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Treasury Committee

Banking Crisis

Volume III

Written evidence

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The Treasury Committee

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The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/treascom.

A list of Reports of the Committee in the current Parliament is at the back of this volume.

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Contacts

All correspondence should be addressed to the Clerks of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.

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Written evidence

Memorandum from M J Evans

I was surprised to read in today's press comment concerning failed bank executives being schooled by professional coaches prior to forthcoming Treasury Select Committee hearings.

I am an experienced Chartered Accountant, with prior employment in blue-chip organizations such as PwC, the united Nations and ICI plc; also developed and grew a successful accounting and advisory business for many years advising SMEs and larger corporates in the UK and overseas. Therefore I think I can interpret recent events with some knowledge and authority.

Like many people, I am shocked and disgusted by the lack of accountability to date arising from the actions over many months and years of senior bankers, government policy and regulation "ineffectiveness" in this arena, and the apparent inability of professional firms to control and address problems timorously.

I first examined this area early in 2002 in the context of a dispute I had with HBOS; now settled out of court. I enclose certain extracts[1] that demonstrate my cursory reading of the position as early as April 2008 clearly identified the huge issues, required HBOS bail out and impending losses. This incidentally well before the flawed HBOS rights issue, sold on I believed then, at a massively inflated price—which in my opinion was a highly negligent act condoned by HBOS executives and its relevant advisers; if I was able to put the bank (and its CEO0 on direct notice of the problem, why was that issue not addressed more widely at the time (perhaps myopia, arrogance and detachment from reality together with a vested interest by advisers as to fees may have influences matters?). The market was speaking clearly, the quoted share price capitalised was less than the recorded net assets in the accounts, clearly indicating massive overstatement—as now recognised in "write-offs" further funded by taxpayers.

[List of enclosures not printed]

It is clear problems have extended across many banks (and large commercial businesses, also with flawed business models—such as Woolworths—the net impact of well paid executives fouling and not addressing change, combined as with banks with a healthy mix of megalomania at Chief Executive level, all causing massive loss and ripple-on-cost to many families and businesses.

My own professional body, the ICAEW, has not—in my humble view—covered itself in glory given the repeat unqualified audit reports and presumably reports from accountants on bank prospectuses accompanying rights issues. In fact, together with the FRS, and other such bodies, I feel there has been an out and out failure as to a reasonable level of regulation and subsequent accountability.

I hope my comments might help support your review, and like many others would be pleased to see some real action leading to acknowledgment and recompense where relevant as to failures of fiduciary duty and professional "warning". The article dated 8 January 09 to Accountancy Age from Martin Lloyd-Penny, another experienced accountant well known to me, probably sums that up succinctly.

February 2009

Memorandum from UK Financial Investments

I am writing to submit the UK Financial Investments framework document as evidence for the Committee's work on the Banking Crisis inquiry. This can be considered alongside the oral evidence that I and Glen Moreno will be giving to the Committee tomorrow.

The framework document sets out the objectives of UKFI. which has been set up to manage the Government's investments in financial institutions.

Government investments currently comprise:

(a) Holdings in RBS comprising £5 billion in preference shares and 57.9% of the company' s ordinary shares, with an agreement to refinance the preference shares with ordinary shares which could take the Government' s stake up to 70%;

(b) holdings in the Lloyds Banking Group comprising £4 billion in preference shares and 43.4% of the company's ordinary shares; and

(c) 100% ownership of Northern Rock and Bradford and Bingley.

Our goal as we manage these investments, as set out in the Framework Document, is to develop and execute an investment strategy for disposing of the investments in an orderly and active way through sale, redemption, buy-back or other means within the context of an overarching objective of protecting and creating value for the taxpayer and shareholder, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition.

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[1] Not printed.

This objective includes:

(a) 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;

(b) maintaining financial stability by having due regard to the impact of it value realisation decisions; and

(c) 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.

In pursuing this goal we are asked to operate like any other active, engaged shareholder to protect and create value, operating on a commercial basis and at arm's length from Government. We will follow in full the Institutional Shareholders' Committee's Statement of Principles. This includes monitoring performance; intervening where necessary; voting; evaluating and reporting, and providing regular updates to our client HM Treasury.

In practice, our early work has focussed on:

— setting up UKFI as a small company, recruiting a handful of professional staff and putting in place rigorous compliance arrangements etc;

— working to strengthen the boards of our investee companies. Two appointments have been made with our agreement to the board of Lloyds Banking Group, and there have been substantial changes to the board at RBS including the appointment of Sir Philip Hampton as chairman and the departure of seven non-executive directors;

— early discussion with our investee companies on matters such as: capital structure; strategy; and risk management;

— extensive discussion with RBS and Lloyds on their approach to 2008 and 2009 remuneration;

— agreement with RBS (announced in January) on the restructuring of the Government's preference shares; and

— discussions with other investors in our investee companies.

John Kingman
UK Financial Investments

2 March 2009

Supplementary memorandum from UK Financial Investments

I am writing to provide, in the Annex to this letter, the various items of follow-up information we promised at the Committee's hearing on 3 March.

On various specific questions relating to the detail of Sir Fred Goodwin's pension (item 2 of the attached Annex) RBS is responding to the Committee direct in parallel with this letter.

In two other areas (remuneration of staff, and overseas activities; items 1 and 4 of the attached Annex) the Committee asked for detailed information from our investee banks. I should say first that the Government has informed us that its general policy in relation to the disclosure of commercial information by state-controlled companies that are PLCs is that their approach to disclosure should follow the requirements for companies listed on the Stock Exchange, including the Combined Code on Corporate Governance and Directors' Remuneration Report Regulations—and the Government has told us that it would expect UKFI to take the same approach to disclosure by our investee companies, ie not to seek to impose different disclosure obligations on UKFI investee companies than apply to existing state-owned companies such as the Royal Mail etc. I am afraid this is unlikely to encompass the full range of information sought by the Committee, for which I apologise.

Nevertheless, I have written to the Chief Executives of RBS and Lloyds Banking Group bringing the Committee's requests to their attention and asking them to respond promptly and directly to you, setting out what they are willing to disclose, consistent with the Government's policy. The Treasury has written in the same terms to the Chief Executives of Northern Rock and Bradford & Bingley.

John Kingman

Annex 1

AREAS OF ADDITIONAL EVIDENCE

1. *The number of staff in the banks in which Government has investments who were paid more than £100,000, and the number of staff who had bonuses of more than a] £100,000 and b) £1 million*

All the banks' Annual Reports contain a Directors' Remuneration Report, and RBS' and Lloyds' Annual Reports also include some additional information on aggregate remuneration of directors and other members of key management during the year.

I enclose the relevant extracts from the RBS 2008 Annual Report, published this week, and the Northern Rock Annual Report, published 3 March 2008. The Lloyds Banking Group Annual Report will be published within the next few weeks, and the Bradford and Bingley Annual Report will be published by the end of March.

The Government's policy is that state-controlled companies' (including UKFI investee companies') approach to disclosure should take account of the requirements for companies listed on the Stock Exchange, including the Combined Code on Corporate Governance and Directors' Remuneration Report Regulations.

UKFI has nevertheless written to the Chief Executives of RBS and Lloyds (and the Treasury has written to the Chief Executives of Northern Rock and Bradford & Bingley) bringing the Committee's request to their attention and asking them to reply promptly and directly to the Committee, setting out what they are willing to disclose, consistent with the Government's policy on disclosure.

We would also draw the Committee's attention to the following points:

- In agreement with UKFI, RBS has undertaken the most radical restructuring of bonus arrangements undertaken by any major bank in the world, including no bonuses for 2008 performance and no pay increase for board executives directors in 2009; no discretionary cash bonuses to be paid in 2009 for 2008 performance; and termination of the existing profit share scheme, with an equivalent payment made as part of monthly salary award package for lower paid staff on average salaries of £18,979;
- LBG has committed to a restructuring based on the same principles as the RBS settlement, including no discretionary bonuses to be paid in 2009 except to the most junior staff earning an average of around £20,000, and no annual free share award to anyone in the bank;
- Northern Rock has concluded in the strategic review of its business plan that Executives and senior management receive no cash bonus for 2008 and 2009, apart from contractual entitlement, and will receive no pay increase in 2009. A 10% bonus was paid to front-line employees based on the successful attainment of the agreed performance targets: specifically, the repayment of a significant portion of the Government loan during 2008. Junior management, subject to Qualifying criteria, will receive a 10% deferred bonus in the form of a loan note. There are around 4,400 employees in this total, combined group with an average salary of around £21,000 per annum; and
- Bradford and Bingley has reached agreement with Government on its approach to remuneration for 2008: senior and middle managers will receive no immediate payment, although a pool of around £1.3 million earned under the various scheme rules will be allocated on a deferred basis in order to help retain key staff. Around 800 junior staff will receive a bonus payment of just under 8% of salary at a cost of around £1.7 million. The average salary of this group is approximately £22,000. These will be in the form of loan notes and subject to 100 percent clawback.

2. *Whether Sir Fred Goodwin's relationship with RBS has been fully terminated: whether he is still receiving any other benefits from RBS aside from his pension; and where the funding for his pension will come from*

RBS is responding to the Committee on these points in parallel with this letter.

3. *Whether the note taken by the lawyer at the meeting of Lord Myners and the members of the RBS board regarding Sir Fred Goodwin could be provided to the Committee*

A note is attached.

4. *Details of overseas assets for the various banks in which UKFI has a holding*

UKFI and HM Treasury have written to the banks in which Government has investments, asking them to respond to you promptly and directly on what they are willing to disclose, consistent with the Government's policy on disclosure of commercial information by state-controlled companies. We have also asked them to address Mr Mann's specific question on what assets, liabilities and investments the banks in which the government has a stake have in UK dependent territories and UK overseas territories.

Published information of which we are aware is:

A detailed breakdown of the overseas assets of RBS, taken from the Annual Results for the year ended 31 December, is attached as an annex. This contains disclosures on assets in the UK, US, Europe and the rest of the world.

— Northern Rock has activities in Ireland and Guernsey. The Guernsey subsidiary produces its own financial statements available on its website (http://www.northernrock-guernsey.co.gg). Northern Rock's half year results (http://companyinfo.northernrock.co.uk/) from June 2008 set out that their Danish Branch was closing.

— Bradford and Bingley does not have any significant overseas subsidiaries.

5. *UKFI's Business Plan and Budget*

The Committee asked UKFI to consider whether it is possible to disclose its Business Plan and Budget. I can confirm that we will be happy to send these to the Committee once they are agreed with HM Treasury.

6. *UKFI's costs to date*

In advance of putting the business plan in place, HM Treasury has approved month by month the costs of running UKFI. UKFI expenditure from 3 November 2008 to the end of February totals £1.057 million.

7. *Job advertisement for UKFI non-executive directors*

The advertisement is attached as an annex.[2]

8. *More detail on the subordinated debt in which discretionary bonuses at RBS will be paid*

The awards will be in the form of RBS subordinated bonds, which will in the event of liquidation rank after all senior debt holders and deposit-holders. The bonds will rank pari passu with all other issues of dated subordinated debt, and ahead of junior subordinated debt (typically perpetual) hybrid Tier 1 capital, preference shares and ordinary equity. The bonds will contribute to the Group's regulatory capital base.

11 March 2009

Annex

NOTE OF DISCUSSION CONCERNING SIR FRED GOODWIN ON THE EVENING OF SATURDAY 11 OCTOBER 2008

Slaughter and May advised HM Treasury in relation to the recapitalisations of RBS, Lloyds and HBOS. These recapitalisations needed to be agreed and announced by the morning of Monday 13 October 2008. As a result, during the weekend of 11 and 12 October 2008 I attended a series of meetings at the Treasury with a number of banks relating to the recapitalisation arrangements.

The main focus of the meetings was agreeing the terms of the recapitalisation agreement to be struck with each of the banks, in the context of the broader package of measures announced by the Treasury on 8 October 2009 (including the implementation of the Credit Guarantee Scheme and the liquidity measures to be taken by the Bank of England). However, during the meetings Paul Myners made clear to those attending from the banks, including RBS, that in relation to departing directors there should be no rewards for failure, that payments to departing directors should be minimised but that the Government did not expect the banks to break existing contracts.

I was present at a meeting on the evening of Saturday 11 October between the Treasury and RBS starting at 17.00 at which a range of matters concerning the recapitalisation were discussed. During this meeting, Paul Myners told the RBS representatives present, who included Sir Tom McKillop, Sir Fred Goodwin and Bob Scott, that there should be no bonuses paid to directors for 2008–09. The RBS side confirmed that there were no contractually agreed bonuses for directors in respect of this period. Paul Myners also said that the Board should review the remuneration structure for the future, and that it should have regard to risk; that there should be no rewards for failure; and that going forward contracts should provide for the situation where a board member underperforms. There was also mention of a specific issue of a bonus pool in the Global Banking and Markets division, for which RBS had accrued £1 billion or more. Paul Myners also said that going forward the Government would need to be involved in major decisions, to be discussed.

There was then a smaller meeting attended by Sir Tom McKillop and Bob Scott of RBS, Paul Myners and myself. In a discussion between Treasury officials, Paul Myners and myself, I was asked to attend this smaller meeting in order to ensure that Paul Myners did not attend the meeting unaccompanied. At this smaller meeting, RBS reported on some proposed changes to the Board and their senior executive team. This

[2] Not printed.

was the only meeting at which I was present when the specific question of the departure of Sir Fred Goodwin was discussed. On this point RBS said that it had been the unanimous view of the Board before the rights issue that Sir Fred Goodwin was the best person to lead the ABN-Amro integration. Bob Scott went on to say that they had come to the conclusion unanimously that RBS must part company with Sir Fred Goodwin. He said that Sir Fred Goodwin knew that he was going and that the Nominations Committee had convened and considered options. He added that it would be necessary for Sir Fred Goodwin to continue for a short period.

Paul Myners said RBS should put it to Sir Fred Goodwin that he should make a gesture in relation to his compensation terms. Bob Scott said that they would endeavour to get Sir Fred Goodwin to agree to this, but indicated that Sir Fred Goodwin was not the sort of person to give things up, adding that it had taken a long time to agree terms in relation to his service contract. Bob Scott told Paul Myners that Sir Fred Goodwin's pension number would be "enormous" but no number or further details about the pension were given. In particular, neither Sir Tom McKillop nor Bob Scott indicated at any stage that they envisaged exercising a discretion that would increase Sir Fred Goodwin's pension. Bob Scott then explained that Sir Fred Goodwin was on one year's contractual notice. Paul Myners said that he would be expected to mitigate his loss and that it would be a good gesture for him to forego any compensation.

This smaller meeting lasted about 15 minutes, being followed very shortly by meetings with HBOS starting at 18.50 and Lloyds starting at 20.15.

This note reflects my contemporaneous manuscript notes and my recollection relating to the discussion that I witnessed concerning Sir Fred Goodwin's pension on 11 October 2008.

Charles Randell
Slaughter and May

10 March 2009

Memorandum from Credit Suisse

1. Credit Suisse is pleased to submit evidence to the Committee's inquiry into the banking crisis. We have focussed our response on the specific questions outlined in the Committee's request.

2. As one of the world's leading banks, Credit Suisse provides its clients with private banking, investment banking and asset management services worldwide. Credit Suisse offers advisory services, comprehensive solutions and innovative products to companies, institutional clients and high-net-worth private clients globally, as well as retail clients in Switzerland. Credit Suisse is active in over 50 countries and employs approximately 47,800 people. Credit Suisse is comprised of a number of legal entities around the world and is headquartered in Zurich. The registered shares (CSGN) of Credit Suisse's parent company, Credit Suisse Group AG, are listed in Switzerland and, in the form of American Depositary Shares (CS), in New York. Further information about Credit Suisse can be found at www.credit-suisse.com.

Background Information

How rapidly did your bank grow from 1997? And for the 10 years before that?

3. The main growth period for Credit Suisse was prior to 1997. Between 1997 and 2007 the growth in the bank's revenues was 89% and the growth in assets was 97%. Credit Suisse financial statements were only prepared on a consolidated basis from 1989; during the eight year period until 1997, revenues grew by 422% and assets grew by 401%.

4. We would note that the financial statements for 1989 and 1997 were prepared under Swiss GAAP (Generally Agreed Accounting Principles) but in 2007 they were prepared under US GAAP. The growth rates include a number of significant acquisitions and disposals, which took place during the periods in question.

What happened to holdings of British government securities over the two periods?

5. Credit Suisse is a global bank headquartered in Zurich and accesses liquidity primarily via the US and Swiss markets. Our holdings of UK treasuries have, as a consequence, not been significant but are reported to the Bank of England on a monthly basis.

How did tier one and two capital ratios change over both these periods?

6. Please see Annex A for details (pp.11–12).

What happened to the size of investment banking relative to "high street" banking over the two periods?

7. Credit Suisse does not have a "high street" banking presence in the UK. We only have a retail presence in Switzerland.

What share of business was domestic at the beginning and end of each period?

8. In 1997, Swiss domestic revenues were 41% compared to 30% in 2007. The Swiss domestic revenue as a percentage of total revenues is unavailable before this date.

Are investment banks as crucial to the functioning of the economy as commercial banks are?

9. In today's highly integrated global financial system, investment banking is a vital complement to the activities of commercial banks.

10. Investment banking has three main functions:

1. Making markets (price discovery) and providing secondary market liquidity to asset and liability managers (eg pension funds, insurance companies, mutual funds on the asset side; companies, governments on the liability side).
2. Raising new debt and equity capital for companies, governments, government agencies and supranational institutions.
3. Providing advice to companies (and sometimes governments) on corporate strategy, asset sales and purchases, as well as mergers and acquisitions.

11. There are important linkages between these functions: for example, the absence of a liquid secondary market for government or corporate debt, or for equities, would substantially reduce the ability of governments or companies to raise new capital, and substantially increase its cost. Equally, corporate strategy often critically depends on the availability and cost of debt or equity capital.

Consumers

12. Credit Suisse has a limited personal customer base in the UK and accordingly has no particular insight into the consumer related questions set out in the request for evidence.

Risk Management

How do you control the risks in your organisation?

— *How many items are there on your risk register?*

— *How often is your risk register reviewed and by whom?*

— *Was "collapse of wholesale markets" on your risk register as a potential risk and what were your mitigating controls?*

— *What improvements do you think are required to risk control frameworks in the banking industry?*

— *How many FTE staff posts do you have devoted to risk management, both as a number, and proportion of total staff?*

13. Risks in Credit Suisse are controlled through an appropriate risk management framework, based on transparency, management accountability and independent oversight. There are three key components: risk governance, risk organisation, and risk control. The risk management framework reflects the specific nature of the various risks in order to ensure that they are managed within limits set in a transparent and timely manner: for example, overall risk limits are set by the Board of Directors and its Risk Committee. There are other senior management level committees to support risk management, for example, to approve standards regarding risk management and risk measurement methodologies and parameters.

14. The Chief Risk Officer area is responsible for risk management oversight and for establishing an organisation to manage all risk management matters. In addition, a sound system of risk limits is fundamental to effective risk management; these limits define our maximum exposure given the market environment, business strategy and financial resources available to absorb losses.

15. A variety of risk management reports, covering all the risk types (eg market risk, credit risk, operational risk, and liquidity risk) are produced regularly (eg daily, weekly, monthly or ad hoc dependent on the type of risk) and reviewed by risk specialists and senior management.

16. Any enhancements to risk control frameworks in the banking industry should focus on the following: ensuring appropriate risk governance and oversight of the business; ensuring risk organisations are appropriately set up with experienced staff who have the authority to challenge the business; and ensuring there is appropriate transparency and controls around the risks being managed (eg through having a variety of risk measures and reports and a complete set of risk limits).

17. For the Credit Suisse Group, staff in the Chief Risk Officer area represent approximately 3% of the total FTE of Credit Suisse.

18. Credit Suisse has two Risk Officers on the Executive Board of Credit Suisse, reporting to the CEO of the bank.

Did you stress-test your balance sheet against a scenario where the wholesale funding markets closed down?

19. Our liquidity stress-testing assessed the impact on the bank's funding profile in the event that the unsecured wholesale funding markets became unavailable to us and we were unable to roll over funding of this nature at maturity. In addition, we stressed for a reduction in the availability of secured wholesale funding markets by modelling the implications of a two notch Credit Rating downgrade impacting the bank. We did not model for a complete close down in the secured funding wholesale markets.

20. We consider that our conservative funding strategy has enabled us to be well-positioned to weather the market disruption since August 2007. During the stressed market conditions we have continued to maintain a strong liquidity position, comprising high quality assets, cash balances with Central Banks, and term funding.

Should there be a special insolvency regime for investment banks as there soon will be for commercial banks?

