urge the Government to complete the due diligence on assets in the scheme as quickly as possible, to make public the proportion of assets, by value, in each category covered by the scheme, and to disclose as soon as possible the mechanism for determining and the projected timeline for the crystallisation of any losses. (Paragraph 172)
19. We are mindful of the Governor of the Bank of England's comments that identifying the toxic assets on the balance sheets of banks is a task that will take many months. Dealing with so-called toxic or bad assets is a priority if confidence in the banking sector is to be restored and a prerequisite for this is establishing a clear and comprehensive picture of exactly what is on the balance sheet of the banks. To this end, we support the due diligence on assets of banks participating in the scheme currently being conducted by the Treasury. The Government has decided to tackle this problem through the establishment of an Asset Protection Scheme, which will provide guarantees on 'toxic' assets held by banks as well as other assets they retain that may suffer losses during the economic downturn. However, it is unclear at this stage whether the APS is a precursor or an alternative to the introduction of a so-called bad bank and we would welcome clarity as to the Government's intention in this area. We note that the exact value of the assets that the taxpayer will be guaranteeing has yet to be determined and that the eventual cost to the taxpayer of this arrangement is unknown. In hindsight, there were clear signs of an impending financial crisis since the summer of 2007. We question whether more analysis should

have been instituted by the regulators earlier to clarify the nature and value of assets on which banks were relying. We would welcome transparency regarding the methods used to calculate the fee charged for participation in the Asset Protection Scheme and the relationship between the fee charged and the degree of risk. It is also as yet unclear how the Office for National Statistics will classify the potential liabilities assumed. (Paragraph 178)

Bank lending

20. Whilst noting some positive signs, we are very concerned about the availability and terms of credit to the small business sector, and the slow movement on this issue by the banks. We regret the reports of sharp increases in bank charges and arrangement fees which can often be more damaging to businesses than higher interest rates. We deplore the behaviour of a number of those banks who have received so much public money and behaved in such an insensitive manner particularly to established customers. We ask the Lending Panel to set up a unit to monitor and investigate such practices, which seem to work against the letter and the spirit of the signed agreement. We invite the banks and Government to report back to us on progress in this area on a quarterly basis. (Paragraph 189)
21. There are currently a number of Government schemes aimed at encouraging lending by the banks. However, it is difficult to form an overall picture of how effective those efforts are, and how well they are working together. We recommend that the Government, via the Lending Panel, ensure that there is published a clear overall strategy, with each of the schemes outlined, indicating its aim and progress to date. At present, the approach seems to be piecemeal and disjointed. The Lending Panel has not provided detailed information on how the lending level targets set when negotiating the recapitalisation and asset protection schemes have been met. The relevant data should be published. Meanwhile there is an unresolved inconsistency between, on the one hand bankers' assurances that they are increasing their lending and, on the other hand the widespread complaints of business that credit is difficult to obtain and increasingly expensive. This information should be published now, and on a quarterly basis in future. (Paragraph 201)
22. We are concerned about the arrangements for monitoring lending levels, which reverted from UKFI to the Treasury with the announcement of the January 2009 package. We feel that annual reporting of the lending levels, as announced by the Government to Parliament, is inadequate, and recommend that the quarterly figures reported to the Treasury by the banks should be made public. (Paragraph 202)

UKFI

23. UKFI is managing billions of pounds of taxpayer money but at this stage too little of its activities are in the public domain. UKFI's website, for example, is almost devoid of content. Its Framework Document was published on 2 March 2009, four months after UKFI was set up, and the Investment Mandate is still not in place. We urge the Treasury to complete this document expeditiously, and to publish it. We consider it important that the public, the markets and Parliament understands the full details of UKFI's objectives with respect to its investee banks. The Government must publish a

strategy for UKFI addressing how it will use its control of the investee companies, and what role it envisages for UKFI in promoting change within the banking sector more generally. We recommend that this should be done within the next three months. We do not think it is in the national interest for UKFI to remain so enigmatic a body. (Paragraph 212)

24. In owning a majority stake in both RBS and Lloyds Banking Group, UKFI is in a strong position to influence banking remuneration structures across the entire banking sector, and should use this opportunity to fundamentally change the bonus culture provided by current banking remuneration practices. In a forthcoming report we will discuss in detail the contribution of remuneration practices to the banking crisis and how banking pay could be better structured. (Paragraph 217)
25. It is right that the Government's investments in UK banks should be managed at arm's length and it is important to retain a clear division of responsibility between UKFI's role as an institutional investor, and any other public policy objectives that the Government may pursue. However, we think it important that "arm's length" in this instance is clearly defined so that what is appropriate behaviour can be clearly discerned. Certain aspects of UKFI's institutional arrangements do lead us to wonder just how "arm's length" UKFI actually is from the Treasury: it shares a building and support staff such as IT and HR professionals, while the Chief Executive and several other staff are Treasury secondees. Whilst we acknowledge the cost savings that might be made through the collocation of UKFI with the Treasury, the effectiveness and independence of UKFI should not be compromised for the sake of relatively inconsequential sums of money, especially bearing in mind the onerous responsibility placed on UKFI. To this end, we recommend that UKFI consider moving out of the Treasury building, even if that means elsewhere on the Government estate. The Treasury has constrained UKFI's discretion by introducing a power of direction to be used if UKFI strays too far from the Treasury's wishes. The existence of this power, even if it is a nuclear option, undermines the "arms length" nature of UKFI's engagement with the investee companies. We invite the Treasury to set out clearly the precise circumstances in which it envisages this power being used. (Paragraph 222)
26. Given the importance of the task entrusted to it and the vast sums of public money involved, we believe that UKFI should be established, at the earliest opportunity on a proper statutory basis. While the current ad hoc administrative arrangements persist we have no confidence that UKFI will have the real operational independence that is necessary. (Paragraph 223)
27. We appreciate that UKFI has many urgent priorities to consider at the moment, but shaping an exit strategy must be one of them. We think it vital for investor confidence that, even at this early stage of ownership, preconditions for UKFI's exit should be outlined, and a strategy for achieving exit devised. It is clear that setting out an exit strategy has advantages and disadvantages for banking system stability and UK economic recovery. The taxpayers must be satisfied that any exit strategy will maximise the direct financial benefits and minimise the risks to them. This precondition for any exit from the results of recapitalisation must be clearly set out. The existence of an exit strategy would greatly improve the clarity of UKFI's mission,

and enable more effective scrutiny of UKFI's performance. We recommend that the Treasury provides details of an exit strategy for the taxpayer's investment in the banking sector. This strategy should include an analysis of the pros and cons of selling the Government's stake in tranches rather than as a whole. (Paragraph 229)