— *Would this prevent post Lehman-type problems?*

21. From the perspective of a dealer in the wholesale markets, it is desirable that the insolvency regimes for "commercial banks" and "investment banks" should be consistent (so far as is practicable) although we recognise the interests of depositors in the former case may necessitate a difference of treatment. It is also important that national insolvency regimes are aligned globally.

22. In our view, it is the facts not the applicable law that are significant in the Lehman matter. Lehman had entered into a large number of complex legal and financial relationships. It is inevitable that understanding and discharging the related duties would take a significant amount of time.

Narrow Banks

Do investment banks make natural partners for retail banks or is the culture too different?

23. There are many reasons why such a partnership can be advantageous, including:

- Increased ability to serve sophisticated clients.
- Improved delivery capabilities, eg the ability to execute client transactions in the areas of FX and brokerage.
- Facilitated international expansion, eg the presence of investment banking can facilitate the establishment of onshore business.
- Increased resilience to economic downturns, eg through diversification of revenue streams: investment banking and retail banking earnings cycles tend to be countercyclical and hence buffer any negative impact on capital.
- Robust funding structure.

Credit Suisse remains committed to the integrated model (Investment Banking, Private Banking, and Asset Management) which we believe enables us to most effectively deliver best-in-class service to our clients while realising enhanced operating efficiencies. Credit Suisse only has retail banking in Switzerland, but Investment Banking and Private Banking work well together.

What are the strongest reasons both for and against the separation of traditional, narrow banking activities from riskier trading and investment banking activities by your organisations?

24. The market events of the past months have shown that traditional narrow banking activities are not necessarily less risky than investment banking activities (eg as in the cases of Northern Rock, Alliance & Leicester, and Bradford & Bingley).

25. Some degree of operational separation, for example, in terms of organisation, governance and control, is meaningful:

— Performance management: in addition to bank-wide key performance indicators, Credit Suisse has set division-specific key performance indicators to ensure the implementation of our strategy.

— Capital and risk management: Credit Suisse systematically monitors and develops individual businesses based on through-the-cycle risk/return goals. This enables the bank to earn competitive returns based on business specific hurdle rates, preventing cross subsidies.

26. At the same time, there are strong commonalities or synergies that support an integrated approach, for example:

— Revenue synergies: seizing collaboration revenues.

— Economies of scale in the area of purchasing, centralising shared services functions, running shared platforms (eg IT infrastructure or research capabilities).

— Knowledge synergies: actively leveraging expertise between businesses.

— Diversity of business model: diversity of funding is recognised as a vital component of liquidity risk management.

Remuneration

What was the share of bonuses in total remuneration 20, 10 and one year ago?

27. The information requested is not readily available due to the numerous and significant organisational changes within Credit Suisse over the last two decades. These changes significantly impact our ability to report accurate, like-for-like compensation analyses going back several years.

28. For 2008, variable compensation paid as unrestricted cash was down over 60% compared to 2007. The actual year-on-year decrease in compensation varied according to business area and seniority. The decline was more pronounced for senior employees than for junior employees. Overall variable compensation, which includes unrestricted cash and retention payments, declined 44% compared to the prior year.

Why do investment banks pay bonuses as a large part of take-home pay when no other type of firm does?

29. Credit Suisse operates in an industry where the success of our business revolves around people, not capital (as is the case with many other industries). Credit Suisse, like most financial services companies, is heavily reliant on technical skills and competence in a wide range of disciplines unique to this business, many of which are in scarce supply in the market place. A large majority of roles performed are often complex both in nature and scope. Credit Suisse compensation structures therefore need to be able to facilitate remuneration of key staff accordingly in order to protect this talent. This is done within the context of Credit Suisse financial performance and a detailed understanding of the market data norms for each particular skill-set.

How are these bonuses structured within your firm?

Why do they have this structure?

30. Credit Suisse wants to ensure that we pay our employees fairly in the context of individual and bank performance, both in terms of the level of compensation and the instruments we use. We also have to strike the right balance between the interests of our shareholders and our employees.

31. This is a challenging task; however, we have done our best to accomplish these goals by introducing a new structure for variable compensation for 2008.

32. The Credit Suisse compensation structure is addressed in terms of performance, and the main compensation components of our plans:

33. Performance Measurements: The setting of variable compensation for an individual employee in the UK (irrespective of level) is based on a range of performance measurements such as bank performance, divisional performance, departmental performance and/or individual performance. Additionally, individual employee performance is measured not only on achievement of contribution but also success in achievement of both competency objectives (eg people leadership, ethics and control) and compliance with the principles outlined in the Credit Suisse Code of Conduct.

34. Main Compensation Components: In 2008 our main compensation components were:

— Base Salary.

— Cash Retention Award (CRA).

— Incentive Share Units (ISUs).

— Partner Asset Facility (PAF).

— Proprietary Trading Plan (PTP).

Further details of these components are captured in Annex B (pp.13–14).

35. We believe the structure outlined above is a prudent and constructive approach, which reflects the performance of individuals and the bank, and at the same time, more closely aligns the interests of employees with those of shareholders.

Securitisation and Complex Products

What proportion of securitised investments do you keep on your own books? How has this proportion changed in the past ten years?

36. Until the market for securitised products reached a standstill mid-2007, the Credit Suisse business model was not to hold any securitised products on our books. However, we are left with some legacy positions, which the relevant businesses are currently focussed on winding down.

When you sell products on, do you consider whether they are suitable for and fully understood by your clients? If not, why not? If yes, give examples

37. Credit Suisse has policies and procedures in place relating to suitability in accordance with FSA rules. Examples covered in the policies and procedures include:

38. Suitability Assessment

A requirement that a suitability assessment should be undertaken before any personal recommendation is provided to a client. To be considered suitable, the proposed personal recommendation must:

- meet the client's investment objectives and risk profile;
- be such that the client appears reasonably able to financially bear the investment risks involved given their financial status; and
- be such that the client has the necessary knowledge and experience to understand the risks involved in the product.

In order to properly assess suitability the following information is obtained:

- knowledge and experience of the client in the product or service to be provided;
- financial situation of the client; and
- investment objectives of the client.

Personal recommendations should not be provided to a client (or a decision made to trade for a client) if:

- the information required to conduct the suitability assessment could not be gathered from the client; or
- having carried out a suitability assessment it is determined not to be suitable for the client.

A personal recommendation for these purposes is any specific recommendation of a product or service provided to a client based on a consideration of the specific circumstances of that client.

39. Appropriateness Assessment

A requirement that an appropriateness assessment should be undertaken before executing an unsolicited order for a retail/private client in a complex product (eg derivatives, structured products, hedge funds). Client initiated transactions are deemed appropriate if it can be demonstrated that the client understands the nature of and risks involved in the transaction. If the transaction is not deemed to be appropriate or insufficient information has been obtained from the client to make the appropriateness assessment then the client is provided with a risk warning that the transaction is not appropriate or adequate information has not been provided to make an appropriateness assessment.

Appropriateness requirements generally do not apply to non-complex products or to institutional/professional clients as it is assumed that such clients have the necessary knowledge and experience in order to understand the risks involved.

40. Product Development and Approval

Those designing or creating products for distribution to retail/private clients are required to consider the overall suitability and appropriateness of the product for the target market.

Management and Ownership Structure of Investment Banks

What is the role of non-executive directors in an investment bank?

41. Credit Suisse is not only an investment bank, but also provides its clients with private banking and asset management services worldwide, as well as serving retail clients in Switzerland.

We expect directors who act in a non-executive capacity to:

— be independent in judgement, have an enquiring mind, challenge executive directors and business managers constructively, and help develop proposals on strategy;

— scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance; satisfying themselves on the integrity of financial information and that financial controls and systems of risk management are robust and effective;

— be well-informed about the company and the external environment in which it operates, with a good command of issues relevant to the business notably in relation to complex financial products and the company's risk management and legal and compliance framework; and

— uphold the highest ethical standards of integrity and probity and promote the highest standards of corporate governance.

Investment banks were once partnerships. Why did this change?

42. Investment banks were partnerships in the past because their activities did not require significant amounts of capital. Prior to "Big Bang", they were not market makers in securities and their underwriting commitments in both debt and equity were syndicated away rapidly. This changed as their requirements for capital changed. As financial markets became more international, investment banks needed capital to finance expansion. They also needed it to finance securities trading after "Big Bang" and to enable them to take on the increasingly large underwritings of debt and equity which their clients required.

The FSA

How would you describe your engagement with the FSA before the current crisis?

43. Credit Suisse maintained a high level of engagement with the FSA before the current crisis. Engagement with the FSA at this time was in line with the regulator's standard industry supervision methods, namely Close & Continuous supervisory meetings, ARROW Risk Review Visits as well as Credit Suisse participation in the industry wide thematic reviews that the FSA conducts eg Regional Governance.

Did the FSA ever express concerns to you about your business models, or request a slow-down in lending?

44. No.

How has your interaction with the FSA changed since the crisis at Northern Rock?

45. Due to the size of Credit Suisse we have always had a dedicated supervisory representative at the FSA. Since the Northern Rock crisis this team has grown in line with the increase in regulatory initiatives and queries.

46. Interaction with the FSA has increased since the Northern Rock crisis due to the general enhancement of the FSA's Close & Continuous Supervisory Schedule, which the FSA launched in May 2008. This has increased the frequency of Market, Credit and Liquidity risk meetings.

One of the features of the FSA's supervisory enhancement programme is that "there will be raised emphasis on assessing the competence of firms' senior management". Have you seen any evidence of that?

47. The FSA has instigated a regular meeting programme with the Senior Regional Management of the bank in order to obtain a strategic overview of the bank's business plans. The FSA has also recently begun to interview key Significant Influence Function appointees to ensure their suitability.

The Future of Banking

Do you consider pro-cyclicality of capital requirements to be a problem?

48. We define pro-cyclicality as the general reduction in capital ratios at the time of market disruption or economic downturn. Pro-cyclicality has been an area for discussion amongst regulators, banks and academics given the implied relationship that if capital ratios fall then institutions are likely to reduce or curtail their risk taking activities, particularly in respect of advancing credit.

49. The points that we would note on pro-cyclicality are:

— It is not a new phenomenon, as losses incurred (eg from credit impairments or trading losses) have always reduced capital ratios.

— Under newer capital rules (typically referred to as 'Basel II') pro-cyclicality is somewhat increased given that capital ratios can increase owing to credit downgrades, not just impairments; as is well known, the Basel II rules for credit assets were amended during the final design stage to mitigate some of this effect.

— Reflecting on the past two years the larger drivers of reductions in capital ratios have often been losses on trading book assets (typically via mark-to-market processes) or increased trading book capital under the Value at Risk models regime (which dates from 1996 and has not fundamentally changed under Basel II) via capturing new risk types or updating the time series of market prices.

— Overall, we see capital ratios as fairly pro-cyclical, though the largest impacts affecting Credit Suisse stem from trading style assets rather than regular credit assets.

— It is somewhat less clear whether the pro-cyclical impacts on capital ratios are a problem or not. At times of extreme market movements, increased capital ratios can be a way of ensuring orderly trading with counterparties and differentiating ones position in the market place. These positive points have to be set against the potential negatives highlighted above.

Andrew Crockett, former general manager of the Bank for International Settlements, has suggested that it would be advantageous for higher capital ratios to be imposed on institutions that were more reliant on short-term funding. Do you agree?

50. It has always been our philosophy that banks should be well capitalised and have adequate liquidity as twin pillars underpinning their operations. Capital and liquidity are somewhat different in nature and, as has been seen over the last 20 months, inadequacies in one are not easily compensated by buffers in the other. Given this we broadly support the current regulatory change agenda of improved calibration of capital charges as well as enhanced liquidity practices.

The FSA has brought forward proposals on liquidity regulation, including an Individual Liquidity Assessment and a "liquidity buffer" specific to each firm. Are you confident that their proposals amount to an effective way to assess and limit the liquidity risks which individual institutions face?

51. We consider that the proposals on liquidity supervision in the FSA Consultation Paper on "Strengthening Liquidity Standards" represent a material enhancement to the supervision of liquidity for UK firms and will bring liquidity supervision to a more comparable standard to solvency and capital supervision.

52. The principles in the Consultation Paper are broadly consistent with the Basel Committee for Banking Supervision (BCBS) "Principles for Sound Liquidity Risk Management and Supervision". They will form an effective approach to enhancing liquidity risk management within UK firms and will provide a sound framework for measuring and mitigating liquidity risk.

53. In our response to the FSA we have urged for greater international cooperation and progress on liquidity management both via the BCBS working group and bi-laterally between the FSA and home state supervisors for internationally active groups operating in the UK.

Paul Tucker and Charlie Bean have both suggested that the Bank of England should have some kind of macro-prudential risk instrument to guard against sector-wide risks. What form do you think such an instrument could reasonably take?

54. There is a need for macro-prudential data to be gathered and communicated efficiently between relevant authorities so that supervisors are aware of systemic risks. We would suggest there should be effective global coordination of centralised macro-information gathering from local and regional sources and analysis at global level by International Monetary Fund and the Financial Stability Forum.

How far do you agree with John Moulton that "Supervision and regulation will only work if it is within the capabilities of the people involved to actually discharge those duties"?

55. We agree that those responsible for supervision and regulation should be fully capable of discharging these duties.

Do you think that the FSA can properly regulate you as you are currently configured?

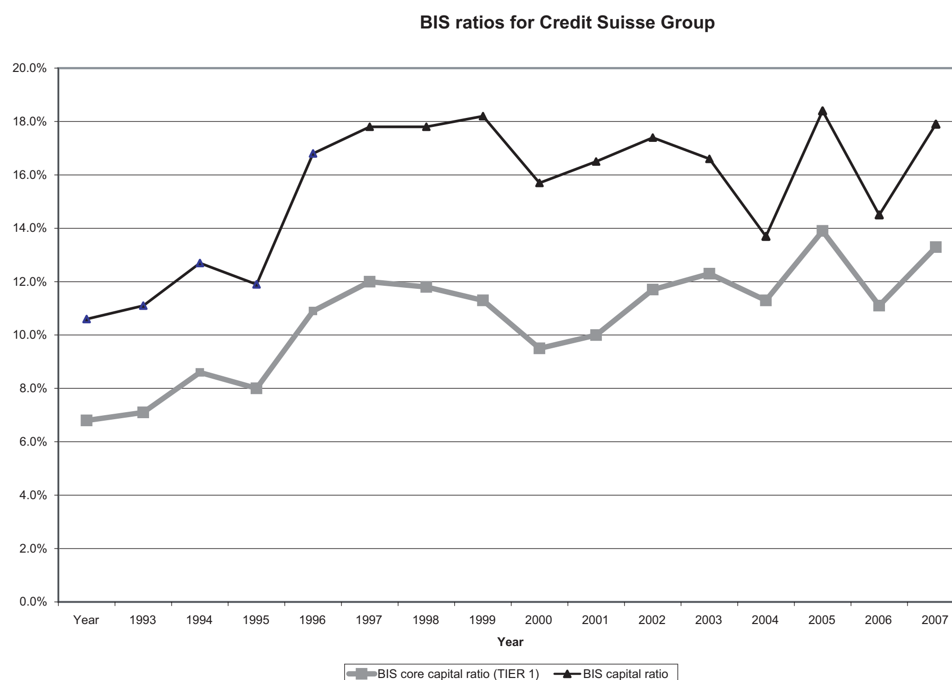
56. Credit Suisse fully supports the regulatory college of FINMA/FSA/FED and believe that increased collaboration between regulators will lead to improvements in the way that Credit Suisse is regulated and reduce the potential duplication of regulatory initiatives.

Annex A

BIS RATIOS TIME SERIES

Year	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*
BIS core capital ratio (TIER 1)	6.8%	7.1%	8.6%	8.0%	10.9%	12.0%	11.8%	11.3%	9.5%	10.0%	11.7%	12.3%	11.3%	13.9%	11.1%	13.3%
BIS capital ratio	10.6%	11.1%	12.7%	11.9%	16.8%	17.8%	17.8%	18.2%	15.7%	16.5%	17.4%	16.6%	13.7%	18.4%	14.5%	17.9%
Corporate structure:	CS Holding Group				Credit Suisse Group											
Accounting standard:	Swiss-GAAP											US-GAAP				
BIS Framework:	Basel I															Basel 2

Notes:
° Swiss regulatory capital adequacy rules were aligned with BIS framework, effective as of Feb 1, 1995
° Ratios 1994 and 1993 are pro forma
° No BIS ratios available prior to 1993



Annex B

MAIN COMPENSATION COMPONENTS

Base Salary

Base salaries are local to the specific market in which employees operate. These are reviewed on an annual basis on a country by country level.

Cash Retention Award (CRA)

All employees with a corporate title of Managing Director or above together with all Directors in the Investment Bank received the cash element of calendar year 2008 variable compensation in the form of the Cash Retention Award (CRA). Directors in all other divisions had any cash element of variable compensation over CHF 300,000 (or the local currency equivalent) granted as CRAs.

The cash element of variable compensation granted in CRAs results in recipients receiving cash at the time a regular cash bonus would be received, however, some or all of the payments can be reclaimed from the employee in the event that the employee voluntarily resigns, is terminated for Cause or engages in a Restricted Activity. CRAs vest at the rate of 1/24th of the award each completed month from the date of grant.

All employees who fell below the thresholds above and who received variable compensation would have received either a normal cash payment or normal cash payment and ISUs (where applicable).

Incentive Share Units (ISUs)

This plan works on awarding a proportion of variable compensation into the Credit Suisse Master Share Plan. All titles are eligible excluding Analysts. Allocations are applicable on variable compensation at or in excess of CHF 125,000, USD 100,000 or the local currency equivalent.

Levels of equity awards issued to employees depend on the size of variable compensation; the greater the variable compensation the greater the level of equity.

Each ISU will deliver a minimum of one Credit Suisse Group (CSG) share over a three year period subject to compliance with the terms of the share plan, which include forfeiture provisions in events such as termination for cause, resignation, etc. Additional shares may be delivered based on CSG share price performance metrics in year three these metrics being the average share price over the three years and the final share price near the time of settlement.

Partner Asset Facility (PAF)

Partner Asset Facility (PAF) units are a new form of award that compensates employees with an equity-interest in assets that originated in the Investment Banking division. The PAF units will be linked to the performance of a pool of illiquid assets.

Managing Directors and Directors in the Investment Bank who received variable compensation for calendar year 2008 of CHF125,000 (or local currency equivalent) or more, received a portion of this compensation in the form of awards under the Share Plan. The majority of their Share Plan Awards were in the form of PAF Units and the balance in the form of Incentive Share Units.

The equity deferral is effectively used to purchase equity in a pool of assets on a leveraged basis. Holders of PAF Units would receive interest payments calculated on the outstanding notional award based on LIBOR plus 250 basis points semi annually. From the fifth year, it is anticipated that a portion of the notional award will be paid, subject to a net asset value limitation, each year. During the eighth year the net asset value remaining of the pool of assets will be distributed.

Proprietary Trading Plan (PTP)

Similar to previous years, select members of the Proprietary Trading group also had a portion of their 2008 variable compensation linked directly to the future performance of the Proprietary Trading group.

These employees are subject to the standard amount of equity allocation consistent with all other eligible employees. However, 40% of their allocation is granted as ISUs, 40% in a deferral linked to the Proprietary Trading sub-group which the employee works in, and 20% linked to the consolidated Proprietary Trading group overall.

Proprietary Trading Plan awards are maintained as cash balances that are credited with a return based on the ROE of the sub-group and programme for each year.

Trading losses in subsequent years result in a portion of the loss being clawed back from the balances in the Proprietary Trading plan. Payout of the plan occurs following the third anniversary of grant.

March 2009

Memorandum from Goldman Sachs International

Goldman Sachs International ("GSI") is pleased to provide our views on The Treasury Select Committee's banking crisis inquiry questions. The perspective provided by us is intended to contribute constructively to your work to restore confidence in markets and financial institutions, and to revive credit and investment flows to the economy.

GSI is an English-incorporated and FSA-regulated investment bank which forms part of the group ("Goldman Sachs" or the "firm") of which The Goldman Sachs, Group Inc. ("GS Group") is the parent. GS Group is a bank holding company regulated by the Board of Governors of the Federal Reserve System, and is a leading global investment banking, securities and investment management firm. The firm provides a wide range of services worldwide to a substantial and diversified client base that is predominantly institutional—corporations, financial institutions, governments—and includes high net worth individuals. Goldman Sachs does not have a direct retail client base and has only limited dealings with retail customers.

Founded in 1869, Goldman Sachs is headquartered in New York and maintains offices in major financial centres including London, Frankfurt, Tokyo and Hong Kong. Our three core businesses are Investment Banking (financial advisory and underwriting services), Trading and Principal Investments (market making in, and trading of, fixed income and equity products, currencies, commodities and derivatives, and merchant banking), and Asset Management and Securities Services (advisory and financial planning services, prime brokerage, financing services, and securities lending services).