The future of the banking sector

28. The rebuilding of consumer trust is closely wound up in depositors having faith in the safety of their deposits, and the stability of payment systems and other utility aspects of banking. In our view, depositor reassurance can in the short term best be provided through improving and strengthening the regulatory regime for all types of bank. We do not lightly dismiss the Governor of the Bank of England's instinct that a separation of retail from investment banking functions is "very attractive". We believe that this is a live issue which requires further debate, and one to which we will return.. (Paragraph 245)
29. We acknowledge that the toxic shock that major financial institutions have been exposed to by securitisation is likely to result in changed business practices. We expect that one such change will see banks returning to the practice of keeping a greater portion of the loans they originate on their own balance sheets. But we also believe that a regulatory response may be required and recommend that the FSA coordinate efforts with its international counterparts to require that those undertaking securitisation retain a tranche of the commodities they trade. (Paragraph 249)
30. We are concerned about the lack of transparency inherent in over-the-counter trading. One of the many reasons why "toxic" assets had such a devastating impact was that institutions had only a shaky grasp on where they were, what they comprised and what their value was. Their judgment was further clouded by the strong correlation between complexity and profitability. Looking to the future it is desirable that such obscurity is avoided. We recommend that the FSA takes steps to encourage trading through clearing houses and where appropriate on exchanges. The international nature of finance means that unilateral action by the UK would be ineffective. Nevertheless, the UK's central role in world finance makes it a key player in moving forward this agenda. (Paragraph 258)
31. It is widely accepted that the Government has been obliged to intervene very heavily in the banking sector to ensure its survival and maintain economic stability. In doing so, competition concerns have not been a priority. However the benefit of free competition in this area remains important and we recommend that the Government address this issue during the next two years. (Paragraph 272)
32. Some banks' management and boards have failed their shareholders and created concerns for their customers and this failure has had devastating consequences for the UK's private and public finances. The consequences of this are being felt by individuals and households around the UK, and by UK businesses. Enormous effort will be needed on the part of financial institutions to restore public confidence in them. Moreover such is the sophistication of current (and no doubt future) banking operations that a different intensity of supervision may be needed to protect lenders,

investors and other participants. We look forward to contributing to discussions on this issue. (Paragraph 282)

Formal minutes

Tuesday 21 April 2009

Members present:

John McFall, in the Chair

Nick Ainger	John Mann
Mr Graham Brady	Mr George Mudie
Jim Cousins	John Thurso
Mr Michael Fallon	Mark Todd
Ms Sally Keeble	Mr Andrew Tyrie
Mr Andrew Love	Sir Peter Viggers

* * * *

Draft Report (*Banking Crisis: dealing with the failure of the UK banks*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 282 read and agreed to.

Annex agreed to.

Summary agreed to.

Resolved, That the Report, be the Seventh Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Monday 27 April at 3.45 pm.]

Written evidence

Further written evidence received as part of the Committee's inquiry into the Banking Crisis:

	<i>Page</i>
1 Supplementary memorandum from Nationwide	Ev 1

Reports from the Treasury Committee during the current Parliament

Session 2008–09

First Report	Administration and expenditure of the Chancellor's departments, 2007–08	HC 35
Second Report	Pre-Budget Report 2008	HC 27
Third Report	Work of the Committee, 2007–08	HC 173
Fourth Report	Appointment of Paul Tucker as Deputy Governor of the Bank of England for Financial Stability	HC 34-I
Fifth Report	Banking Crisis: The impact of the failure of the Icelandic banks	HC 402
Sixth Report	MPC Appointment Hearing: Paul Fisher, Executive Director, Markets, Bank of England	HC 415

Session 2007–08

First Report	The 2007 Comprehensive Spending Review	HC 55
Second Report	The 2007 Pre-Budget Report	HC 54
Third Report	The Work of the Committee in 2007	HC 230
Fourth Report	Climate change and the Stern Review: the implications for Treasury policy	HC 231
Fifth Report	The run on the Rock	HC 56
Sixth Report	Financial Stability and Transparency	HC 371
Seventh Report	Administration and expenditure of the Chancellor's departments, 2006–07	HC 57
Eighth Report	Re-appointment of Dr Andrew Sentance to the Monetary Policy Committee	HC 454
Ninth Report	The 2008 Budget	HC 430

Tenth Report	Re-appointment of Mervyn King as the Governor of the Bank of England	HC 524
Eleventh Report	Counting the population	HC 183
Twelfth Report	Inherited Estates	HC 496
Thirteenth Report	Budget Measures and Low Income Households	HC 326
Fourteenth Report	Appointment of Lord Turner of Ecchinswell as Chairman of the Financial Services Authority	HC 916
Fifteenth Report	Appointment of Charlie Bean as Deputy Governor of the Bank of England	HC 917
Sixteenth Report	Appointment of Spencer Dale to the Monetary Policy Committee of the Bank of England	HC 1009
Seventeenth Report	Banking Reform	HC 1008

Session 2006–07

First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor's department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934
Tenth Report	Private equity	HC 567
Eleventh Report	Unclaimed assets within the financial system	HC 533

Twelfth Report	The Monetary Policy Committee of the Bank of England: ten years on	HC 299
Thirteenth Report	Financial inclusion follow-up: saving for all and shorter term saving products	HC 504
Fourteenth Report	Globalisation: prospects and policy responses	HC 90

Session 2005–06

First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	“Banking the unbanked”: banking services, the Post Office Card Account, and financial inclusion	HC 1717

Written evidence

Supplementary memorandum from Nationwide

I am writing further to your verbal request at the meeting of the Treasury Select Committee inquiry on 4 February at 1600 hours. During that meeting you asked me to write a note providing more detail on the main points I gave in evidence. The areas I wish to draw the Committee's attention to in this regard are the Financial Services Compensation Scheme (FSCS) levy, coverage and limit; Section 9 of the Building Societies Act 1986; and measures to improve the mortgage market. For convenience, I have provided an initial summary of our recommendations in each section below.

SUMMARY RECOMMENDATIONS

1. *Financial Services Compensation Scheme (FSCS)*

- Introduction of a risk-weighted scheme as recommended by the Treasury Select Committee's Seventeenth report (2007–08, paragraph 159).
- Temporary protection of building society deposits until 30 September 2009 across all brands up to £50,000 to be made permanent.
- Increase in the deposit protection limit from £50,000 to at least £100,000.

2. *Building Societies Act*

- Review of relevant sections of the Building Societies Act (such as Section 9) in light of the changing regulatory environment to ensure that ongoing obstacles to the efficient operation of societies' activities are removed.

3. *Improving the Mortgage Market*

- Improve retail funding by offering better products—such as increasing the ISA limit and flexibility—and ensuring government owned institutions do not have an unfair competitive advantage.
- Address the inequities of Credit Default Swaps, in which we pay the highest price for CGS despite having the lowest risk profile.
- Ensure that exit strategies from the Special Liquidity Scheme and Credit Guarantee Schemes take in to account the refinancing needs of institutions.
- Permanent Interest Bearing Shares (PIBS) to be categorised as core capital.
- Government focus on demand side measures to improve consumer sentiment and affordability in the housing market.

FINANCIAL SERVICES COMPENSATION SCHEME (FSCS)

1. *FSCS Levy*

Total FSCS liabilities in respect of the failures of five banks—Northern Rock, Bradford & Bingley, Icesave, Kaupthing and London Scottish—amount to £19.5 billion. The interest on this is borne by banks and building societies within the deposit-taker contribution group, up to a maximum of £1 billion per annum in each of the next three years to September 2011. It is estimated that building societies will be required to pay up to a fifth of the total interest every year.

For 2009–10, the cost to societies of this interest is £130 million, equivalent to about 9% of the sector's pre-tax profit for the end of the financial year 2007–08. After 2011, the principal of the FSCS's borrowings, less recoveries, will then become due. The impact on building societies contrasts starkly with the banking sector, where the levy for FSCS management expenses is typically well below 3% of pre-tax profits.

There are two main reasons for this: first, the current allocation of FSCS levies relates to the size of each contributor's retail deposit balances. Second, building societies aim to provide the best rates to both borrowers and savers (profit optimisation) rather than to maximise profit extraction to pay dividends to external shareholders (profit maximisation). So all other things being equal, societies' stated profits, even in good times, will be much lower.

Accordingly, the building society sector considers there to be a strong case in equity for the allocation of the FSCS levies to be modified to meet these concerns. As the evidence provided at the session pointed out, it is particularly galling that, in the few cases where societies have got into difficulty, mergers have been arranged with stronger building societies, without recourse to the public funds that have been needed in the banking sector.