1. Investment Banks and Commercial Banks

1.1 We note your questions regarding differences between commercial banking and investment banking. We would observe that, as a practical matter, the distinction often drawn between the investment banking model and the commercial banking model has become blurred, given the evolution of banking and finance over the past fifty years. While there are differences in individual financial firms' business models, the businesses of virtually all large, integrated financial intermediaries overlap. Their core activities include classic financial intermediation, lending, market making, advisory services and underwriting securities. While the term "investment bank" is often associated with firms like Goldman Sachs, it is a fact that many commercial or universal banks have significant business units engaged in the investment banking business. An important distinction between Goldman Sachs and most of the universal and commercial banks is that Goldman Sachs' business is predominantly in the wholesale/institutional markets, whereas the large universal and commercial banks have large retail businesses and client bases.

1.2 Investment and commercial banks through their investment banking businesses play a critical role in the financial and economic systems. Goldman Sachs and other banks are active market makers across a wide range of financial products and instruments. Market making is core to the functioning of markets. It is critical to the provision of liquidity and to the price discovery process, both of which are central to the workings of the financial system as a whole and to the global process of mobilizing savings and allocating those savings to the best possible use consistent with economic growth and rising standards of living.

1.3 In addition, we believe that robust lending activity and capital markets activity are vitally important to the economy. Businesses, financial institutions and the economy in general rely on a number of financing sources: equity, deposits, bank loans, corporate bond issuance and securitization (among others). The mix of these sources differs between countries and has changed over time. We set out below a series of charts which illustrate a number of these points.

1.4 It is clear that the volume and value of deposits in the banking system is not sufficient to meet all funding needs:

Exhibit 1

EUROZONE COUNTRIES AND UK LOANS AND DEPOSITS (EURO BILLIONS)

EUR'bn		*Loans Dec-08*	*Deposits Dec-08*	*GDP 2007*
1	Germany	2,529	2,823	2,424
2	France	1,943	1,514	1,892
3	Spain	1,897	1,622	1,050
4	Italy	1,558	1,127	1,536
5	Netherlands	969	783	560
6	Denmark	499	162	228
7	Ireland	393	217	186
8	Sweden	364	163	332
9	Austria	326	288	273
10	Belgium	313	444	331
11	Portugal	271	197	163
12	Greece	201	233	229
13	Finland	155	108	179
14	Luxembourg	142	209	36
15	UK	2,730	2,374	2,024
	Average	14,291	12,265	13,447

Source: ECB (Loans, Deposits), GDP (Eurostat)

1.5 Exhibit 1 above shows a financing gap (loans minus deposits) of Euro 356 billion for the UK and Euro 1.7 trillion for the Euro area countries.

1.6 Businesses in different countries have used differing mixes of capital. Exhibits 2 and 3 demonstrate that the UK has relied much more heavily on bonds than other major European countries and that in 2007, the latest year for which OECD data is available, loans (a traditional commercial banking product) and bonds (an investment banking product) constituted approximately equal percentages of total financing sources.

Exhibit 2

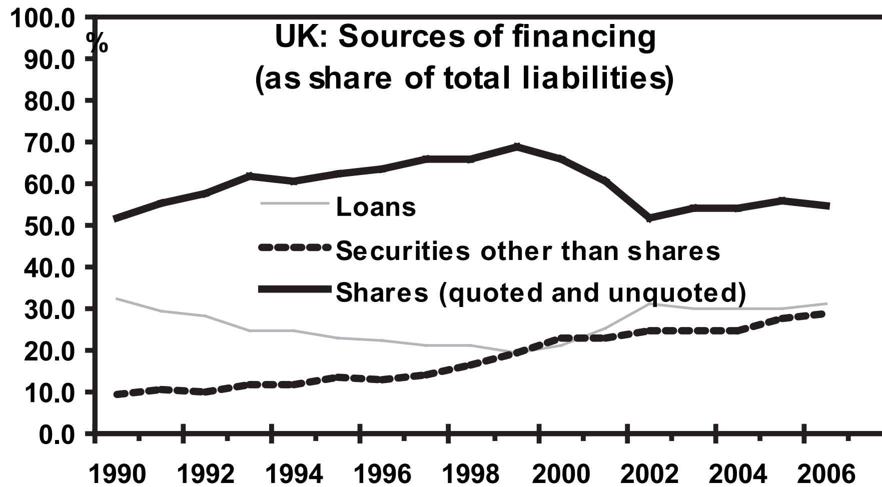
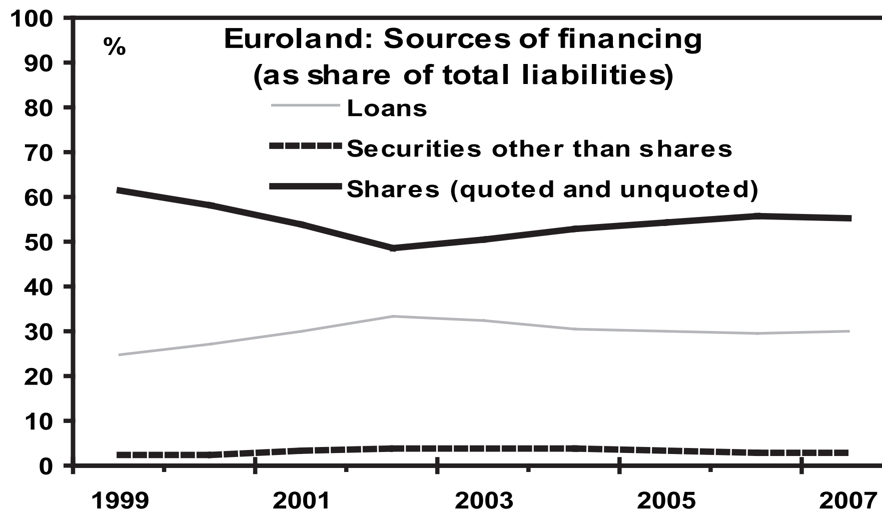
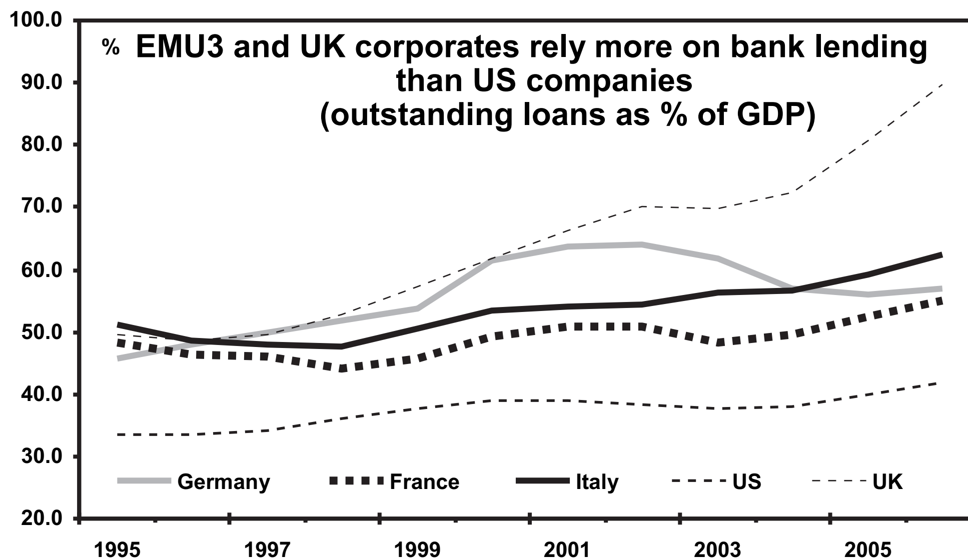


Exhibit 3



1.7 The proportion of credit provided in Europe by capital markets instruments has been growing since the introduction of the euro. However, capital markets instruments do not play as large a role in the Euro area as in the US (though this varies considerably by country).

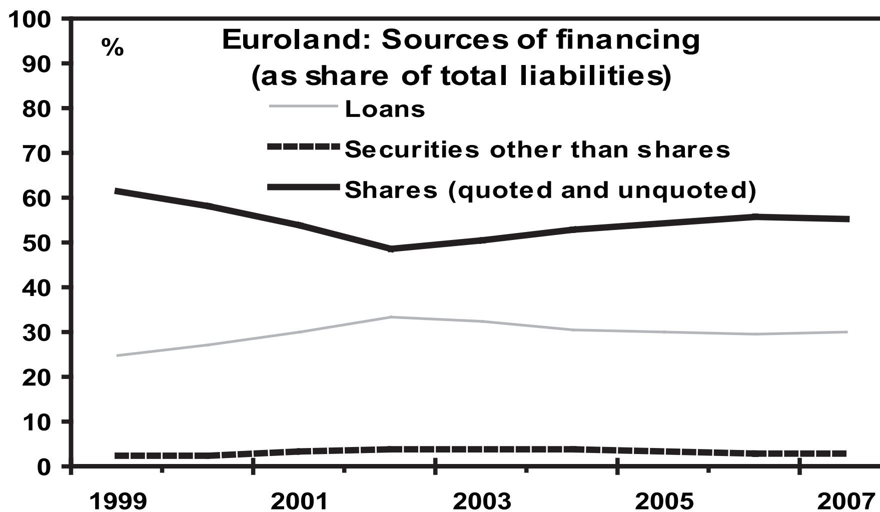
Exhibit 4



Source: OECD

1.8 Even though bank lending has been more important to UK and European companies than bond issuance, the absolute amount of bond issuance has increased over the last decade and has been strong for higher credit-quality companies in the last few months.

Exhibit 5



Source: OECD

1.9 Our economic research analysts believe that the importance of bonds will likely increase as a result of the banking crisis, because the costs of commercial bank lending will rise. Bank lending would become more expensive to the extent that (1) banks need to meet higher capital ratios, (2) wholesale funding costs for banks is higher (if they are perceived as less stable/more risky by investors), and (3) the cost of equity for banks increases. Given that these three factors are key "inputs" in pricing a loan, banks may demand higher lending rates. These factors will apply to a lesser degree to corporate bonds, and therefore bonds may become more attractive as a financing source.

1.10 The great majority of equity and debt origination is facilitated by financial intermediaries. Wholesale funding is a critical component of the operation of the financial services industry, and loan growth has exceeded deposit growth over the last 30 years. Financial intermediation plays a central role in facilitating the raising of both equity and debt capital, providing liquidity in secondary markets and transferring credit risk. This (1) has allowed for the efficient transfer of risk between lenders and investors, (2) has contributed to improved market efficiency in pricing credit, and (3) has enabled better diversification of portfolios by enabling a wider range of techniques for risk management. We believe that this improved ability for lenders to both price and transfer risk has been central to the improved flow of credit to a broader range of borrowers than would otherwise have been possible.

1.11 Financial intermediation activity also plays a central role in the origination, structuring and trading of securitized credit which in turn is critical for the provision of credit to the broader economy. In our view, restoring the normal functioning of securitization markets is a fundamental step in restoring the flow of credit to both consumers and companies because, if financial institutions cannot securitize credit that they extend, their ability to extend additional credit will be constrained.

2. Goldman Sachs—Business and Background

2.1 Goldman Sachs was a private partnership for over one hundred years and became a public company in 1999 when it listed on the New York Stock Exchange. A number of factors played a part in that decision, many of which would be applicable not only to investment banks but also for non-financial companies. The factors considered include the following:

- the relative ease of raising capital as a public company (both at the initial public offering and thereafter);
- the need to be better capitalized in order to execute the increasingly large and global transactions being undertaken by clients;
- the market's desire to transact with entities with permanent capital (rather than partnership capital which could be withdrawn by partners on retirement);
- the flexibility given by having shares which could be used as an "acquisition currency" in an industry which was growing fast and consolidating;
- the need to compete with other financial institutions which could point to their better capitalization; and
- the ability to incentivise all employees by granting rights to shares which could be exercised over time.

2.2 Investment banks take many different forms with differing mixes of businesses. Some investment banks only carry out advisory work and have limited capital requirements. It is possible to imagine that these advisors might elect to remain, or revert to, partnership form. However, we do not believe it is feasible for diversified financial firms undertaking a wide range of risk taking and advisory activities, in light of their size and capital needs, to revert to a "pure" advisory role in partnership form. We would observe that many of these institutions, including ourselves, never had a "pure" advisory role; they were always risk takers as underwriters and market makers.

2.3 A large majority of the most established investment banks offer a wide range of activities, including market making, block positioning, underwriting, lending and other financial services. Banks engage in these and other activities to meet the needs of their clients. We believe that the efficient operation of the capital markets require large, well-capitalised investment banks which have the execution capabilities, risk management skills and depth of capital to support the size of transactions in today's markets. For example, it is inconceivable that any number of advisory-only, partnership investment banks could have carried out the rights issues that have been launched over the past few months.

2.4 As shown below, our firm has grown considerably during the last two decades. Higher growth in the last 10 years or so has coincided with largely benign markets and the firm's increasing international footprint. We have also included the eleven year period from 1997 to show the effect of last year's extreme conditions. As GS Group converted from a partnership into a public company in 1999, the figures before and after 1997 are not entirely comparable. Even allowing for this fact, however, it is notable that shareholders' equity and long-term borrowings have at least kept pace with other measures of growth.

($bn)	*1997*	*2008*	*CAGR*
Net Revenues	7.4	22.2	10%
Total Assets	178.4	884.5	16%
Long Term Borrowings	15.7	168.2	24%
Shareholder's Equity[1]	6.1	64.4	24%
Employees	10,622	30,067	10%

[1]. 1997 represents Partners' capital

($bn)	*1997*	*2007*	*CAGR*
Net Revenues	7.4	46.0	20%
Total Assets	178.4	1,119.8	20%
Long Term Borrowings	15.7	164.2	26%
Shareholder's Equity[1]	6.1	42.8	21%
Employees	10,622	30,522	11%

[1.] 1997 represents Partners' capital

($bn)	*1987*	*1997*	*CAGR*
Net Revenues	2.1	7.4	14%
Total Assets	43.9	178.4	15%
Long Term Borrowings	NA	15.7	NA
Partners' Capital	1.7	6.1	14%
Employees	7,392	10,622	4%

[CAGR is Compound Annual Growth Rate]

2.5 GSI's net position in Gilts represented less than 0.5% of its balance sheet at the end of November, 2008. As of the end of November 2008, securitised investments made up less than 5% of the securities owned by GSI which themselves made up less than 5% of the total trading inventory (ie securities and derivatives positions) of GSI. We would expect that this percentage was smaller in 1997 as the securitisation market has developed substantially during the last ten years. In Goldman Sachs' view, any requirement to retain a proportion of each issue of securitized instruments will not, of itself, guarantee that those instruments are sound (as evidenced by the number of financial institutions which, to their ultimate detriment, held a large proportion of such issuances in the recent past).

2.6 Retention provides no information to investors on the underying risk profile of the assets, or the structure of the transactions, nor does it provide any incentive to disclose such information. It is therefore unlikely to align the underwriting standards of originators with credit quality sought by investors because their desired risk and return profiles will continue to be different. It is also possible that relying on retention could create moral hazard by encouraging investors to rely on the originator's participation in the transaction (rather than their own proper due diligence).

2.7 In situations like the current financial crisis where credit markets are frozen or relatively illiquid, retention of a portion of the securitized instruments could add to the firms' financial strain, which would have further adverse consequences for the wider economy.

2.8 Goldman Sachs believes that financial institutions should take full account of all their liabilities and that securitization activities should be recognized on-balance sheet. In August 2008 the Counterparty Risk Management Policy Group III ("CRMPG") issued its report on "Containing Systemic Risk: The Road to Reform"[3]. The Policy Group endorsed, in principle, the direction in changes to US Generally Accepted Accounting Principles which would lead to many vehicles that currently qualify for off-balance sheet treatment to come onto the balance sheets of sponsoring institutions. Goldman Sachs supports the Policy Group's recommendations in this area, including:

— the adoption of a single, principles-based global consolidation framework that is based on control and the ability to benefit from that control; and

— the consideration by standard setters and industry participants of a holistic and principles-based approach to disclosure of off-balance sheet activities similar to that found in international standards.

2.9 We believe that the enhanced disclosure that would follow from changes in accounting consolidation rules as recommended by CRMPG would go a long way to addressing the concerns around accounting for securitizations because most securitization vehicles would be on balance sheet.

3. Risk Management

3.1 The bedrock of our approach to risk management is framed in the context of the culture and governance of Goldman Sachs and is grounded in our Business Principles. We have a strong firmwide risk control culture which is defined by long-standing, but continuously evolving, firmwide control standards, by the training, supervision and development of our people to identify and escalate issues, by the active participation and commitment of senior management in a continuous process of identifying and mitigating key risks across Goldman Sachs, and by a framework of strong and independent control departments that monitor risk.

[3] Counterparty Risk Management Policy Group III—*Containing Systemic Risk: The Road to Reform*, 6 August 2008.

3.2 In addition, we are firmly convinced that control departments that are fully independent from all revenue-producing business units are critical, and their independence is the core precept of our governance structure. Nowhere is control department independence more important than in regard to such activities as credit appraisal, liquidity appraisal and, very importantly, price verification. By way of example, where personnel in our trading businesses and Controllers disagree about the price for a position on our books, final decision-making always rests with professionals in Controllers.

3.3 Goldman Sachs considers risk management as a core competency for the firm as a whole, and believes that every employee should focus on this issue. Approximately 54% of the firm's employees are engaged in control functions and in areas such as Technology, Operations, Compliance, Legal, Treasury and Credit. Approximately 7.5% of employees work in Market Risk, Credit Risk, Operational Risk, Corporate Treasury and Controllers. We would like to emphasise that the numbers of staff working in risk control functions does not tell the full story. The quality and judgment skills of these individuals; their equivalent status with their counterparts on the trading desks; the emphasis to all employees of their individual responsibility to put clients' interests first and to manage the firm's risk and reputation; the firm's risk management structures and disciplines; and senior management backing and involvement in valuation dispute resolution, all contribute to the firm's culture of prudent risk taking.

3.4 For decades, the successful application of fair value accounting across a variety of markets in different stages of development has been a central tenet of our risk management approach. In our view, the principal benefit of fair value accounting is that, while it involves judgment (as do all accounting models), it comes closer to capturing economic reality than any other approach. Our approach to fair value is supported by robust, independent model validation and price verification processes. Goldman Sachs is one of the few financial institutions in the world that carries all financial instruments held in inventory at fair value, with changes in value reflected immediately in the income statement. The daily marking of positions to current market prices was a key input to Goldman Sachs' decision to reduce risk relatively early in markets and in instruments that were deteriorating. This process can be difficult, and sometimes painful, but we believe it is a discipline that is critical to managing our risk. Fair value accounting promotes rigorous internal risk management because the review by risk managers of our profit and loss account according to fair value invariably leads to a deeper understanding of the sources of risk, by the regular posing of the question, "Do I understand why the profit and loss account and risk have changed?"

3.5 We also believe that fair value provides shareholders with the best possible estimate of current economic value. We remain committed to the fair value model as the best available model but note that there are some fresh efforts being undertaken to develop enhancements to accounting policy and practice. For example, the International Accounting Standards Board announced in June 2008 the formation of an "Advisory Panel of Experts" drawn from preparers and users of financial statements, regulators and auditors to discuss financial instrument valuation. The IASB and U.S. Financial Accounting Standards Board have recently announced a joint project that seeks to improve the recognition and measurement of financial instruments as one of its primary objectives. The CRMPG advocates that under any and all standards of accounting and under any and all market conditions, individual financial institutions must ensure that adequate independent resources are at the centre of the valuation and price verification process and valuation and price verification processes should always pass the tests of reasonableness and consistency, whether positions or instruments have gains or losses.

3.6 The US Securities and Exchange Commission was the first regulator to apply Basel II standards to its regulated entities under the Consolidated Supervised Entity regime, and the firm has been subject to Basel II capital requirements since April 2005. We believe that the Basel II standards, with their approach of incentivizing firms to invest in better risk management systems, are a significant improvement on the crude measures utilized under Basel I. We are generally supportive of the concept of assessing capital requirements through the cycle, and our approach to the internal capital assessment required under Pillar 2 of the Basel II framework is based on stress and scenario tests which are designed to identify changes in capital requirements resulting from severe shocks. These shocks are calibrated to a 1-in-25 year downturn scenario as stipulated by the FSA. More detail on these stress tests can be found in "Credit Risk" and "Market Risk" in paragraphs 3.15 and 3.16 below. It is important that the exact form of each stress tests is not prescribed by regulators because each portfolio will have different characteristics and be subject to downturn conditions at different times. We would be concerned to see counter-cyclical regulatory capital requirements based on methodologies that are automatically applied without discretion or judgment.