In view of the high risk strategies undertaken by failed institutions, we would strongly advocate that consideration is given to a risk-weighted FSCS as opposed to one that is based on deposit size. As you will recall, the Treasury Select Committee report last year (Banking Reform, Session 2007–08, Seventeenth report, paragraph 159) favoured a risk based, pre-funded scheme.

There are several ways in which this could be done. For instance:

- The FSCS levies could be based wholly on balance sheet quantities, taking account of total balance sheet size, rather than just the retail balance sheet.
- Alternatively, FSCS levies could be capped as a proportion of a deposit taker’s pre-tax profits—a cap could be set at, say, 5% of the rolling average of the most recent three years’ pre tax profits.
- A further approach would be for the contribution groups for deposit takers to be re-cast so that the banks meet in full the first slice of any FSCS levy resulting from a bank failure, ie before other firms, including building societies, are required to contribute.
- Finally, the FSA could identify those institutions pursuing more risky strategies and ask them to pay more into the fund, relative to their size, than institutions seeking safer strategies.

Any of these is likely to produce an outcome that, over time, is more fairly reflective of the relative riskiness of the business models of the building societies and banks. We are currently considering, with other building societies, the wider implications of these measures and the costs and benefits of each proposal.

While Nationwide have not been strong advocates of pre-funding in the past, we believe that in view of recent events a scheme that is risk based would provide greater consumer confidence and encourage institutions to act prudently. As the Governor of the Bank of England pointed out last June, “A degree of pre-funding is one of those ideas that is bound to be unpopular before the fund is called upon, but seems decidedly wise after the event as it lessens the burden on the banking system in a time of stress” (quoted in TSC Banking Reform, Session 2007–08, Seventeenth report, paragraph 157).

At present, the FSA have chosen not to consult specifically on the levy issue. At a European level, however, this issue has been given a greater priority as the Commission has been requested to write a report by the end of 2009 (see Articles 7(1a); 10(1)(3) and 12(1) of revised Directive 94/19/EC1) which covers the introduction of risk-based contributions. The recent report of the “de Larosiere Group” on European regulation and supervision also favoured a pre-funded scheme (Recommendation 13).

In recognition of the concerns of building societies with regard to the FSCS levy, Ann Cryer, MP for Keighley in West Yorkshire tabled Early Day Motion 426 on 13 January in the House of Commons, which, as at 29 March, had attracted 166 signatures and was the subject of a Westminster Hall debate. We urge the Committee to give further thought to this issue, to support the EDM and to follow up on your own recommendations put forward last year for a risk based, pre-funded scheme.

2. FSCS Coverage

As a building society, we also face the unhelpful anomaly—compared to the banking sector—whereby we are not permitted to merge with another building society and retain their authorised deposit taker status within our group. This meant that members of the Derbyshire and Cheshire Building Societies who held savings in excess of £50,000 across all societies following our merger last year would no longer have received protection of their deposits above £50,000. They would, in other words, have been disadvantaged through no fault of their own.

Following an FSA rule change, our members across all three societies were allowed to benefit from FSCS “coverage by brand” until 30 September 2009, when a permanent solution is required. If it is not, it will be detrimental to the interests of our members who would like to retain their savings within the wider group while remaining inside the £50,000 protection limits. The protection until the end of September is also applicable to the savings accounts of the Dunfermline building society following our recent acquisition.

As the Treasury Select Committee report last year pointed out (TSC Banking Reform, Session 2007–08, Seventeenth report), there is still much customer confusion around whether an organisation with multiple brands grants multiple protection across savings. According to the report, which recommended coverage by brand, customers are very familiar with their brand but cannot be expected to know if it is a licensed deposit taker, whereby they are protected up to £50,000, or a trading division, whereby they may not be protected up to £50,000 if they have savings elsewhere in the trading group.

To resolve this confusion and provide confidence to our members, we would like the temporary “coverage by brand” solution granted by the FSA and favoured by the Committee report to be made permanent for our members at the end of September. As part of this process, we would encourage the FSA to consider a permanent legislative solution for any further mergers in the sector and would be willing to work with the FSA and the government to explore solutions.

3. FSCS Protection Limit

Nationwide propose an increase in the compensation limit to £100,000. The European Deposit Guarantee Scheme Directive, which will override UK legislation, proposes that member states need to adhere to €100,000 per legal entity from 31 December 2010 (unless an impact assessment demonstrates that this would not be appropriate, nor financially viable, for all member states).

Nationwide favour an increase to £100,000 earlier than 31 December 2010 as it would ensure that the building society and UK savings sector remains competitive in light of developments since October last year. It would:

- protect 99% of building society deposit balances (an increase of 22% according to FSA figures quoted in FSA CP08/15 FSCS: Review of Limits, Annex 1, p 3).
- bring the UK in line with the \$200,000 protection afforded to consumers in the US and the EU100,000 already afforded to Dutch depositors (ING savers in the UK are no longer part of the UK FSCS protection scheme as they are protected by the higher limit provided by their government).
- protect UK savers following the Irish government's announcement of unlimited protection, including UK post office accounts, to September 2010.
- protect Nationwide and other building societies in light of the tiered retail savings market in the UK, in which nationalised institutions offer 100% guarantees.

BUILDING SOCIETIES ACT 1986 (AMENDED BY THE BUILDING SOCIETIES ACT 1997)

1. Section 9A

The Building Societies Act was passed in 1986 and then amended in 1997. The Act governs how building societies are statutorily governed and where necessary it has been amended to bring the governance of societies into line with new market practices, while retaining the low risk model.

The governance environment for all financial institutions is undergoing significant revision in response to the effects of the credit crisis. For societies, this is most clearly felt through the new policies put forward by the FSA. As market convention and circumstances have evolved, however, building societies have been prevented (primarily by Section 9A) from undertaking a broad array of financial transactions that can, in some circumstances, be helpful to the sector. The restrictions in 9A include entering into transactions involving derivatives, for example to hedge against the risk arising from changes in interest rates, exchange rates, any index of retail prices, residential property prices, securities prices or the creditworthiness of any borrower.

This restriction has meant that societies have had to deal with the counterparties in the market, at cost, as opposed to developing their own internal capabilities. In light of the changed landscape since 1997, and particularly more recent changes, we would ask that the Act is reviewed to ensure that it is fit for purpose in the 21st century financial world.

2. Section 9B

As part of the prudent management of our liquidity we have increased substantially our holding of UK Government and Bank of England issued securities, including Treasury Bills, via the Special Liquidity Scheme (SLS). In order to use these securities, particularly the Treasury Bills, and turn them into cash, we need to be able to conduct repos (sale and repurchase agreements).

Section 9B of the Act restricts our ability to enter into repo transactions. The wording of Section 9B is over 20 years old, prescriptive in style and inconsistent with transactions structures that have become normal market practice. In particular, we are disadvantaged compared to the banks regarding Delivery by Value (DBV) transactions that we may need to operate in order to turn Treasury Bills in to cash.

Under DBV, the counterparties agree the cash amount of the repo and the CREST system allocates assets from the borrower's account to cover the value of the deal ("delivery by value"). The DBV method is low-cost and low risk compared to the counterparty risk in open market transactions.

In order to conduct the DBV transaction, participants need to be able to create charges in favour of their settlement bank, over their assets. However, it is legally uncertain for building societies whether any given charge would be regarded as fixed (relating to a fixed set of collateral) or floating. This legal ambiguity calls into question the ability of building societies to offer any form of charge in respect of DBV transactions.

This is unfortunate, since the DBV process may otherwise assist in enabling societies to make any financial assistance they receive fully liquid. As a result, we have therefore not benefited from SLS to the same extent as banks. It has been a source of continuing difficulty for us during a period when flexibility to act in a commercially pragmatic way has been of fundamental importance.