3.7 Risk management within Goldman Sachs is undertaken both centrally and at the GSI level. This approach is designed to ensure that GSI, as a regulated entity, understands, measures and manages appropriately the risks that it is taking and that the group as a whole understands, measures and manages risks on a consolidated basis. We describe below the structure which is applicable at both the GS Group and GSI levels.

3.8 Management believes that effective risk management is of primary importance to the success of Goldman Sachs. Accordingly, the firm has a comprehensive risk management process to monitor, evaluate and manage the principal risks we assume in conducting our activities. These risks include market, credit, liquidity, operational, legal and reputational exposures. In addition to a variety of separate but complementary reporting systems, a number of committees are responsible for monitoring risk exposures and for general oversight of our risk management process, as listed further below. These committees

(including their subcommittees) meet regularly and consist of senior members of both our revenue-producing units and departments that are independent of our revenue-producing units. Segregation of duties and management oversight are fundamental elements of our risk management process. In addition to the committees described below, functions that are independent of the revenue-producing units, such as Controllers, Compliance, Finance, Legal, Internal Audit and Operations, perform risk management functions, which include monitoring, analyzing and evaluating risk.

Committees include:

Management Committee

Risk Committee

Business Practices Committee

Capital Committee

Commitments Committee

Credit Policy Committee

Finance Committee

New Products Committee

Operational Risk Committee

Structured Products Committee

3.9 By way of example, our CEO or President frequently attend Risk Committee meetings. Their presence is reflective of the fact that the firm views risk management on an integrated, horizontal and vertical basis such that senior management directly participates in the risk management process. Senior people in London sit on, or in some cases chair or co-chair, each of the above global committees. In addition, there are analogous but separately constituted and coordinated risk management structures at the level of material subsidiaries (of which GSI is the most significant).

3.10 GSI lists the following risk headings in its Internal Capital Adequacy Assessment Process (ICAAP) and Risk Management of Other Risks (RMOR) documents:

Credit Risk

Market Risk

Operational Risk

Residual Risk

Concentration Risk

Securitization Risk

Underwriting Risk

Settlement Risk

Business (Downturn) Risk

Liquidity Risk

Reputational Risk

Strategic Risk

Pension Risk

Equity Awards

3.11 GSI's ICAAP and RMOR documents are updated on an annual basis and reviewed by the GSI Board. For risks that GSI believes require capital, a quarterly numerical internal capital calculation is performed and presented to the GSI Risk Committee.

There are tens of thousands of individual items captured in the firm's internal management reporting, and reviews take place daily at an aggregate level by business heads and risk controllers, and weekly by the Risk Committee, as well as at the highest levels of senior management. The firm's global Sarbanes Oxley review process provides a further means of identifying relevant risks.

3.12 While Goldman Sachs routinely conducts dozens of scenario analyses and stress tests, we did not fully anticipate the extent of the recent collapse of wholesale markets. However, we did recognize the gathering storm clouds and were able in early 2007 to instigate additional risk management initiatives that served the firm well. We expect regularly to revise and update our risk methodologies to take account of market changes and other developments.

3.13 The ICAAP and RMOR documents referenced above describe various stress tests that are run by the firm at varying frequencies. The following risk areas consider stress tests that can be generally described as "wholesale market" stresses.

3.14 *Liquidity Risk*

3.14.1 Liquidity is of critical importance to companies in the financial services sector. Most failures of financial institutions have occurred in large part due to insufficient liquidity resulting from adverse circumstances. Accordingly, Goldman Sachs has in place a comprehensive set of liquidity and funding policies that are intended to maintain significant flexibility to address both Goldman Sachs-specific and broader industry or market liquidity events. Our principal objective is to be able to fund Goldman Sachs and to enable our core businesses to continue to generate revenues, even under adverse circumstances.

3.14.2 The cash needs of Goldman Sachs are driven by many factors, including market movements, collateral requirements and client commitments. These factors and others are captured and analysed in an internal liquidity model called Modelled Liquidity Outflow ("MLO") that is calculated daily. The amount of the firm's estimated likely cash needs during a liquidity crisis is pre-funded in the form of unencumbered, highly liquid securities, which can be sold or pledged in a crisis to provide same-day liquidity. This pool (predominantly comprised of central bank repurchase-eligible, government securities including Gilts, US Treasury bonds, Japanese and Euro government bonds) is called the Global Core Excess ("GCE"). The size of our GCE is based on both the internal liquidity model and a qualitative assessment of the condition of the financial markets and of Goldman Sachs. This Global Core Excess is designed to allow the firm to meet its immediate obligations without needing to sell other assets or depend upon additional funding from credit sensitive markets. As market strains intensified, we deliberately increased the amount of GS Group's Global Core Excess—average GCE was $61 billion during the first quarter in 2008 and $111 billion during the fourth quarter.

3.14.3 The firm's stress test for liquidity purposes includes the risk that financing sources are disrupted. For example, the MLO stress test addresses the risk that investors ask the firm to buy back previously issued debt and that counterparties to repurchase transactions are unwilling to roll over existing transactions that finance the firm's assets. Furthermore, the stress test assumes that the firm cannot sell assets immediately; and, therefore, the firm seeks to ensure that financing sources, including wholesale sources, have a contractual term that is appropriately long-dated.

3.14.4 Overall we are very supportive of the FSA consultation paper 08/22 on strengthening liquidity standards, and the principles published by the Basel Committee which form the basis of the proposals. Post the insolvency of Lehman Brothers International (Europe) in the UK, the FSA and other regulators are moving towards a policy of ring fencing legal entities and ensuring local legal entity integrity. We are very conscious of the need to manage the risks of individual legal entities within integrated financial groups, and we manage our business and liquidity pools accordingly. GS liquidity policy is based upon an asset and liability management structure that assumes a crisis environment, and we are pleased to see many of the aspects of our liquidity policies as part of the proposed new framework. For example, we operate a liquidity model that has diversification of funding sources with appropriate term as a core objective. We recognize the need for more coordinated, common and regular liquidity reporting to enable the FSA to view the market as a whole.

3.15 *Credit Risk*

3.15.1 Credit risk represents the loss that we would incur if a counterparty or an issuer of securities or other instruments we hold fails to perform under its contractual obligations to us, or upon a deterioration in the credit quality of third parties whose securities or other instruments, including OTC derivatives, we hold. Our exposure to credit risk principally arises through our trading, investing and financing activities. To reduce our credit exposures, we seek to enter into netting agreements with counterparties that permit us to offset receivables and payables with those counterparties. In addition, we attempt to further reduce credit risk with certain counterparties by (i) entering into agreements with them that enable us to obtain, on an upfront or contingent basis, assets as security for amounts owed to us ("collateral"), (ii) seeking third-party guarantees of the counterparty's obligations, and/or (iii) transferring our credit risk to third parties using credit derivatives and/or other structures and techniques.

3.15.2 To measure and manage our credit exposures, we use a variety of tools, including credit limits referenced to both current exposure and potential exposure. For example, we calculate potential exposure as an estimate of exposure, within a specified confidence level, that could be outstanding over the life of a transaction based on market movements. In addition, as part of our market risk management process, for positions measured by changes in credit spreads, we use Value at Risk and other sensitivity measures. To supplement our primary credit exposure measures, we also use scenario analyses, such as credit spread-widening scenarios, stress tests and other quantitative tools.

3.15.3 Our global credit management systems monitor credit exposure to individual counterparties and on an aggregate basis to counterparties and their affiliates. These systems also provide management, including the firmwide Risk and Credit Policy Committees and the GSI Risk Committee, with information regarding credit risk by product, industry sector, country and region.

3.15.4 The risk of "collapse in wholesale markets" is present in the assessment of credit risk primarily through the firm's analysis of the liquidity and funding risks of its counterparties, which in turn feeds into internal credit ratings and credit limits. For example, the template for the credit assessment of banks includes

a section on "Liquidity risk / Funding profile" where the credit analysts and relevant committees specifically assess "diversification of sources of funding and amount of funding that comes from confidence sensitive sources" (we would consider wholesale markets as "confidence sensitive sources"). Moreover, a number of specific credit ratios address the question of what portion of a bank's balance sheet is not funded by traditionally more stable sources such as customer deposits. While access to ample liquidity does not necessarily lead to a rating uplift we do note as negative factors an inappropriate exposure to confidence sensitive funds, especially short-term funds. We consider cautiously the funding of illiquid assets with short-term capital market or interbank funding. Similar considerations are included in our assessments of other types of counterparties, particularly to the extent that liquidity and refinancing risks are high.

3.15.5 We also perform our counterparty review process at country, industry or peer levels, allowing us to identify concentration of funding risks across multiple counterparties exposed to a similar operating or financial environment.

3.15.6 A number of our stress tests (eg a 1-in-25 year recession scenario) which are run periodically make extreme assumptions about a potential deterioration in market conditions across multiple asset classes, allowing us to identify significant exposure sensitivities. The assumptions made in those tests are consistent with some potential contributors to a "collapse in wholesale markets" (eg we assume credit spreads increasing by 150%, default probabilities increasing, equity markets collapsing, etc.). We also recognize our exposure to a "collapse in wholesale markets" through our active management of:

— our unfunded liquidity commitments (credit risk is managed assuming they will become fully funded); and

— inventory and outstanding placements of commercial paper and similar confidence-sensitive financing products which expose the firm to principal or contingent risk (through disciplined limit setting and monitoring).

3.16 *Market Risk*

3.16.1 The Market Risk function runs a number of scenario analyses and stress tests to highlight the profit and loss impact of significant market moves on our positions. Most of these scenario analyses and stress tests are subject to limits which are set by the relevant Risk Committee and monitored by Market Risk. They incorporate extreme market deterioration assumptions derived from both historical scenarios and projected stress events. They also incorporate very conservative assumptions about the ability to reduce exposures during a period of stress. The results are reported to senior management regularly and are used to inform risk management decisions (eg risk mitigation through hedging or liquidation).

3.16.2 We compute the effect of "Worst of Worst" stress events on our portfolio. These WoWs are applied across each business unit and calibrated to the worst peak to trough quarterly move in the last 25 years (99th percentile). Our WoWs are constantly reassessed in terms of appropriateness as markets develop and our trading portfolios change in composition and size. We use the WoW impact to define the level of additional capital which will be maintained as a buffer above the Pillar 1 market risk capital.

4. Improvements to Banking Industry Risk Control Frameworks

4.1 By their nature, our risk management policies and practices are in a constant state of adaptation and evolution, and Goldman Sachs devotes substantial senior level resources to ensuring as far as possible that this process of adaptation and evolution keeps pace with the rapidly changing framework within which financial institutions and financial markets operate. Indeed, the comprehensive family of risk measures, metrics and mitigants of today have precious little in common with their predecessors of only a few years ago. We would also draw a sharp distinction between risk management and risk monitoring. Risk monitoring involves getting the right information to the right people at the right time and is absolutely critical. If the risk monitoring process is flawed, failures in risk management will surely follow.

4.2 Goldman Sachs conducted a rigorous and systematic analysis of its practices by reference to the August 2008 CRMPG recommendations, as well as by reference to reports of the Financial Stability Forum, the Senior Supervisors Group, the President's Working Group and the Institute for International Finance[4]. We shared the results of that analysis with our Board of Directors and primary US regulators, and will shortly be doing so with the Financial Services Authority. While the firm believes its control framework is one of the strongest in the industry, it has identified further areas where the industry and/or the firm can improve.

[4] Counterparty Risk Management Policy Group III—*Containing Systemic Risk: The Road to Reform*, 6 August 2008; Financial Stability Forum—*Report of the Financial Stability Forum, Enhancing Market and Institutional Resilience*, 7 April 2008; *Follow up on Implementation*, 10 October 2008: President's Working Group on Financial Markets—*President's Working Group on Financial Markets, Policy Statement to Improve the Future State of the Financial Markets*, 13 March 2008; Senior Supervisors Group—*Observations on Risk Management Practices During the Recent Market Turbulence*, 6 March 2008; Institute of International Finance—*Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations: Financial Services Industry Response to the Market Turmoil of 2007–08*, July 2008.

4.3 On 9 February 2009, the Financial Times published an article by the firm's Chief Executive Officer and Chairman, Lloyd Blankfein, titled "Do not destroy the essential catalyst of risk". The article discussed some of the lessons learned from the recent and ongoing crisis in the financial markets. We believe these highlight some of the key improvements that are required to risk control frameworks in the banking industry. The article included the following points:

a) Risk management should not be entirely predicated on historical data. In the past several months we have heard the phrase "multiple standard deviation events" more than a few times. If events that were calculated to occur once in 20 years in fact occurred much more regularly, it is clear that risk management assumptions did not reflect the distribution of actual outcomes. The industry must do more to enhance and improve scenario analysis and stress testing.

b) Too many financial institutions simply outsourced their risk management. Rather than undertake their own analysis, they relied on the rating agencies to do the essential work of risk analysis for them. This was true at the inception and over the period of the investment, during which time too many financial institutions did not heed other indicators of financial deterioration. This overdependence on credit ratings coincided with the dilution of the coveted triple A rating. In January 2008, there were 12 triple A-rated companies in the world. At the same time there were 64,000 structured finance instruments, such as collateralised debt obligations, rated triple A. It is easy and appropriate to blame the ratings agencies for lapses in their credit judgment. But the blame for the result is not theirs alone. Every financial institution that participated in the process has to accept its share of the responsibility.

c) Size matters. For example, whether you hold $5 billion or $50 billion of (supposedly) low risk super senior debt in a CDO, the likelihood of losses was, proportionally, the same. But the consequences of a miscalculation were obviously much bigger if you had a $50 billion exposure.

d) Many risk models incorrectly assumed that positions could be fully hedged. After the collapse of Long-Term Capital Management and the crisis in emerging markets in 1998, new products such as various basket indices and credit default swaps were created to help offset a number of risks. However, the industry did not consider carefully enough the possibility that liquidity would dry up, making it difficult to apply effective hedges.

e) Risk models failed to capture the risk inherent in off-balance activities, such as structured investment vehicles. It seems clear now that managers of companies with large off-balance sheet exposure did not appreciate the full magnitude of the economic risks they were exposed to; equally worrying, their counterparties were unaware of the full extent of these vehicles and, therefore, could not accurately assess the risk of doing business.

f) Complexity got the better of the industry. Growth in new instruments outstripped the operational capacity to manage them. As a result, operational risk increased dramatically and this has had a direct effect on the overall stability of the financial system.

g) Financial institutions did not account for asset values accurately enough. If more institutions had properly valued their positions and commitments at the outset, they would have been in a much better position to reduce the exposures.

In addition, the importance of some fundamental principles has been underlined:

— risk and control functions must be completely independent from the business units;

— clarity as to whom risk and control managers report to is crucial to maintaining that independence; and

— risk managers must have at least equal stature with their counterparts on the trading desks; if there is a question about the value of a position or a disagreement about a risk limit, the risk manager's view should always prevail.

5. Suitability and Complex Products

5.1 The CRMPG strongly recommends that high risk, complex financial instruments should only be sold to sophisticated investors, and that a standard of behaviour and consistent practice be introduced for all market participants. The group recommends that involvement in the market for high-risk complex financial instruments in any capacity requires education and training in the nuances of these instruments; systems and models sufficient for tracking performance, managing risk and running stress scenarios; strong governance procedures; and internal controls and financial resources sufficient to withstand potential losses associated with these instruments.

5.2 Goldman Sachs undertakes careful suitability assessments for its clients, and our practices follow not only the letter, but also the spirit of our legal obligations under the Markets in Financial Instruments Directive.

5.3 Significant concern has been expressed during the financial crisis about possible weak suitability practices for structured products. In contrast, Goldman Sachs assesses the suitability of structured products for its clients in line with extensive processes, policies, management oversight and regulatory requirements

which differ depending upon the type of client involved. Our client base in this area includes institutional clients (such as pension funds, banks and insurance companies), regulated intermediaries who may distribute the products to their own client base and high net worth individuals.

5.4 The starting point in this area is to understand the client's rationale and purpose for the transaction, to explain to the client how the trade performs and the extent of losses that can occur, to confirm that clients have capacity and authority to enter into the trade, and to assess the materiality of the trade for the client. The compliance and legal departments are involved in these types of transactions and the due diligence that is undertaken on intermediary distributors. There are also defined guidelines for trade approval and escalation to business heads or Regional Suitability Committees, comprised of local senior business, legal, compliance and credit risk management personnel. Regular reporting to the firm's senior management is also required.

5.5 Our approach to structured products which may be sold to distributors or high net worth individuals has developed under the auspices of the Structured Investment Products Committee which sets policy and reviews new types of transactions. Where a third party distributor is involved, we seek to assess whether it has adequate processes to determine the suitability of the structured product for its own individual clients. Legal representations are obtained from the distributor to confirm it meets its obligations in this regard.

5.6 Where high net worth clients are involved we seek to determine whether a client has the necessary knowledge and experience to understand the risks of the structured product, for example, on the basis of their financial qualifications and/or investing and trading experience. Depending on the complexity and risks of the product and the size of the trade, additional pre-approval is required from senior business management, compliance, product specialists, and various other control functions.

5.7 The firm has conducted an extensive review of its processes and controls over the past year in the context of the Financial Services Authority's Treating Customers Fairly initiative. Outcome 2 of this initiative specifically addresses suitability issues and recommends design controls such as product stress testing where appropriate.

6. Compensation Policies and Practices

6.1 In the banking industry, people are the most important asset and therefore the greatest expense. We do not have meaningful manufacturing, product, and/or inventory expenses like other industries, so the focus is on people and the value they bring to the firm. This creates the necessity to align pay with performance while avoiding incentivizing excessive risk taking in a manner which is inconsistent with the interests of the organization and its stakeholders. Our compensation program is designed to ensure compensation expense is appropriately correlated to the firm's financial performance and to provide appropriate incentives while maintaining the flexibility to respond to market conditions and individual performance year over year.

6.2 Compensation is made up of fixed and variable components with the variable component being entirely discretionary and determined towards fiscal year end when the financial performance of the firm is apparent. As a result, management and the Compensation Committee of the Board of Directors of GS Group have maximum flexibility to set variable compensation in light of the firm's performance and market conditions. For example, given the environment in 2008, the Firm's seven most senior executive officers were not paid any variable compensation and the variable component of employee compensation was down on average 65% compared with the prior year.

6.3 The variable component is based on a bottom-up approach reflecting current year firmwide and divisional operating results and individual performance (including compliance, teamwork and corporate citizenship as well as commercial effectiveness). Financial metrics, including net revenues, net earnings, amount of risk exposure, return on balance sheet, and earnings per share, are important inputs in determining compensation. This approach allows maximum alignment between compensation and firmwide, divisional and individual performance, which is the basis of our compensation philosophy.

6.4 In addition, a significant portion of variable compensation is deferred into equity, which vests over three years. For the 2008 awards, 100% of the shares received upon exercise of options and a portion of the shares received upon vesting of Restricted Stock Units are restricted for sale for five years from the date of grant. This helps us to retain and motivate employees for future performance. In addition, by paying a portion of compensation in equity awards, we encourage our people to focus on the performance of the firm as a whole over the long-term (during which time performance can vary considerably) and encourage teamwork. Moreover, the awards contain a forfeiture provision which we have consistently applied to employees enabling us to forfeit their equity, where the employee is terminated for "cause" or otherwise engages in activities detrimental to the interests of the firm or which violate other material terms and conditions of employment. This equity deferral program aligns employees with the long-term interests of the Firm and its shareholders.

6.5 The proportion of total compensation accounted for by the discretionary component of employee compensation has varied over time reflecting economic cycles and the firm's performance:

- 58% of total remuneration in 2008.
- 80% of total compensation in 2007.

- — 60% of total compensation in 1998.
- — 62% of total compensation in 1988.

7. The Role of Independent Directors

7.1 Goldman Sachs has independent directors at the ultimate parent level (where they form the majority on the GS Group board) and on the boards of a number of regulated subsidiaries, including GSI. GSI's Board includes two non-executive directors (one is Chairman of the Board and the other is Chairman of the European Audit, Business Practices and Compliance Committee).

7.2 The FSA has set out their view of the responsibilities of non-executives in their December Consultation Paper: "The approved persons regime—significant influence function review", in particular:

- — "assisting executive colleagues within the firm's governing body in setting and monitoring the firm's strategy;
- — providing an independent perspective to the overall running of the business, scrutinizing the approach of executive management, the firm's performance and standards of conduct; and
- — carrying out other responsibilities as assigned by the board, for example as a member of a board committee, such as an audit or remuneration committee".

7.3 We also believe it is essential that the board includes executive directors who are intimately connected to the various businesses and control functions and who are fully aware of the risks that arise in connection with those businesses. Recent events have reconfirmed how vital it is that directors understand fully what is happening within the company, have an open dialogue with each other and have the ability and inclination to direct changes in business mix and resource allocation in short order.

8. A Special Insolvency Regime for Investment Banks?

8.1 As the Committee will be aware, HM Treasury has established the Investment Banking Advisory Panel (the "Panel") to examine whether there should be a special insolvency regime for investment banks. It is intended that the Panel will publish a final report and recommendations later in the year. GSI is represented on the Panel and as such, we believe that it would be inappropriate for us to answer this question definitively ahead of the published report of the Panel considering the same question. However, we have set out the following observations which we trust will be of interest to the Committee.

8.2 The question of whether a special insolvency regime is required by investment banks arises because of a number of difficulties experienced by customers and counterparties of Lehman Brothers International (Europe) ("LBIE") during the administration of that entity. Goldman Sachs group companies interacted with LBIE in a number of ways: we were a bilateral dealing counterparty in, inter alia, the equity, bond and exchange traded and OTC derivative markets; hedge funds managed by our asset management business were prime brokerage customers of LBIE; and, as a major prime broker ourselves, many of our hedge fund clients were also clients of LBIE and have shared their experiences with us.

8.3 We would observe that the two main issues experienced by customers and counterparties of LBIE following the appointment of the administrators were respectively (i) inability to rapidly access and deal with customer assets held by LBIE as custodian; and (ii) uncertainty surrounding the settlement of bilateral securities transactions.

8.4 While some of the issues faced by counterparties and customers of LBIE arose as a result of the particular way in which LBIE structured and documented the relevant businesses and would not necessarily result in similar problems in the insolvency of another investment bank, there is in our view a clear need for changes to be made in the areas of customer asset protection and trading and settlement rights upon default. Whether these changes need to be made solely by way of legislation to create a special insolvency regime for investment banks is a question that the Panel will consider and report on in due course. It is possible that many of the issues faced by customers and counterparties of LBIE could be addressed in the future by a combination of new regulation, market-led solutions and, as a last resort, proportionate new legislation or amendments to existing legislation. In our view, any changes made are likely to reduce the likelihood of post-Lehman type problems but it may not be possible to prevent all such problems arising.

8.5 Whatever changes are introduced should seek to ensure financial stability, to preserve and promote market confidence and to maintain the international competitiveness of the United Kingdom. In this regard it is imperative that important protections against systemic risk that exist within current UK and EU law such as the enforceability of netting and set-off rights for financial contracts are not undermined by future legislation. At the same time, we believe that there is a clear need for flexibility on the part of the authorities in seeking the most effective and efficient resolution of these situations. Today, the market perception is probably that the United States has greater flexibility in this regard. We would support a well balanced initiative to increase flexibility in this area in the UK.

March 2009

Memorandum from Morgan Stanley

I refer to your letter of 20 February addressed to the Chief Executive of Morgan Stanley & Co International plc, requesting information relating to a number of general and specific questions related to your inquiry into the Banking Crisis. Mr Chammah, Morgan Stanley Co-President, has asked me to reply.

As I am sure you will appreciate, it is difficult to respond to every detailed question you sent us in the time available. We have therefore tried to focus on the sections addressing our risk management systems and controls and our remuneration policy. As you would expect, as a US based bank lead regulated by the US supervisory authorities and listed in the US, we have been in discussion with Congress and our US regulators about these issues too. I attach the testimony recently given by John Mack, our Chairman and Chief Executive Officer, to the House of Representatives Committee on Financial Services. It focuses naturally on the US TARP programme, but should also serve to answer some of your questions.

Background

In terms of background information on Morgan Stanley we would refer you to our public website for general information, specifically to the section[5] that gives an over view of Morgan Stanley. For ease of reference I attach the most relevant pages. Committee members may also find useful a recent presentation from 28 January 2009, available on our website[6], which outlines inter alia the recent reductions in Morgan Stanley's risk positions and leverage. I attach a copy of the slides on these issues. For more detailed information on our activities we would recommend our latest so called "10k" filing with the SEC, which is also available directly from our website.[7] The first part of the "10k" is a particularly useful public summary of our business activities and again for ease of reference, I enclose a copy of "Item 1: Business". We regret that we do not have the older historical data you requested readily to hand.

FSA

We have a very close working relationship with the FSA at all levels. As a high impact Firm, aside from our daily interaction with the FSA, we have regular meetings with FSA to discuss issues such as our strategy, business model, risk management and governance. FSA's engagement with us has, if anything, increased over the last few years and this is something that we welcome.

Risk Management

Risk is an inherent part of Morgan Stanley's business and activities. The Company's ability to properly and effectively identify, assess, monitor and manage each of the various types of risk involved in its activities is critic al to its soundness and profitability. The Company seeks to identify, assess, monitor and manage, in accordance with defined policies and procedures, the following principal risks: market, credit, liquidity and funding, operational and legal risk.

The cornerstone of the Company's risk management philosophy is the execution of risk-adjusted returns through prudent risk-taking that protects the capital base and franchise. The Company's risk management philosophy is based on the following principles: comprehensiveness, independence, accountability, defined risk tolerance and transparency.

Risk management at the Company requires independent Company-level oversight, accountability of the Company's business segments, constant communication, judgment. and knowledge of specialized products and markets. The Company's senior management takes an active role in the identification, assessment and management of various risks.

The Company's risk governance structure includes the Firm Risk Committee, the Chief Risk Officer, the Internal Audit Department, independent control groups, and various other risk control managers, committees and groups located within and across business segments. The Firm Risk Committee, composed of the Company's most senior officers, oversees the Company's risk management structure. The Firm Risk Committee's responsibilities include oversight of the Company's risk management principles, procedures and limits, and the monitoring of material principal risks and the steps management has taken to monitor and manage such risks. The Firm Risk Committee is overseen by the Audit Committee of the Board of Director s (the "Audit Committee").

The Chief Risk Officer, a member of the Firm Risk Committee who reports to the Chief Executive Officer, oversees compliance with Company risk limits; approves certain excessions of Company risk limits; reviews material market, credit and operational risks; and reviews results of risk management processes with the Audit Committee.

[5] http://www.morganstanley.com/about/company/index.html
[6] http://www.morganstanley.com/ahout/ir/01232009disc.html
[7] http://www.morganstanley.com/about/ir/shareholder/10k11300811/10k1108.pdf

The Internal Audi t Department provides independent risk and control assessment and reports to the Audit Committee and administratively to the Chief Legal Officer. The Internal Audit Department conducts audits designed to cover all major risk categories.

The Market Risk, Credit Risk, Operational Risk, Financial Control, Treasury, and Legal and Compliance Departments (collectively, the "Company Control Groups"), which are all independent of the Company' s business units, thoroughly analyze, monitor and report on a wide range of risk measures, including Greeks, VaR, notional exposures, stress tests and scenario analysis s, in order to provide senior management with a holistic and extant view of the Firm's risk profile.

Each business segment has a risk committee that is responsible for ensuring that the business segment, as applicable, adheres to established limits for market, credit, operational and other risks; implements risk measurement, monitoring, and management policies and procedures that are consistent with the risk framework established by the Firm Risk Committee: and reviews, on a periodic basis, its aggregate risk exposures, risk exception experience, and the efficacy of its risk management policies and procedures, and related controls. Designated operations officers, committees and groups, including operations and information technology groups together with the Company Control Groups manage and monitor specific risks and report to the business segment risk committee. Participation by the senior officers of the Control Groups helps ensure that risk policies and procedures, exceptions to risk limits, new products and business ventures, and transactions with risk elements undergo a thorough review.

The "10k" SEC filing referred to above contains extensive public disclosures on our risks and risk metrics, in addition to our financial results. I attach for ease of reference "Section IA: Risk Factors" which outlines the range of risks that we face in our business and "Section 7A. Quantitative and Qualitative Disclosures about Market Risk" that explains our systems and controls in more detail and gives some useful metrics.

Remuneration

We have made the following change s to our 2008 remuneration process. Our Chairman and CEO, Mr John Mack, and Morgan Stanley's two Co-Presidents (including Mr Chammah) all chose to forego a bonus for 2008. Reflecting the difficult market conditions, stock price performance and the Firm's full earnings, significant year over year reductions were also confirmed for the Firm's Global Operating Committee and Management Committee.

For 2008 and beyond, the bonus element of our employees' remuneration is structured as follows:

- For all bonus-eligible employees, part of the year end bonus deferral was a cash award subject to a clawback provision that can be triggered if the individual engages in conduct detrimental to the Firm. The clawback can be triggered if an individual, for example, causes the need for a restatement of results, a significant financial loss or other reputational harm to the Firm or one of its businesses. 2008 year end compensation therefore generally consisted of three components for eligible employees;
    - A regular cash component.
    - An equity component vesting over a three year time frame.
    - A deferred cash component vesting over a three year period which will also contain the clawback provision during this time.
- Consistent with the Firm's pay-for-performance philosophy, starting in 2009, we expect to institute a multi-year performance plan for senior executives that will tie a portion of their compensation directly to the Firm's performance over a three year period—with one third of this compensation tied to the Firm's average return on equity (ROE), a second third tied to Morgan Stanley's average ROE relative to our peers, and the final third tied to total shareholder return on a relative basis.

I hope you find this information useful. As you will be aware, we are unable to provide you with non public information on our activities. but if there are areas where you would like us to forward you more information, please let me know.

11 March 2009

Memorandum from Nomura International

Introduction

Nomura International plc ("Nomura International") is pleased to have been asked to provide a written submission to the Treasury Select Committee as part of its ongoing inquiry into the Banking Crisis. Our understanding is that the Committee has made similar requests for evidence from a number of London financial market participants. To ensure ease of comparison we have therefore sought to structure our submission around the specific questions (1–15) provided by the Clerk of the Committee.

Context

Nomura International is a London-based securities broker/dealer. It is a wholly-owned subsidiary operating company within the Nomura Group, which is part of Nomura Holdings Inc. The responses made in this submission relate to Nomura International unless stated otherwise. The figures provided cover the period up to 31 March 2008, when Nomura posted its last full-year financial results. As the Committee is aware, in September 2008 Nomura International acquired the equities and investment banking businesses of Lehman Brothers from the administrators of Lehman Brothers Europe Ltd. Under the terms of the deal, Nomura did not acquire any of Lehman Brothers' assets or liabilities.

Nomura International's activities include:

- Trading and sales in fixed income and equity products, including related derivatives;
- Investment banking services;
- Asset and principal finance business; and
- Corporate finance and private equity.

Nomura International is not involved in retail banking.

Nomura International recognises the current concerns about the organisation, conduct and regulation of financial services companies. We appreciate too, that the global economy is in the midst of a major downturn in which the role of the financial services sector is under intense scrutiny. As such, Nomura International seeks, in this submission, to assist the Treasury Select Committee in the most constructive way possible as it seeks to learn the lessons from the current banking crisis. However, it should be noted that due to the extraordinary dislocation that continues to affect the industry, Nomura International cannot yet with confidence derive any definitive conclusions about the causes, consequences and lessons of the current crisis.

Background Information

1. *How rapidly did your bank grow from 1997? And for the 10 years before that?*

Below we provide figures relating to growth in headcount, net assets and share capital. The figures show the change between 1997 and 31 March 2008, when Nomura International's last complete financial year closed. Comparative figures are not available for the much earlier periods, when Nomura International was much smaller and a quite different business.

Nomura International Headcount

Number of employees as at 31 March 1997 = 682

Number of employees as at 31 March 2008 = 1,218

Nomura International Net Assets

Net assets as at 31 March 1997 = £365m

Net assets as at 31 March 2008 = £998m

Nomura International Share Capital

Share Capital as at 31 March 1997 = £200m

Share Capital as at 31 March 2008 = £1,019m

2. *What happened to holdings of British government securities over the two periods?*

Over the past 10 years Nomura International had the following approximate long positions of UK Treasury Bonds:

As at 31 March 1998 the long positions were £479m

As at 31 March 1999 the long positions were £322m

As at 31 March 2008 the long positions were £22m

3. *Are investment banks as crucial to the functioning of the economy as commercial banks are?*

Nomura International believes that investment and commercial banks both have fundamental economic functions.

Investment banks support economic growth by supporting corporate change and development and 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.

Looking to the future, as the economy begins to expand again, the role of investment banks will be central in identifying, arranging, managing and delivering the capital that will be needed to facilitate business growth.

Risk Management

4. *How do you control the risks in your organisation?*

The Board of Directors is ultimately responsible for identifying and controlling risks through its overall risk management framework and approval of risk strategies and principles. In addition Nomura International has also established a number of specific mechanisms, departments and functions to identify and control risks across the business.

Risk at Nomura International is managed through appropriate organisations, capabilities and departments that are independent of the businesses; through clear decision-making forums; and through appropriate risk reporting and control. For further details see Appendix A.

a) *How many items are there on your risk register?*

Nomura International operates a comprehensive risk reporting and control framework, including registering risks on two key databases: "market and credit risk" and "operational risk". Nomura International would caution on the comparison of mere number of entries as these can vary considerably in their scope and impact.

Market and Credit Risks: As of close of business on 27 February 2009 there were 18 market risk items on the market risk register. On the same date there were eight items on our credit risk register.

Operational Risks: At close of business on 27 February 2009 there were 37 open operational risk action points on the operational risk register.

b) *How often is your risk register reviewed and by whom?*

Nomura International reviews its "risk registers" frequently and at a senior level.
Market and Credit Risks: The risk database reports are reviewed weekly by senior management in London and Tokyo.

Operational Risks: Operational risks are reported monthly to senior management.

In addition, specific risks identified during reviews of either market and credit risks or operational risks are routinely considered by relevant committees within our overall risk management framework (described in Appendix A).

c) *Was "collapse of wholesale markets" on your risk register as a potential risk and what were your mitigating controls?*

Treasury, a corporate function, carries out stress tests on the balance sheet on a monthly basis to test liquidity risk. These stress tests define an amount of funding required to cover this risk and funds are maintained. The funds raised are held by Treasury in a liquidity pool of highly liquid assets until required.

From a market risk perspective, Nomura International did not stress test for a "collapse" of wholesale markets. However, the company did prepare for a serious deterioration of trading conditions via stress testing and detailed analysis of the trading books. The limit framework is designed to restrict serious losses from traded risk. Value at Risk (VaR) is not heavily relied on due to its lack of tail risk.

d) *What improvements do you think are required to risk control frameworks in the banking industry?*

Nomura International believes Value at Risk (VaR) is a useful tool but must be used with care.

The use of VaR based models to estimate risk capital requirements has contributed to an increase in cyclicality in the banking system. This is because asset price volatility is a key input in the VaR estimate. As volatility increases VaR increases, and vice versa.

In addition, as asset prices increase there is a tendency for asset price volatility to decline. So rising asset prices will be associated with a reduction in the VaR generated by any given asset. Since VaR is an input into a bank's capital requirement estimate, as asset prices rise, required capital will tend to fall. This in turn will encourage the acquisition of additional risk assets.

Conversely, as asset prices fall, the process goes into reverse. Asset volatilities increase, resulting in required capital increases, which in turn forces banks either to raise additional capital or sell assets. Moreover, the cyclicality induced by the use of VaR is compounded by accounting policies which require mark to market values and disallow non-specific reserves. This increases capital availability in rising markets, and prevents banks from taking reserves which can be used to cushion losses in adverse markets.

These policies undoubtedly increase the cyclicality of the banking system. The adverse consequence may be mitigated by sensible modifications to accounting and regulatory capital regimes.

Other industry wide issues already debated by the Treasury Select Committee include:

- Improved stress testing capabilities, including basis risks and stressed capital, liquidity and default expectations.
- A diminution of rating agency influence.
- Improved global co-ordination of regulatory capital regimes, oversight structure and approach, particularly to address cyclicality.

At a company level, specific improvements might include:

- Senior management to have additional awareness, understanding and accountability of the risks inherent in their businesses.
- Clear articulation by Boards of core risk principles against which all business can be benchmarked.
- An acceptance of the need to challenge and debate risks, as well as an appreciation of the partnership but ultimately independent role and stronger voice of risk and control functions.

e) *How many FTE staff posts do you have devoted to risk management, both as a number, and proportion of total staff?*

As described in Appendix A, the identification, monitoring and management of risk involves all staff within Nomura International in addition to the specialist teams within our formal risk control framework, overseen by our Board of Directors. We have therefore provided the numbers for the specialist teams, the legal and compliance functions as well as a calculation of the time committed by line managers. Figures are as of end February 2009 and reflect the increased workforce count arising from Nomura International's acquisition of staff from the administrators of Lehman Brothers Europe Ltd.

Specialist teams

Investment Evaluation and Credit	30
Treasury	20
Market Risk	42
Risks and Controls	10
New Product Approval	5
Risk IT	31
Product Control	120
India Risk	27
Internal Audit	26
Total	**311**

Specialist teams as proportion of overall staff: 7.7%.

Legal and transactional staff

Legal and compliance based in EMEA and India	44
Transaction legal based in London	92
Corporate legal based in London	14
Compliance staff based in London	46
Total	**196**

Specialist risk and legal/compliance teams (507) as a proportion of overall staff 12.7%.

f) *Line management of risk*

Nomura International estimates about 700 management employees spend about 20% of their time on risk issues, which results in an additional FTE of 140.

Total FTE for overall risk management effort (647) as a proportion of overall staff is 16.2%.

5. *Did you stress test your balance sheet against a scenario where the wholesale funding markets closed down?*

Yes. Balance sheet stress tests are run monthly by the Global Treasury Department. These stress tests have been a key component of Treasury policy for many years. One of the main scenarios embedded in these tests is a complete closure of the wholesale funding markets.

6. *Should there be a special insolvency regime for investment banks as there soon will be for commercial banks—would this prevent post Lehman-type problems?*

Nomura International believes a special insolvency regime should be seriously considered by the Committee and that lessons need to be learnt from the bankruptcy of Lehman Brothers International (Europe) ("LBIE") in the UK. Nomura International also believes that the various interconnected regimes in the US may provide valuable lessons in the development of more effective arrangements. In addition, Nomura International believes that further areas the Committee might like to consider are:

— Failure of settlement systems

  In order to prevent further disruption and instability following the insolvency of a broker/dealer, additional clarity needs to be provided on what clearing and settlement houses should do with regard to the settlement of the insolvent broker/dealer's trades. If this cannot be achieved by practical means, such as communication with the regulators, then there is a need to resolve this through legislation. For example, in the US, the Securities Investor Protection Corporation ("SIPC") which commenced action against Lehman Brothers International ("LBI"), broker/dealer in the US on 19 September 2008, was given authority to complete settlement of pending transactions up to 23 September 2008.

— Perceived/potential conflict of interest of the Administrators

  In the UK, the Administrators' duties are to act in the interest of the creditors to maximise the assets to be distributed among them. However, they are also effectively acting as custodians/trustees for investors who have assets still held at the entity in administration. There are no separate official "trustees" who act in the interests of such investors/customers. We believe this can contribute to the slow recovery of customer assets, thus exacerbating the instability in the financial market. In the US, SIPC, which acts under the authority of the Securities Investor Protection Act ("SIPA"), is allowed to initiate insolvency proceedings against certain regulated broker/dealers. A SIPC Trustee is then appointed by the court.

a) *Would this prevent post Lehman-type problems?*

Without underestimating the scale of the circumstances surrounding the collapse of Lehman Brothers, Nomura International believes the establishment of a special insolvency regime for investment banks, as well as additional improvements set out above, could be beneficial in the event of a similar event in the future.

Narrow Banks

7. *Do investment banks make natural partners for retail banks or is the culture too different?*

Nomura International is not involved in retail banking and is therefore not in a strong position to comment on any difficulties in operating retail and investment banking cultures alongside each other.

8. *What are the strongest reasons both for and against the separation of traditional, narrow banking activities from riskier trading and investment banking activities by your organisation?*

Nomura International is not involved in retail banking and does not have FSA regulatory permission for "Accepting Deposits" (the closest definition of "narrow banking"). However, it does not rule out such a move in the future if customer requirements and its developing business model were to necessitate such a move.

Many retail investors wish to seek as high a return as they can achieve consistent with their approach to risk. Some may use traditional current or saving accounts, but others may be willing to accept the higher risks that come from investing in funds, bonds, equities and derivative products. Some investors may feel that a fully-integrated house that offers all services within a single financial services business would be more attractive.

On the other hand, corporates and financial institutions may feel that a distinct service offering better fits with their own business model and needs. This clearly varies between clients and may differ depending on their stage of business development.

Depositor's interests are paramount. By co-mingling risky investment banking activities with the traditional, less risky, lending activities of commercial banks, depositors may be exposed to undue risks. The need to protect depositors' interests will result in asymmetric treatment of banking profit and loss, with losses being socialised while profits remain in the private sector.

This asymmetric treatment of risk profit and loss leads to public subsidy of commercial banks' investment banking activities, ultimately damaging both the public purse and independent investment banks.