To address this issue, we would like an amendment to be made to this part of the Act, or a change in overriding legislation, that would allow us to create a floating charge in our normal course of business. We have had several discussions with HM Treasury on this issue and understand that clause 251 (7) of the Banking Act 2009 seeks to ensure that building societies are able to obtain appropriate financial assistance from the authorities without undue penalties. We understand HM Treasury are seeking further views on using this clause to resolve the matter and we fully endorse this activity.

MORTGAGE MARKET

The mortgage market grew as a result of the buoyant economic background which led to a self-reinforcing cycle of rising house prices, high borrower expectations, reducing risk perception and easy availability of credit. As conditions have changed, the cycle has reversed, so prices have fallen, borrowers have lost confidence, risk is increasing and funding has been withdrawn.

The key issues within this market, including our views on measures that may alleviate the difficulties, are outlined below:

1. *Funding to Lenders*

(a) Retail Funding

Lenders are beset by a lack of low-cost, long-term wholesale funding to support new lending, replace maturing funding and provide liquidity. While government measures to open up wholesale lending have been widely mooted, retail funds are also significant, particularly for Nationwide.

Securitisation markets have closed, but retail savings balance growth has also slowed dramatically over recent months and we believe this trend will continue for a significant period ahead as consumers seek to rebalance their finances. Additionally, savers have chosen to invest significant proportions of their money in government backed organisations and/or NS&I. In the three months to December last year, for example, NS&I accounted for 44% of the balance growth in the household savings market. This, of course, limits the amount of retail funds available to building societies for mortgage lending.

Nationwide's business model requires retail funding and we are expecting the retail savings market to be weak, with competition intensifying. We would advocate the continued monitoring of Northern Rock to ensure it does not have a competitive advantage and urge the government to consider options for savers, such as increasing the flexibility and tax-free limits of ISA products and exploring the potential for tax-free savings vehicles for children ineligible for child trust funds. As mentioned above, savers would also be helped if the FSCS increased their protection limit to £100,000 and made permanent the temporary protection of deposits across all four societies.

(b) Wholesale Funding

(i) **Credit Guarantee Scheme (CGS)**

We utilised the CGS in November and see this as an important mechanism for refinancing wholesale maturities in 2009. The extension of the CGS scheme to the end of December 2009 is welcomed by Nationwide. The initial issuance pattern adopted by UK banks was met with strong investor reception and a supportive secondary market developed on the back of orderly primary issuance.

As you are aware, the cost of the guarantee is determined by reference to each institution's Credit Default Swap (CDS). A Credit Default Swap is a contract issued by an institution that guarantees the holder will be covered if a particular company defaults on its debts. The CDS is priced differently for each company and as a percentage of the value of the debt to be insured. If the market price of a CDS is too high it will erode the interest a creditor is earning. This makes the debt less attractive and it can become more difficult for the debt-issuing company to raise money.

The CDS for Nationwide is not actively traded and as a consequence is relatively illiquid. The end result is that we pay the highest price for the guarantee (compared with Lloyds, HBOS and RBS) despite having the lowest risk profile.

We feel the Credit Guarantee Scheme is expensive relative to other international schemes and that building societies are unfairly penalised because Credit Default Swap spreads do not accurately reflect the real default risk in the building society model.

To the extent we are unable to achieve a level playing field on the costs we incur relative to others, we will inevitably suffer a disproportionate impact on our profitability over the next two to three years based on the use of CDS. The likely impact of reduced profitability may come in the form of a ratings downgrade, which clearly could have serious consequences in current markets.

(ii) Exit Strategies

Whilst the Government funding initiatives (SLS & CGS) have been most welcome and critical in sustaining funding in the market, consideration needs to be given to the expectations placed on the exit strategies from these funding initiatives.

The FSA and HMT are asking all lenders for detailed exit strategies from these schemes and we understand they are not willing to accept the fact that such a strategy may be predicated on wholesale markets returning to their position prior to the credit crunch.