Remuneration Information

9. *What was the share of bonuses in total remuneration 20, 10, and one year ago?*

The bonus regime within Nomura International is a combination of cash and deferred stock (see response to question 11 below). As a result the proportion of total remuneration is complicated by leavers or others who "lose" their deferred bonus between being awarded and receiving the payout as well as the cash equivalent of stock options when received. For this reason, data about accrued cash bonuses alone have been provided.

For the year ended 31 March 2008, bonuses represented 48% of total remuneration.

For the year ended 31 March 1999, bonuses represented 64% of total remuneration.

Equivalent figures are, unfortunately, not available for 1987.

10. *Why do investment banks pay bonuses as a large part of take-home pay when no other type of firm does?*

The cyclical nature of investment banking revenues requires firms to manage their staff costs carefully through these cycles. One method is to release staff as work reduces and recruit them as the cycle changes. However, for financial firms working on longer term work cycles this can be both highly disruptive and inefficient. By paying variable bonuses, investment banks can keep down their variable costs in lean times, while continuing to pay for performance.

11. *How are these bonuses structured within your firm?*

Nomura International awards bonuses using a combination of cash, deferred cash and stock awards. Stock awards are deferred and vest after two years, with their ultimate value dependent upon their share price.

The level of bonus is dependent on performance. The overall level of bonus awards is made in the context of recruitment, retention and the wider employment market for these professionals.

a) *Why do they have this structure?*

The use of deferrals helps align reward and longer-term measures of performance. The link to the overall performance of the firm as well the performance of a particular business area or division is created through the award of stock that has a future value determined by the share price at the time of vesting. The cash deferral is intended to act as a retention mechanism only. As such, employee rewards remain tied to the overall value of the firm from a shareholder perspective.

Securitisation and Complex Products

12. *What proportion of securitised investments do you keep on your own books? How has this proportion changed in the past 10 years?*

Nomura International does not take part in "traditional" securitisation activities. However, on occasions, when a client wants a payout linked to some form of credit exposure, the company can create bond-linked notes issued by Nomura International or, if required, via a Special Purpose Entity.

13. *When you sell products on, do you consider whether they are suitable for and fully understood by your client? If not, why not? If yes, give examples*

As previously mentioned, Nomura International does not sell directly into the retail market in Europe. For institutional investors Nomura International does consider the general appropriateness of products for specific types of investor. Sale processes within the firm are reviewed to ensure proper consideration of the risk factors of products and risk profiles of investors at the time of sale.

As an example of the seriousness with which Nomura International considers the need for clients to fully understand our products consistent with their needs and objectives, the documentation associated with, for instance, asset-backed high-risk complex financial instruments includes:

> *A Preliminary and Final Offering Memorandum*: The offering memorandum would include prominently within its first several pages the nature of the economic interest of the underwriter or placement agent (and its affiliates) in the transaction, including a clear statement of the roles to be undertaken and services to be provided by the underwriter or placement agent (or its affiliates) to the transaction, as well as any interests in the transaction (if any) that the underwriter or placement agent (or its affiliates) are required or expected to retain.
>
> *A Marketing Book*: The marketing book would include an in-depth description of the materials contained in the term sheet. It would especially focus on the collateral manager (in the case of a managed portfolio) and deal structure.
>
> *Portfolio Stratifications*: This documentation would be in the form of spreadsheets containing bond level information (sector, rating, par balance, etc.), where known, and weighted average loan level information.
>
> *Cash Flow/Stress Scenarios*: This documentation would be in the form of spreadsheets and cash flow model outputs. Standard runs would be provided for each tranche offered. The output will typically be in the form of tranche cash flows and default/loss percentages for the tranches and collateral.

In addition, term sheets and offering memoranda for all high-risk complex financial instruments have a "financial health" warning prominently displayed indicating that the presence of these characteristics gives rise to the potential for significant loss over the life of the instrument.

Nomura International has also been actively engaged with the FSA in relation to the extensive work carried out by the FSA in this area. In short we believe that the work carried out by the FSA and the conclusions reached (both final and preliminary) strike the correct balance in protecting the consumer. One area that the FSA does not cover and perhaps should be an area of greater focus is the cross-border distribution into the UK of products by overseas entities that are not subject to a similar regulatory regime as the FSA.

Management and Ownership Structure of Investment Banks

14. *What is the role of non-executive directors in an investment bank?*

At Nomura International, our non-executive directors sit on the main UK holding company and operating company boards. They are also members of the Audit Committee and Compensation & Nominations Committee.

We have appointed non-executives to certain of our boards and committees, despite being a wholly owned subsidiary, so that they may bring independent and objective views to the relevant boards and committees.

Our non-executives are highly experienced individuals, who actively and constructively challenge the other Board/Committee members by asking critical and probing questions. As independent members of the board, our non-executives do not participate in the day-to-day management of Nomura International. However, our non-executives remain well-informed about the business of Nomura International by their attendance both at monthly board meetings (which include regular agenda items covering risk and financial reporting matters) and as invitees to the Executive Management Committee (the board's main committee overseeing strategic and operational issues). In these ways, we consider our non-executives properly exercise one of their fundamental roles as promoters of good corporate governance.

15. *Investment Banks were once partnerships. Why did this change? If Investment banks go back to their traditional purely advisory role, should they revert to partnerships?*

Nomura International has never been a partnership, even when it was purely an advisory broker. In addition, given the increasingly litigious environment, partnerships that were common among dealers, accounting firms and investment banks are more and more viewed as out-dated. While smaller advisory firms may use a partnership structure, this does not seem to be the most suitable structure for most financial services firms whether advisory or otherwise. Nomura International would not consider it appropriate, nor an enhancement of risk, control or effectiveness overall to become a partnership.

11 March 2009

APPENDIX A

RISK AT NOMURA INTERNATIONAL

Key Relevant Departments and their Functions

Risk Management Department: monitors and reports compliance with internally set market risk limits and is completely independent of the business areas. In addition, the model risk team is responsible for the validation and periodic review and risk based assessment of pricing models.

Investment Evaluation and Credit Department: monitors and reports compliance with internally set credit limits and is completely independent of business areas.

Legal and Compliance Department: is responsible for the identification and proper management of the legal, regulatory and reputational risk that arises in the day to day operations of the bank and is completely independent of the business areas.

Treasury Department: monitors compliance with the company's liquidity, currency and cash flow policies.

Finance Department: monitors compliance with internally and externally set regulatory limits and guidelines. In addition, the Product Control department performs independent price testing on inventory positions and provides daily profit and loss account verification.

Risks and Controls Department: monitors and evaluates risk indicators, conducts investigations on operational risk issues and the internal control framework.

New Product Approval Department: administers the process of review and approval by key control functions of new products and business lines.

Internal Audit: performs a comprehensive and independent review of systems and processes on a periodic basis.

Key Committees and their Remits

The European Executive Management Committee is a committee of the board which is primarily responsible for setting and developing business strategies and policies, ensuring resources are prioritised and allocated effectively, including capital allocation, and for monitoring performance against financial and strategic goals for the group in Europe, the Middle East and Africa (EMEA). The committee is also responsible for the oversight of legal, compliance and regulatory issues (including reputational risk and conflicts) for the group in EMEA.

The Capital Commitments Finance and Risk Committee considers and approves capital commitments requirements on a transactional basis. The Capital Commitments, Finance and Risk Committee has established a sub-committee called the New and Complex Products Committee that is primarily responsible for the product approval and governance of new business and product initiatives.

The Risk Management Committee considers and monitors operational, credit and market risk exposures. Key asset risks, market trends, specific business risks, including wrong way risk and limit breaches, are reported to the senior management in attendance at the committee meeting.

The Audit Committee considers matters of financial judgement, audit issues and issues raised by the Risks and Controls function with respect to Operational Risk and Sarbanes-Oxley compliance. It has independent reporting lines to the Chairman of the Audit Committee.

Risk Reporting and Control

Market risk management, via a limit framework, controls day to day activity in the trading books. Limits for the Greeks (the sensitivities of derivatives to a change in underlying parameters on which the value of an instrument or portfolio is dependent) and scenario analysis are monitored daily. Procedures are in place for dealing with limit excesses and escalation.

Additional weekly and monthly reporting is also in place. This includes: Top market risks; credit risk weekly management reports which reflect concentrations of risk (sector, single obligor, country); illiquid debt and equity positions which are monitored independently of the business and valuations ascribed; and key risk indicator monitoring reports and loss event/near miss investigation and control recommendations.

Financial resource reporting and control is administered via Management Information Systems and is distributed daily to management providing daily financial indicators including profit and loss, Value at Risk, economic capital, regulatory capital, unsecured funding and balance sheet.
Monitoring of risk issues is applied at all levels in the business hierarchy and reported on and escalated to management via the various committees and forums that support the corporate governance framework.

Memorandum from UBS Investment Bank

Background Information

1. *How rapidly did your bank grow from 1997? And for the 10 years before that?*

As a result of the merger in 1998 of Union Bank of Switzerland and Swiss Bank Corporation, we do not retain equivalent data to comment on the period before 1999. However, the spreadsheet attached as Appendix 1 highlights the profile of headcount growth since that point in time.

Global headcount of the Investment Bank grew by nearly 3,000 staff between the end of 1999 and 2000, mainly as a result of the Paine Webber acquisition, reaching 15,391 by the end of 2000. There then followed a broadly flat period from 2000 to 2003, with headcount reaching 15,633 by the end of 2003.

As a result of the Investment Bank's growth strategy, headcount increased significantly in the years following the end of 2003, reaching a maximum of 22,833 during Q3 2007, an increase of 46% (7,200) since December 2003. Headcount had fallen to 17,171 by the end of 2008 reflecting in part the market turmoil.

This growth strategy can also be observed on the attached spreadsheet in the sizable increase of both gross balance sheet (total assets increased 152% between end of 2000 and the end of 2006) and risk weighted assets (RWA), increasing by 90% between end of 2003 and end of 2008.

2. *What happened to holdings of British government securities over the two periods?*

The spreadsheet attached as Appendix 2 provides details of UBS's holdings—in practice mostly the Investment Bank's—of UK Government securities (comprising UK Treasury Bills, Bank of England Euro Bills, British Government Stocks and Bank of England Securities), as at year-end for the period between December 1998 and December 2008. Our data retention procedures mean we do not have data extending back beyond this date.

The spreadsheet shows position variations of between c. £2.75 billion long in 2001 and c. £1.6 billion short in 2006 reflecting our changing outlook on the UK Government securities market and the needs of our clients. Most recently, whilst we have reduced our hedging positions in these securities (reflecting the reduction in our proprietary risk taking), we have increased our holdings of gilts as part of our overall liquidity strategy.

3. *Are investment banks as crucial to the functioning of the economy as commercial banks are?*

The contribution of banks to the wider economy largely reflects how effectively they discharge their core functions. Banking provides three distinct vital functions: (i) payments, (ii) intermediation between suppliers and users of capital, and (iii) supply of credit.

Historically, commercial banks provided (i). Commercial banks and investment banks provided (ii) and (iii). The distinction between commercial and investment banks has become blurred, so it is helpful to identify the mechanisms in category (ii) and (iii).

Intermediation: suppliers of capital are, ultimately, individual savers who buy financial products (eg bank deposits, securities, pooled schemes). Users of capital are companies, or government, which issue financial instruments (eg loans, bonds, shares). "Intermediation" means that banks sell or facilitate the sale of financial products to suppliers of capital, and buy or facilitate the purchase of financial products from users of capital. To facilitate this process banks undertake various forms of risk transformation (eg syndication and securitisation). Sometimes, banks combine execution of intermediation activities with the provision of advice.

Over time, the system has developed under the influence of two opposing forces. Efficiency considerations tend to lead to the creation of complex, multi-functional financial firms. Conflicts of interest considerations tend to lead to limitations on the scope of operation of different types of firm. The speed of evolution is affected by improvements in information and communication technology.

This system is important to the functioning of the economy. Failure of a large participant can severely disrupt the system, interfering with the liquidity and efficiency of the economy for a period.

Credit supply: it takes a certain amount assets (eg plant, machinery) to enable a given level of economic output. These assets have to be financed, and the banking system needs a certain amount of capital to sustain a given volume of lending. This system is fundamental to the functioning of the economy. The current collapse in world-wide economic activity is associated with the depleted capital base of the world's banks. Until their capital base is replenished, the economy will continue to suffer. Economic activity requires bank solvency.

All types of bank put their capital at risk in the process of credit creation. The processes of intermediation and risk transformation mean that it is not possible to identify which parts of the banking system in fact provide credit to any given part of the economy, making it impossible to say whether investment banks are more or less crucial to the functioning of the economy than commercial banks.

It is possible to say, though, that large banks are more crucial to the functioning of the economy than small banks: that banks which act as principal in credit markets are more crucial than those that act as agent in equity markets: and that banks which operate payments systems connected with the non-financial sector are more crucial than banks that only deal with other banks.

Risk Management

4. *How do you control the risks in your organisation?*

Taking, managing and controlling risk is core to UBS's business. The aim is not to eliminate all risks but to achieve an appropriate balance between risk and return, whether it be Operational, Market or Credit risk. UBS's approach to risk management and control is based on five principles:

— Business management accountability.

— Independent controls.

— Risk disclosure.

— Earnings protection.

— Reputation protection.

There are five key elements in the independent risk control process:

1. Risk policies that reflect UBS's risk capacity and risk appetite, and are consistent with evolving business requirements and international best practice. These policies are principles-based, specifying minimum requirements, high-level controls and standards, and broad authorities and responsibilities—they guide and determine actions and decisions;
2. Risk identification through continuous monitoring of portfolios, assessment of risks in new businesses and complex or unusual transactions, and ongoing review of the risk profile in the light of market developments and external events;
3. Risk measurement using methodologies and models which are independently verified and approved;
4. Risk control by monitoring and enforcing compliance with risk principles, policies and limits, and with legal and regulatory requirements; and
5. Transparent risk reporting to stakeholders and to management at all levels, on all relevant aspects of the approved risk control framework, including limits on an ongoing basis.

Our Operational Risk Framework (ORF) is an integrated quality control model that also supports regulatory requirements (including SOX 404, MIFID, and Basel II). Whilst clear ownership of these risks lies with the business, independent challenge is provided by Operational Risk Control (ORC) to ensure robust disciplines are followed.

— *How many items are there on your risk register?*

Whilst information is only available on a regional basis, the UK represents the lion's share of risks within EMEA.

There were 190 risks on the Operational Risk Inventory (ORI) for the Investment Bank in EMEA as at COB 4 March 2009.

All material risks are disclosed in the public quarterly and annual reports.

— *How often is your risk register reviewed and by whom?*

Open risk items are subject to ongoing review by relevant functions based on progress made against their action plans, with full risk assessments being performed on a monthly basis. Independently, ORC validates the functions' assessment of risk, risk ratings and action plans.

The operational risk profile across the Investment Bank is reviewed on a monthly basis by the IB Operational Risk Committee, which is a cross-functional committee of senior representatives who are required to sign-off that the status of the risk profile is accurate.

Market and Credit exposure risks are discussed in the monthly IB Executive Risk Committee where the IB Chief Risk Officer (CRO) is responsible for the agenda. In addition, the IB CRO is a member of the IB Executive Committee and Group Executive Board Risk Council, giving ample opportunity for discussion of material risk exposures.

Finally, Risk Portfolio Reviews provide a forum for senior risk management to obtain a holistic review of key market, operational and credit risks and to identify significant control issues.

— *Was "collapse of wholesale markets" on your risk register as a potential risk and what were your mitigating controls?*

Whilst the ORI provides a record of our current risks, potential risks on the scale of "collapse of wholesale markets" are incorporated into the risk scenario analyses performed by our Market Risk, Credit Risk and Treasury functions. In answering this question, we have taken "collapse of wholesale markets" to be a

reference to the market events that have unfolded since mid-2007. Many of these market developments had been incorporated into our risk modeling, including (see answer to Q.5) the crisis in the wholesale funding markets. However, whilst many features of the crisis were considered as potential risks, the combination, scale and severity of the events that have unfolded in global markets were not fully anticipated and incorporated into our scenario analyses.

— *What improvements do you think are required to risk control frameworks in the banking industry?*

Given recent events, the importance of a risk-based approach to calculating regulatory capital has become even more important. Basel II has addressed this issue to a certain extent from a counterparty credit risk perspective. A similar approach is now being proposed for the market risk framework which will enable better management and control of the overall risk. Changes to the overall framework will incorporate more extreme market, credit and liquidity scenarios of the sort that we have recently witnessed.

UBS-IB is broadly supportive of these proposals and is actively involved in the various consultation processes with regulators across a number of jurisdictions, including the UK.

— *How many FTE staff posts do you have devoted to risk management, both as a number, and proportion of total staff?*

As at 28 February 2009, the Investment Bank had 565 FTEs devoted to risk management. This equated to 3.35% of the global headcount. The figure covers all staff employed in our Credit, Market and Operational Risk functions based inside and outside the UK. Providing only the figure for those based in the UK would be misleading since the location of a risk management employee is not a reliable indicator of the geographical scope of their risk coverage. Given that a substantial proportion of the Investment Bank's business is located in London, it would be fair to say that the majority of the 565 employees do have some responsibility for the bank's activities in the UK.

5. *Did you stress-test your balance sheet against a scenario where the wholesale funding markets closed down?*

UBS performed regular (monthly) stress tests of its balance sheet which incorporated the assumptions surrounding a loss of wholesale funding.

6. *Should there be a special insolvency regime for investment banks as there soon will be for commercial banks? Would this prevent post Lehman-type problems?*

Following the introduction of a new permanent special resolution regime, providing the Authorities with a range of tools to deal with failing banks and building societies in the February 2009 Banking Act, we think there should be a special insolvency regime for investment banks.

We believe that the Lehman experience illustrates that current UK insolvency law does not take adequate account of the nature and complexity of investment banks' operations, their interaction with the rest of financial services industry, and the fact that they control very large quantities of client assets.

We are optimistic that a more tailored insolvency regime, if carefully designed and applied, and not leading to undue uncertainty, could help to produce a much better overall outcome than there appears to have been following the appointment of joint administrators in respect of Lehman Brothers International (Europe).

Narrow Banks

7. *Do investment banks make natural partners for retail banks or is the culture too different?*

In our view, successful retail banking is about scale and requires perfection of repeated tasks leading to franchise growth, combined with prudent risk taking. Successful investment banking is more about individual skills and requires rapid and accurate identification of temporarily available market opportunities, combined with prudent risk taking.

However, retail and investment banks serve very different client segments. Consequently there is no need to combine the two cultures: many universal banks run retail and investment banking organisations alongside each other.

The risk control problem is precisely the same in both cases: bank managers want to make loans, and traders want to trade. Consequently, the cultures of both types of bank converge at more senior levels of the organisation.

8. *What are the strongest reasons both for and against the separation of traditional, narrow banking activities from riskier trading and investment banking activities by your organisations?*

The Investment Bank at UBS is integrated with Wealth Management and Global Asset Management business divisions. However, it is structurally separate, in order to enhance the incentive for each business division to be successful on its own merits.

The goal is to achieve clear-cut accountability, transparency and optimization of funding and capital usage. This model also creates maximum strategic flexibility to capture opportunities for shareholder value creation. It is potentially more apt to an open architecture approach in private client businesses.

UBS believes in an integrated model where wealth management, asset management and investment banking capabilities are offered to clients as one-stop shopping solutions. A leading position in wealth management requires in-house expertise in the investment banking and asset management areas to be leveraged for large private clients. These are mainly the advisory and commission businesses. A meaningful incentivisation of such cooperation is key.

Remuneration

9. *What was the share of bonuses in total remuneration 20, 10, and one year(s) ago?*

Whilst we do not hold data from 20 years ago, UBS has recently conducted an exercise to review the breakdown of compensation over the past seven years from 2001. It was found that, when considering all staff in the Investment Bank globally, including logistics and control employees, there had been no real change in the proportion of total compensation paid as salary and bonus during this time. In 2001, bonus represented 68% of total compensation, dropping to 64% in 2002, then held steady in the 65–70% range up until 2007. In 2008 bonuses represented 48% of total compensation.

Anecdotally, for the very top revenue producers, for example senior Investment Bankers, a multiple of between 5 and 10 times base pay was as valid in the 1980's as it was in 2007.

10. *Why do investment banks pay bonuses as a large part of take-home-pay when no other type of firm does?*

Investment banking, as it is understood today, is a relatively new business model. The unique characteristics of investment banks are the global operating model, global competition, and the need for highly educated employees in all segments of the organisation. One of the most significant barriers to success is a shortage of appropriate talent on a global scale. Moreover, the investment in, and development of staff, is both expensive and time consuming.

As a result, investment banks use incentive compensation to differentiate themselves from competitors and other industries. The premise is that an effective bonus scheme can stimulate productivity, innovation and ultimately profits and increase individual and company wealth. The scarcity and need to retain talent required a focus on incentive compensation that, whilst observed in many other private and public sector environments, is central to investment banks' ability to compete for talent. Variable pay also offers a degree of flexibility to organisations to manage the cost base during volatile periods. The system demonstrates a direct line of sight between returns generated to the shareholder and employee.

As financial markets grew, supported by rapid product innovation, so the demand for talent rose. A narrow focus on investment banking also ignores the affiliated industries and the intense competition for talented staff they bring, particularly from hedge funds, where the reward in the form of incentive compensation can be even greater. At an industry level, the market for incentive compensation grew in parallel to the developments in the financial services industry.

11. *How are these bonuses structured within your firm? Why do they have this structure?*

UBS considers incentive structures from two perspectives:

1) Pay for performance

   UBS endeavors to provide compensation aligned with the performance of both the individual and the organization. Discretionary incentive decisions take into account several factors, including the individual's performance, the performance of the business area, the performance of the Business Group and the performance of UBS. Additional factors may also include business needs, market levels and other external factors. Employees in revenue-producing roles can expect, in general, to have greater incentive opportunity and volatility in awards on both the upside and downside. Overall, given their discretionary nature, incentive awards can vary significantly from year to year and between geographic markets.

2) Composition of incentive awards

For many years UBS has deferred significant amounts of variable compensation on a mandatory basis. Above a certain threshold, a portion of discretionary compensation is given in the form of a mandatory long-term incentive award, generally in the form of UBS equity which vests over time. In particular, it is critical to award equity-based incentives to those in positions with the greatest degree of influence over the performance of UBS.

These long-term incentive awards vest (become unrestricted) over time, generally over a three to five year period. These awards include provisions that can result in a failure to vest and forfeiture in certain circumstances. They also may include certain internal or externally measured performance criteria that must be achieved in part or in whole for the award to vest. These provisions help protect the interests of UBS shareholders, incentivise company and share price performance and ensure that UBS establishes a meaningful retention tool for key employees.

UBS announced on 17 November 2008 its intention to modify its incentive pay structures, although retaining the basic premise of incentive pay. However, modifications are being made to the measurement basis, mode of delivery, right to recover/ reclaim and time horizon. All proposals are designed with the sole aim of supporting sustainable profitability and providing long-term value creation to our shareholders. This will be meaningfully cascaded within all business divisions. It is expected that in future years the level of compensation paid as salary will increase, and the bonus element decrease.

The structure is supported by an effective, independent, governance process from the Board Director mandated to oversee the compensation systems of the entire firm. As such, the relevant committee has independent oversight of the design and outcome of all remuneration plans and processes.

Securitisation and Complex Products

12. *What proportion of securitised investments do you keep on your own books? How has this proportion changed in the past 10 years?*

We have interpreted this question to refer to the proportion of issues we have securitised that we still hold. It is extremely difficult to provide meaningful supporting data for this question, and so we have therefore answered in terms of the main business areas previously making securitised investments.

Real Estate & Securitization

The evolution of this business over the past ten years can be categorised broadly in to distinct periods. During the period from 1999–2000, the Paine Webber merger had just been completed, and the business was a middle-tier niche player, well respected in the US market.

By 2003 the Investment Bank had begun leveraging UBS's low cost of funds and increased business in Agency Collateralised Mortgage Obligations, Derivatives and Pass-Thru products. This enabled the business to start achieving top league-table status.

In the following period up to 2007, the focus was on closing the revenue gaps with our competitors in the Non-Agency business. The US Mortgage-Backed Security (MBS) business grew in to a full service leader in the market, adding products such as Asset-Backed Securities (ABS), whole loans (prime, Alt-A and sub-prime) for securitisation, asset-backed lending, Collateralised Debt Obligations (CDOs) and Collateralised Loan Obligations (CLOs). The business also progressively expanded in to Europe and APAC over this period.

By adding new product lines such as Home Finance (Residential Mortgage Origination Platform), Mortgage Servicing, ABS Banking, Real Estate Finance, and Securitized Proprietary trading, the business was able to further expand.

From May 2007 (following the collapse of Dillon Read Capital Management) until the present day, the focus has switched entirely to de-risking the Real Estate & Securitization business, significantly reducing the balance sheet and headcount globally. The Home Finance group has been closed down and the Mortgage Servicing group is in the process of being sold. The Investment Bank has exited the Securitized Proprietary group and in February 2009, UBS announced their intention to fully exit the remaining businesses within the Real Estate & Securitization Group.

Auction Rate Securities

Over the past 10 years UBS Securities LLC and predecessor firms have acted in an investment banking capacity for a number of issuers, including issuers of student loan backed Auction Rate Securities. In that capacity the bank has brought these securities to market, supported the auctions by purchasing some of those securities and also engaged in some trading activity. UBS Securities LLC held those Auction Rate Securities on the balance sheet of UBS Securities LLC.

In June 2008, UBS decided to exit the Municipal Securities business and therefore UBS Securities LLC is no longer engaged in the origination of new student loan Auction Rate Securities. Currently, UBS Securities LLC has a settlement agreement with some US regulators which require the bank to buy back Auction Rate Securities from clients who meet the eligibility criteria for settlement. Once bought back, these securities will also be on the balance sheet of UBS Securities LLC.

13. *When you sell products on, do you consider whether they are suitable for and fully understood by your clients? If not, why not? If yes, give examples*

Yes. Under the terms of the Bank's Suitability Policy, all products must be reviewed to assess, inter alia, customer suitability, ie the suitability of that product or transaction for the particular client to whom it is being sold. The primary responsibility for making this assessment lies with the relevant sales person and sales management. The involvement of the control functions (Risk, Finance and Legal & Compliance), which may be extensive, does not in any way relieve the sales team of its responsibility for suitability determinations.

Customers are internally categorised into three categories: market counterparties, intermediate customers (including corporates/ sovereigns and semi-sovereign clients) and less sophisticated/ experienced clients. Products are also categorised into three types: standard cash products (eg bonds and equities), vanilla derivatives (eg rates options/ forwards, flow CDS) and complex structured products/ transactions. Categorisation of product and customer determines the level of due diligence/ suitability assessment that is required, eg sales of standard cash products to professional clients requires no assessment, but sales of complex structured products to any client and all sales to less sophisticated clients require individual suitability assessment.

The Bank also has a policy for approval of all new business initiatives and complex/ unusual transactions. This policy requires that suitability is assessed in all such cases according to suitability guidelines appended to the policy.

For sales of products through intermediaries (whether the Bank's private banking affiliate or third parties), customer suitability determination is the responsibility of the intermediary. This is documented in internal principles and in distribution agreements signed with third parties.

The Bank also has a MIFID Suitability Policy which codifies the suitability assessment requirements of MIFID in connection with any personal recommendations made by staff in the EU.

The Bank requires relevant staff to undertake regular training on, and affirmation of these policy requirements.

Management and Ownership Structure of Investment Banks

14. *What is the role of non-executive directors in an investment bank?*

In the context of an investment bank which is a UK incorporated legal entity, the role of a non-executive director would be expected to comprise the same core elements as is found in the role of a non-executive director of any other UK incorporated legal entity.

This includes the promotion of the highest standards of corporate governance, but which will vary to some degree according to the status and ownership of the respective legal entity (eg whether it is a subsidiary or a parent, listed or unlisted).

In addition to this core role, a non-executive director of such an investment bank will have to be aware of, and comply with, the Financial Services Authority's requirements and expectations under the Significant Influence Function category of CF-02 (Non-Executive Director). If the investment bank is listed, and subject to the UKLA rules and regulations, then compliance with those UKLA rules and regulations is required, or if it is listed under the rules of an overseas listing authority, the rules of that listing authority.

15. *Investment banks were once partnerships. Why did this change? If investment banks go back to their traditional purely advisory role, should they revert to partnerships?*

The form and nature of investment banking has changed profoundly over the course of the last 30 years, principally driven by the increasing size and sophistication of capital markets. There have also been material changes in the regulatory environment such as the repeal of the Glass-Steagall Act in the US in 1999. The Glass-Steagall legislation had prevented a US bank holding company from owning other financial companies and its removal increased the scope for overlap between commercial banking and the securities industries.

Capital markets evolved in order to provide more efficient matching of those requiring capital with those willing to provide it. This was achieved through a variety of means including broader geographic distribution of products, increased liquidity and the development of new products and techniques to

package the underlying risk in different ways. These developments facilitated a much more efficient supply of capital across both the private and public sector which stimulated growth and in turn led to the increasing size and complexity of the capital markets.

The ownership structure of the investment banking industry evolved in response to this changing nature of the industry. As the industry became more sophisticated, capital demands more significant, client demands more wide-ranging and with a desire to attract leading talent there was pressure on investment banks to increase their capital base in order to provide a full range of services and be able to take the size and nature of risks required in order to provide a competitive service to clients. Therefore there was pressure for investment banks to access public capital and as a listed company equity became a useful way to reward employees and align their interests with the firm at all levels of seniority. Goldman Sachs remained a partnership until 1999 and after its IPO all of the world's leading, global full service investment banks were either publicly listed or formed part of broader or "universal" banks.

Although some investment banks remain partnership based these are either much smaller in scale or only offer a much more limited range of investment banking services, typically focusing only on advisory services and only limited direct exposure to capital markets based activities.

If there is a separation between the advisory role and other aspects of investment banking activity then, depending on the nature of the transition from the current model, such "advisory only" firms should be able to function effectively as both privately and publicly owned firms.

An "advisory only" firm would not require a substantial amount of capital in order to make the business model viable because it would not require "risk capital" in order to fund a substantial capital markets business. Instead it would simply require sufficient funding to ensure that costs and overheads could be met. This should allow an advisory firm to function effectively in a partnership structure. This would be analogous to the way in which leading UK law firms currently operate.

A partnership structure would ensure that the interests of all the key decision makers have economic alignment with those of the firm and therefore ensure that risks and rewards are appropriately balanced.

If, however, advisory firms were publicly listed companies and assuming that key employees retained incentive structures involving equity participation then this would also act to align the interests of the employees and the firm although less so than with a partnership structure.

The issue of alignment of employee responsibilities with those of the firm is, however, arguably considerably less relevant to the public interest in an "advisory only" firm because the key capital risks will remain with the capital markets related activities of the investment banks and the failure of these advisory only businesses is likely to have very limited impact beyond the employees immediately involved, akin to the failure of a law firm.

Acronyms

The following is a summary of acronyms used in preparing this document:

ABS	Asset-Backed Security
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
CLO	Collateralised Loan Obligation
COB	Close of Business
CRO	Chief Risk Officer
DRCM	Dillon Read Capital Management
FTE	Full-Time Equivalent (staff)
IB	Investment Bank (business division within UBS Group, not a separate company)
IPO	Initial Public Offering
MBS	Mortgage-Backed Security
ORC	Operational Risk Control
ORF	Operational Risk Framework
ORI	Operational Risk Inventory
MIFID	Markets in Financial Instruments Directive
UKLA	UK Listing Authority

March 2009

APPENDIX 1

BACKGROUND INFORMATION FOR TREASURY COMMITTEE QUESTION 1

Investment Bank Performance	*31/12/2008*	*31/12/2007*	*31/12/2006*	*31/12/2005*	*31/12/2004*	*31/12/2003*	*31/12/2002*	*31/12/2001*	*31/12/2000*	*31/12/1999*
Operating income (CHFm)	(24,167)	(804)	21,773	17,600	16,237	14,478	12,545	14,355	17,997	12,579
Operating expenses (CHFm)	9,925	15,865	16,205	12,840	11,879	10,628	10,998	11,862	12,962	10,095
Performance before tax (CHFm)	(34,092)	(16,669)	5,568	4,760	4,358	3,850	1,547	2,493	5,035	2,484
Additional information										
Total Assets (CHFm)	1,753	1,984	2,059	1,707	1,477	1,319	1,099	1,005	817	
Risk Weighted Assets (CHFbn)	196	191	175	151	117	103				
Personnel (FTE)	17,171	21,779	21,733	18,174	16,970	15,633	15,791	15,690	15,391	12,694

Source:

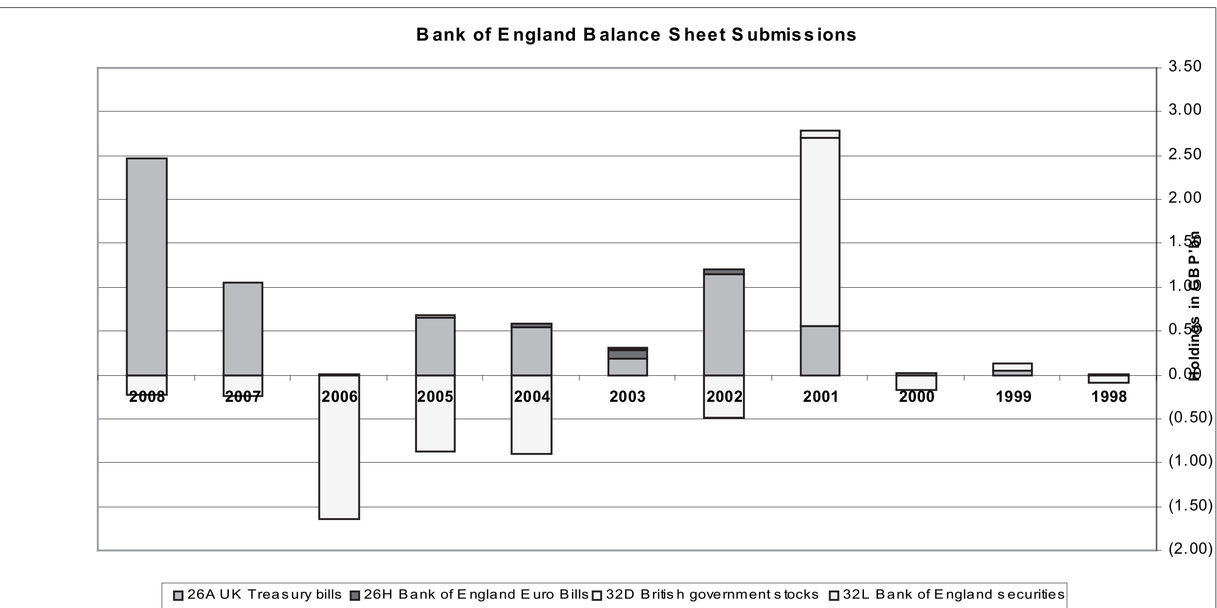
Period	
2008–2003	Historical timeseries for P&L, Personnel / UBS Annual Reports for total assets and RWA
2002–1999	UBS Annual Reports. Numbers represent UBS Warburg only

APPENDIX 2

BACKGROUND INFORMATION FOR TREASURY COMMITTEE QUESTION 2

Figures in GBP'bn

UBS AG London Branch & UBS Limited		*Dec-08*	*Dec-07*	*Dec-06*	*Dec-05*	*Dec-04*	*Dec-03*	*Dec-02*	*Dec-01*	*Dec-00*	*Dec-99*	*Dec-98*
26A	UK Treasury bills	2.47	1.05	0.00	0.65	0.54	0.18	1.15	0.55	0.02	0.05	0.00
26H	Bank of England Euro Bills			0.00	0.00	0.04	0.11	0.05	0.00	0.00	0.00	
32D	British government stocks	(0.23)	(0.24)	(1.65)	(0.88)	(0.90)	0.01	(0.49)	2.15	(0.17)	0.08	(0.09)
32L	Bank of England securities	(0.00)	0.01	0.00	0.02	0.00	0.01	0.00	0.08			



Notes

Example of holdings—Dec 2008 T-bills consists of £1.2 billion in UBSAG London Branch and £1.3 billion in UBS Limited

- Increase in holdings within UBS Limited since 2008 due to investment of £1.2 billion capital in UK Government debt
- UBS AG London Branch holdings predominantly in the MCC business, namely:
  - Represents increase in UBS AG Parent Bank liquidity buffer held in London Branch. This provides liquidity flexibility from a portfolio of high quality, highly liquid assets
  - Holdings from MCC Basis desk—strategy is to hold bonds and hedge via futures market looking for arbitrage opportunities
- The Fixed Income business has positions in British Government stocks, broadly risk managed under the following strategies:
  - Inflation derivatives book—index linked gilts used to hedge OTC inflation risk with conventional gilts hedging treasury risk and nominal risk in OTC portfolio.
  - Gilts book runs short short dated gilts v long futures position
  - Index linked gilts market making book. Net nominal risk hedged with GBP futures.

Further memorandum from Paul Moore

Introduction and Summary

1. I provided my initial evidence to the Treasury Select Committee (TSC) on Friday 6 February 2009 and additional more detailed evidence on 25 February 2009.

2. This further additional evidence is provided following correspondence with the Clerk of the Committee to deal with outstanding points that have not been covered in my earlier evidence or not in sufficient detail.

3. In particular, this evidence deals in more detail with the denials of my allegations by Gordon Brown, the FSA, Sir James Crosby, Lord Dennis Stevenson and Andy Hornby. It also deals in some detail with my response to the FSA's detailed statement dated 11 February.

Summary of my Further Additional Evidence

4. In summary, I now say as follows:

a. The relevant parties stated that my allegations were fully and properly investigated and claimed that they would provide further evidence, including the "so called independent" KPMG report which would prove that my allegations held no merit.

b. The Prime Minister stated in the House of Commons:

"However, it is right that when serious allegations are made, they are properly investigated. No doubt the Treasury Select Committee will want to look at them and no doubt the Conservative Party will want to wait to see how that investigation takes place."

c. Despite the vocal and high profile denials of the parties, in fact, no further evidence other than the KPMG report has been received by the Committee.

d. I stated on numerous occasions after the denials of my allegations that I had detailed additional evidence which would corroborate all my allegations and which would prove that the KPMG report would not withstand truly independent public scrutiny.

e. I have now provided my detailed resume of my additional evidence which proves overwhelmingly the veracity of my original allegations and deals conclusively with the KPMG report. No-one now believes that this report was independent and my additional evidence demonstrates that it cannot be relied on in any way.

f. Following the provision of my additional evidence over a full week and half ago, no additional evidence has been provided by any of the parties to rebut what I have said.

g. The Treasury Select Committee should now accept my allegations and pay due regard to them in writing its report.

h. The Treasury Select Committee should propose that the recommendations I made for policy changes (demonstrated by the allegations I made) should be considered by the appropriate fora including the FSA.

i. Finally that, as my evidence demonstrates potential wrongdoing by the parties (see 18 below), the Treasury Select Committee should recommend in its report that such matters should be dealt with in the appropriate tribunals and by the appropriate authorities.

Further Additional Evidence

5. Lord Dennis Stevenson and Andy Hornby both denied my allegations in their interviews with the TSC and relied on the "KPMG Report".

6. When Sir James Crosby resigned as the Deputy Chairman of the FSA, Gordon Brown told Parliament [PMQs 11th Feb 09] in response to questions from David Cameron:

> "The allegations that were brought before the Treasury Select Committee were investigated by the independent KPMG in 2005. The allegations made by Mr Moore were found not to be substantiated. That was an independent review that was done by KPMG and reported to the Financial Services Authority. However, it is right that when serious allegations are made, they are properly investigated. No doubt the Treasury Select Committee will want to look at them and no doubt the Conservative Party will want to wait to see how that investigation takes place."

7. Gordon Brown also said:

> "It is right that we investigate serious allegations that are made about the banking system. These are serious but contested allegations. In relation to Sir James Crosby, these are allegations that he will wish to defend so it is right that he has stepped down as vice chairman of the Financial Services Authority."

8. The FSA issued a long statement on 11th February which included the following:

> "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."

9. I wish to tell the Committee that, apart from the obvious general point that I disagree with their conclusions, there are a number of specific parts of the FSA statement with which I am at odds.

a. In particular I would say that, although the FSA has said that the specific allegations made by me were "properly and professionally investigated" and "that the changes made by HBOS were appropriate", the FSA themselves also say in the same statement that in June 2006 "there were still control issues" [at HBOS] and "the growth strategy of the group posed risks to the whole group and that these risks must be managed and mitigated".

In these circumstances, how can they genuinely say that the changes made were appropriate?

Also, when Lord Turner gave evidence to the TSC he said that Jo Dawson would not now have been approved by the FSA. Since there has been no change to the relevant rules relating to the approval of approved persons, Lord Turner's evidence amounts to an admission that the changes made by HBOS in 2004–05 were not appropriate.

I also disagree with what the FSA said at the Committee that actions taken then were appropriate under the "philosophy" that applied then. The rules were the same.

b. In their statement, the FSA say:

"the FSA conducted a full risk assessment of HBOS (known as an ARROW assessment) in late 2002 which identified a need to strengthen the control infrastructure within the group".