Therefore, strategies for banks and building societies to exit from these schemes will need to incorporate increasing their share of retail deposits, which is difficult in a market that is unlikely to have recovered and faces competitive pressures from government deposit-takers. The requirement to provide funding for exit strategies is also completely at odds with the government's aims of ensuring the availability of credit in the economy.

In recognition of these issues, we would like refinancing needs to be met by extending the terms of the schemes. At present, there is no guarantee that there will be sufficient market liquidity to absorb the levels of refinancing required beyond the existing terms.

2. Capital Issues

Capital considerations under Basel II constrain lenders' ability to lend at the riskier end of spectrum in the current climate. For example, a loan with an 80% LTV consumes more than three times the Pillar 1 capital of a 60% LTV loan. Clearly, the returns required in future for higher LTVs will need to increase markedly against those achieved for the lower risk business. The increased capital levels required to meet regulator mandated capital adequacy ratios reduces the supply of lending in the market considerably.

As well as increased capital levels, we have the problem that European Capital Requirements Directive proposals may mean that Permanent Interest Bearing Shares (PIBS) lose their exemption from being categorised as Innovative Tier One capital. This exemption is in place because it has previously been recognised and accepted that there is no sizeable market for an issue of PIBS without call or step-up features.

Removal of this exemption would result in building societies only being allowed to issue PIBS up to 15% of total capital. As our current PIB issuance stands at 17%, this could severely curtail our ability to raise inorganic capital in future. It may limit our ability to undertake strategic corporate activity, such as mergers, and would be relevant to credit rating agencies and wholesale investors who rely on measures of tier one capital.

We believe strongly that PIBS are the building society equivalent of ordinary share capital, as they demonstrate the same characteristics in terms of level of subordination and loss absorbency. For this reason, PIBS (in whatever form they are issued) should qualify as Core Tier One capital. We are in discussions with the FSA on this issue and believe that any changes would need to be subject to changes to the Handbook and an associated consultation period.

At present, Nationwide is well capitalised and it remains our clear understanding that the FSA does not believe our business requires additional capital.

3. Responsible Lending

Lenders' obligations as part of "treating customers fairly" involve responsible lending. A more prudent approach to lending, particularly for borrowers with stretched income multiples and high LTVs, has recently been mooted by Lord Turner. Nationwide already adopts a prudent approach to lending that takes in to account broader affordability measures rather than simply focussing on income or LTV.

Given the current economic conditions, it can also be more difficult for lenders to identify the probability of default (PD) and loss given default (LGD) for new lending. Lenders are naturally becoming more prudent in this environment and have a preference for lower risk.

Responsible lending issues serve to underline that 2009 will not be a year in which Nationwide should abandon its prudent lending standards. Whilst the Committee placed an emphasis on increasing lending at the evidence session, these factors should be taken into account during any discussion to avoid imprudent lending and the growth of asset bubbles in future.

4. Consumer Confidence and Demand

Consumers able to move are unwilling to commit due to an expectation that properties will reduce in value and/or that their future income cannot be guaranteed. Remortgage activity has also worsened in recent months as house price falls continue and mortgage owners find themselves in a high LTV bracket or in negative equity.

Consumers' expectations about future capital gains from property have also fallen sharply, suggesting that many borrowers who may like to buy and may even fit the appropriate low risk criteria will wait until they feel the bottom of the market has been reached before they decide to do so. Consumers are looking for house prices to reach a new base and the correction in the market to run its course.

Consumer sentiment should not be underestimated, alongside improved affordability and a more buoyant economy. It is consequently our view that demand side measures in the housing market should form an increasing part of the Committee's and the government's thinking as the recession deepens.

I look forward to further discussion on the issues raised above and would like to thank the Committee for giving Nationwide and other building societies the opportunity to give evidence to the inquiry.

Graham Beale
Chief Executive

30 March 2009