In fact, the Arrow assessment was conducted in 2003 and it did not cover the whole of HBOS. It covered all divisions apart from the Strategy and International division.

c. In their statement, the FSA also say:

"the FSA then conducted a further full risk assessment of the HBOS group to cover all of the group's business, formally recording its assessment in December 2004, the assessment was that the risk profile of the group had improved and that the group had made good progress in addressing the risks highlighted in February 2004, but that the group risk functions still needed to enhance their ability to influence the business, which we saw as a key challenge."

They did not carry out a further full risk assessment in December 2004 and the risks were not highlighted in February 2004 but in December 2003.

d. These simple errors relating to dates demonstrate a lack of care and attention at the FSA which is telling in itself.

e. In their statement, the FSA say:

"following that appointment, the then head of group regulatory risk, Paul Moore, was informed on 8 November that he would leave as part of this restructuring; he subsequently approached FSA to express concerns about HBOS and in particular about the suitability of the new appointee as the group risk director."

This is not fully accurate. I approached the FSA with a long and detailed list of concerns including the allegation that I was dismissed by James Crosby for raising many issues of actual or potential breach of the FSA requirements (ie that I had a whistle blowing claim). In fact that was the post serious allegation of all. The issue of the new appointee was only one of the many issues raised. It was certainly not the most serious as the statement suggests. All the allegations were set out in a detailed Outline Case demanding a full and independent investigation. A full copy of this Outline case can be provided if required.

f. In their statement, the FSA state:

"the FSA satisfied itself about the skill and independence of the individuals selected to conduct the report for KPMG and about the scope of the report."

The investigation did not cover all the areas that should have been covered and we complained about this at the time to HBOS. We also complained at the time about the conduct of the investigation. It is not clear that HBOS passed these criticisms on to the FSA as they should have. I have detailed documentary evidence of each of these complaints and have copied one letter in my earlier evidence.

Secondly, on the so-called independence of the KPMG report, it is worth repeating that my solicitor and counsel have both written to the TSC and stated publicly that the report could not have been regarded as independent since KPMG were the auditors of HBOS. It follows that the FSA should not have regarded it as independent. In fact I am not sure anyone now really accepts that the report was independent.

g. In their statement, the FSA say:

"the FSA approved that individual only when it had received those results, which indicated that KPMG 'did not believe that the evidence reviewed suggested that the candidate was not fit and proper', that 'the process for the identification and assessment of candidates for the GRD position appeared appropriate', and that 'the structure and reporting lines of Group Regulatory Risk are appropriate'

Words such as "did not believe…suggested" and "…appeared appropriate" are hardly the most unequivocal.

In any event, we sent the strongest possible rebuttal of all the points made in the KPMG report to HBOS within a short period of time of receiving the report. The Committee has seen a copy of this letter.

An important question is whether HBOS sent this rebuttal letter to the FSA. Under the FSA Principles for Business they were required to do so. Even if they did not, why did the FSA not call me back to ask me about my view of the report? There is no doubt that they should have done so and not simply accepted the report "as read". That simply suggests that they wanted to close the file without properly completing the work of investigating all the serious allegations that were made. Perhaps this was convenient as James Crosby was a non executive director of the FSA at the time?

h. In their statement, the FSA say:

The FSA also followed up Mr Moore's concerns by meeting him independently and separately discussed the KPMG report directly with KPMG.

This suggests that I met the FSA after the KPMH report. This is not true. They should have done so. In fact, I only met them before the report was commissioned from KPMG in December 2004. They should have called me in to find out my response to the report.

10. Sir James Crosby's resignation statement said:

"Towards the end of my time as CEO of HBOS, as part of a wider restructuring of group functions the Risk Function was elevated to report direct to the CEO……….As part of this I asked one of our risk managers, Paul Moore, to leave HBOS. ……At the time he made a series of allegations. ….These were independently and extensively investigated on behalf of the Board, the results of which they shared with the FSA. That investigation concluded that Mr Moore's allegations had no merit. ……Last autumn (on a BBC programme) and again yesterday (Tuesday) at the Treasury Select Committee he repeated substantially the same allegations. HBOS has reiterated its view that his allegations have no merit. ………. I am totally confident that there is no substance to any of the allegations."

11. Subsequently, I believe that Sir James Crosby said in a newspaper interview that he would bring forward detailed evidence to rebut my allegations. I believe he also told you this.

12. I issued a press release on the 11th February in which I said as follows. I repeated the same points a numerous occasions to the press and TV news programmes.

"I have a significant body of detailed additional evidence which will corroborate what I said. I am confident that the 'independent report' to which Sir James has referred will not bear up to any proper independent scrutiny. I described that report as 'supposedly' independent in my evidence to the committee and I strongly stand behind that statement. No doubt I shall be given the opportunity at an appropriate time to disclose my evidence and demonstrate what I am saying is true.

13. Had all relevant parties not denied my allegations, I believe we could all have moved on to deal solely with the question of future policy construction. However, this has not happened and the Prime Minister himself has said that such serious allegations need to be investigated.

14. As you know, I have now provided my detailed resume of additional evidence to the Committee but Sir James Crosby, Lord Stevenson, Andy Hornby and the FSA have not provided any additional evidence other than the KPMG report which, as you know, I had already offered to send to the Committee before the week ending 13 February.

15. My additional evidence proves my allegations unequivocally and that the KPMG report bears no weight and was effectively a "whitewash".

16. I assume that as no further evidence to rebut my allegations has been received that this means that my allegations are now accepted and the TSC will be able to conclude that this is the case.

17. I believe the public interest demands this conclusion as well as my reputation. I have all the underlying documents which support the detailed resume of additional evidence if these are required. I have referred to these in my detailed resume.

18. I believe that my allegations raise important questions of potential wrong-doing / incompetence by the relevant parties which should be followed up.

They raise questions as to the actions and omissions of the FSA. It should be noted that the Principles and rules which applied then are the same as now and that it is not appropriate to say that everything done then was permitted because the "philosophy was different".

My allegations also raise questions of potential breach of company law fiduciary duties of the relevant HBOS directors as well as their potential breach of the FSA's Principles for Approved Persons, in particular:

Statement of Principle 1

An approved person must act with integrity in carrying out his controlled function.

Statement of Principle 2

An approved person must act with due skill, care and diligence in carrying out his controlled function.

Statement of Principle 4

An approved person must deal with the FSA and with other regulators in an open and cooperative way and must disclose appropriately any information of which the FSA would reasonably expect notice.

Statement of Principle 5

An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function is organised so that it can be controlled effectively.

Statement of Principle 6

An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function.

Statement of Principle 7

An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function complies with the relevant requirements and standards of the regulatory system.

19. My allegations also support the important recommendations for policy changes set out in my first memorandum of evidence which should be accepted by the Committee for further detailed consideration. My advisers and I are prepared to be involved in any discussions to this end. We have more detailed points which we believe would add value to further discussions.

20. If the TSC feels it is impossible under its terms of reference to achieve what Gordon Brown said in the House of Commons ie No doubt the Treasury Select Committee will want to look at them and no doubt the Conservative Party will want to wait to see how that investigation takes place", it may that it should recommend an investigation in another appropriate tribunal eg a judicial enquiry. If it does so, as I have already recommended in my evidence, I would suggest a broad ranging investigation into the banks as a whole not just HBOS.

8 March 2009

Memorandum from Abbey National plc

BANKING REGULATION IN SPAIN & SANTANDER APPROACH TO RISK MANAGEMENT

A. Statistical or Counter-cyclical Provisioning

A.1 *Origins and rationale*

- Credit is pro-cyclical. During the expansionary phase of the economic cycle, increasing asset prices can result in the over-extension of borrowing and the mis-pricing of risk. This phenomenon has been clearly evident during the recent financial crisis.
- The pro-cyclicality of credit is compounded by the fact that credit institutions' loan loss provisions are cyclical in many countries. In other words, provisions increase during the downturn and reach their lowest level at the peak of the cycle. To a large extent this reflects an inadequate ex-post accounting of credit risk. The result is that credit institutions' profits follow the opposite pattern.
- The Spanish banking system was plagued by significant crises during the 1980s and early 1990s, related at least in part to this issue. Thus in seeking to address this problem the Banco de España (Bank of Spain) developed a counter-cyclical regulatory device which it introduced in 2000—the so-called "statistical" provision. With the adoption of the International Accounting Standards in 2005, this third class of provision was abolished, but it was replaced by a similar approach in the form of an estimated general provision.

A.2 *How it works*

— Essentially the "generic" provision model works by requiring financial institutions to put aside reserves in the good times in order to mitigate some of the losses in the bad times. The model looks at the difference between an institution's specific provisions for identified losses in any given year and a statistical provisioning amount that reflects average losses on assets over the whole business cycle. The effect is neutral over the cycle, but the timing of the provisioning should smooth the troughs and the peaks.

— In the expansionary phase of the economic cycle, financial institutions must fill up a general provision according to credit growth and credit exposure. This provision is used as a buffer in the deceleration phase, thereby introducing an automatic stabiliser—something that is particularly helpful in an economy (such as Spain) that does not have autonomy in its monetary policy.

— In calculating the generic provision, assets are classified into six classes according to their risk profile, ranging from negligible to high risk. The calculation takes into account the historical experience of impairment over the full cycle and the other circumstances known at the time of the assessment for each class of risk.[8]

— The rules permit institutions to develop their own model to determine provisions using their own loss experience. For this approach to be effective, the internal models must be integrated into a proper system of credit risk measurement and management, they must use the institution's own historical database spanning at least an entire economic cycle, and they must be verified by the regulator. For institutions that do not have their own model, the Bank of Spain developed a model based on its experience and information on the Spanish banking sector. This model uses the historical credit loss information from the Spanish Central Credit Register, which contains information from 1968 onwards.

— For consolidation purposes, the model calls for a similar approach to be used by foreign subsidiaries of Spanish institutions, although adapted to local experience.

A.3 *Benefits of the model*

— Santander has over €6bn of generic provisions on its balance sheet, a substantial cushion in the event of difficult times. In addition to its counter-cyclical effects, the model has a number of important benefits.

— First, it leads to greater stability in the profit and loss account for institutions that have implemented it. Secondly, it helps financial institutions to maintain lending levels during a recession—something that is particularly relevant at present. Finally, the charge to the provision fund is higher than the expected loss.

— Should this model be adopted outside Spain, we would urge caution in both how and when it is implemented. It is important that the mechanism is as simple as possible to allow for its effective implementation. In terms of timing, it would not appear to make sense to require that generic provisions be built up during a downturn when they would need to be released immediately.

B. Off-balance Sheet Vehicles

B.1 *Origins and rationale*

— Financial innovation has brought numerous benefits to consumers, but it has had the effect of increasing the sophistication and complexity of some financial products. Again, with the experience of banking crises in its recent history, the Bank of Spain became concerned about the potential risks emanating from the complexity of these increasingly popular new products.

— A particular area of concern was the emergence of off-balance sheet operations, such as Structured Investment Vehicles (SIVs). Though these operations maintain contingent risks to the credit institution concerned, the institution's balance sheet does not reflect the actual risk position. The Bank of Spain's response, in 2005, was to introduce new limits to off-balance sheet accounting.

B.2 *How it works*

— The accounting limits imposed by the Bank of Spain require institutions to hold provisions for the assets held off-balance sheet from the moment that the SIVs are introduced, if risks are not substantially transferred.

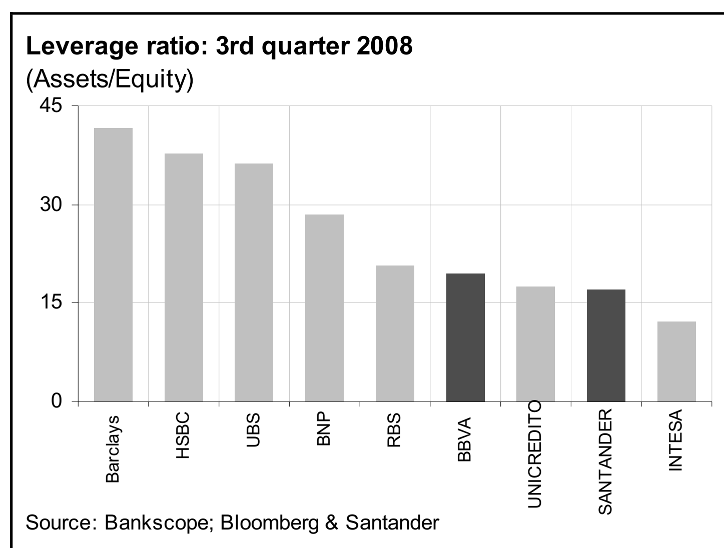
[8] Full details are set out in the Annex.

— Institutions can only derecognise a financial asset when:
  — the contractual rights to the cash flows from the financial asset expire;
  — or all the risks and rewards are substantially transferred;
  — or control over the financial asset is transferred (even if the assets are not substantially transferred or retained).

B.3 *Benefits of the approach*

— As a consequence of the approach adopted in Spain, Spanish financial institutions did not set up SIVs. There was no incentive to do so, as the provisions for assets in off-balance sheet vehicles are treated in the same way as on-balance sheet assets. Off-balance sheet vehicles therefore did not offer a means of avoiding capital requirements imposed by regulators.

— So, whilst securitisation may have been used by some institutions to inflate the asset side of the balance sheet, securitisation in Spain has been used mainly for funding reasons, maintaining institutions' incentives to manage the risk of their credit portfolio. Indeed, this is demonstrated by the fact that Spanish banks have good leverage ratios when compared with their European peers:



— Combined with favourable risk-weighted assets, and more stable asset composition derived from the focus on retail banking, this has contributed to Spanish banks being in a stronger position compared to their European peers in the current financial crisis.

C. Santander's Approach to Risk Management

— In many financial institutions the risk function is embedded within the commercial business areas, meaning the decision to lend can be subject to other pressures, such as sales targets. This is not the case for Santander. Our risk model is somewhat different since our risk function is entirely separate from the bank's commercial business areas.

— Santander's Risk Department is a separate division of the bank which reports to the 3rd Vice-Chairman of the Santander Group. The Vice-Chairman chairs the principal Risk Committee for the group and this committee reports directly to the Santander Board of Directors. The Committee's responsibilities include:
  — setting the group's risk policies;
  — setting the risk limits and the level of delegated authority;
  — ensuring each part of the group meets its risk targets;
  — resolving operations beyond delegated powers; and
  — supervising targets, tools and initiatives to improve risk control.

— The Risk Department within Santander is guided by the following key principles:
  — independence—it reports to the Board;
  — global reach—it covers all types of risk and all clients;

  - — decisions are taken at the senior Committee level;
  - — medium-low profile of risks taken within the business;
  - — it uses a wide range of tools including internal ratings, stress-testing and scenario analysis; and
  - — it has a stable, well trained team, with through-the-cycle experience.
- — Santander is at its heart a retail bank which places specific requirements on the group's approach to risk management. Retail banking requires active risk management, definition of the group's risk appetite and the dissemination of this approach to the whole group. As a result, Santander deals with foreseeable risk in its operations and a clearly defined and conservative risk profile, which ensures: strong asset growth combined with high risk quality; high geographic and business diversification; low concentration in large corporate and financial institutions; sharp focus on risk-return trade-offs; significant reduction of cross-border exposure; low complexity of financial market activities; and economic capital allocation in line with group customer focus.

Abbey National plc

February 2009

APPENDIX

BANK OF SPAIN CIRCULAR 04/2004 ANNEX 9 ON CREDIT RISK—GENERAL ALLOWANCE OR PROVISION

In recognising the losses inherent in debt instruments not measured at fair value through profit or loss, and in contingent exposures classified as standard, entities shall take into account the historical experience of impairment and the other circumstances known at the time of the assessment. For these purposes, inherent losses are the losses incurred as at the date of the financial statements, calculated using statistical procedures, that have not been allocated to specific transactions.

The Banco de España, based on its experience of and information on the Spanish banking sector, has determined that the method and amount of the parameters entities must use to calculate the amounts needed to cover the impairment losses inherent in debt instruments and contingent exposures classified as standard, that are recorded by Spanish entities or that arise from transactions in the name of residents in Spain recorded in the books of foreign subsidiaries, shall be those described in the following section. The Banco de España shall, by means of the appropriate amendment to this Circular, periodically update the parameters used in the method to reflect changes in the data for the sector.

To estimate the general allowance or provision for transactions with non-residents in Spain recorded at foreign subsidiaries, the methods and criteria indicated in the following section, adapted to the particular circumstances of the country in which the subsidiary operates, shall be applied. For these purposes, entities shall take as required reference the parameters indicated in section below.

The method for estimating the general allowance or provision mentioned in the previous section is as follows:

a) The general impairment charge to an allowance or provision to be made in each period shall be equal to (i) the sum of the products of the positive or negative change during the period in the amount of each risk class and the related a parameter, plus (ii) the sum of the products of the total amount of the transactions included in each risk class at the end of the period and the related ß, less (iii) the amount of the overall net impairment charges for the relevant specific allowances or provisions made in the period.

b) The parameters a and ß take into account the historical inherent loss and the adjustments to adapt them to the current economic circumstances. Their values for each of the risk classes are:

		α	ß
(i)	Negligible risk	0%	0%
(ii)	Low risk	0.6%	0.11%
(iii)	Medium-low risk	1.5%	0.44%
(iv)	Medium risk	1.8%	0.65%
(v)	Medium-high risk	2.0%	1.10%
(vi)	High risk	2.5%	1.64%

c) The overall balance of the general allowance or provision shall at all times be between 10% and 125% of the sum of the products obtained by multiplying the amount of each risk class by its related a parameter.

d) The amounts to be taken as the basis for calculating the general allowances or provisions for contingent exposures shall be those calculated as specified in paragraph 2 of Rule 65 of this Circular weighted by the percentages established in Rule fourteen of Circular 5/1993 of 26 March 1993.

With regard to specific allowances and provisions, the overall net impairment charges are equal to the specific impairment charges for customer insolvency arising from debt instruments and contingent exposures less the reversals of such specific allowances or provisions and of asset write-offs in the period. Impairment charges for country risk are not included.

Supplementary memorandum from Abbey National plc

This is Abbey's response to the Treasury Select Committee's request (dated 13 February 2009) for supplementary evidence as part of its inquiry into the Banking Crisis.

Background Information

1. *How rapidly did your bank grow from 1997? And for the 10 years before that?*[9]

Abbey's Trading Statement for the year ended 31 December 2008, issued on 5 February 2009, reported double digit trading income growth and statutory profit before tax up over 20%. 2008 statutory results are planned to be released on 16 March 2009.

Year	*Total operating income £m*	*Growth/(decline) in income %*	*Profit/(loss) after tax £m*	*Total assets £m*
2007	2,782	12.6	685	199,623
2006	2,470	4.9	68	191,805
2005	2,355	(6.9)	420	207,034
2004	2,530	(0.1)	(54)	184,733
2003	2,533	(28.9)	(1,323)	176,775
2002	3,565	(12.9)	(1,322)	205,194
2001	4,092	(2.4)	346	214,367
2000	4,192	—	484	204,337

2. *How did tier one and two capital ratios change over both these periods?*[9]

Year	*Tier 1 capital ratio (%)*	*Total capital ratio (%)*
2007	7.3	11.4
2006	8.0	12.6
2005	10.0	12.5
2004	10.4	12.0
2003	10.1	13.3
2002	9.2	11.6
2001	8.4	11.6
2000	8.8	13.5

3. *What happened to holdings of British government securities over the two periods?*

Abbey does not actively trade in British government bonds, but we do hold such securities as part of a liquidity buffer. Abbey holds UK and European government bonds under the requirements of the FSA's stock liquidity ratio; these holdings have been relatively constant. Abbey's holdings have remained at levels required by the liquidity ratio but the aggregate group holding of government securities rose with the acquisition of Bradford & Bingley liabilities and with the acquisition of Alliance & Leicester.

4. *What happened to the size of investment banking relative to "high street" banking over the two periods?*

There has been a disconnection between the balance sheet growth of the commercial and investment banks over the last 10 years driven primarily by the ability to grow the asset side of the balance sheet through leveraging. Although income returns were perceived to be higher in the short term, the price has been greater product complexity and opacity and a degradation in the relationship between financial institutions and consumers.

[9] Source Abbey *2004 Annual Report on Form 20-F* and *2007 Annual Report on Form 20-F*.
Data for 2004–07 presented in accordance with IFRS.
Data for 2000–03 presented in accordance with UK GAAP.
NB. In reference to the original questions (1&2), data for years prior to 2000 has not been adjusted for subsequent changes in accounting policies, and therefore not comparable.

Abbey is part of the Santander Group, which is at its heart a retail bank. Santander has over 64 million retail customers, more branches than any other international bank and derives over 80% of its income from commercial banking activities.

5. *What share of business was domestic at the beginning and end of each period?*

In 2002, Abbey set up the Portfolio Business Unit (PBU) to manage Abbey businesses that were judged not to be consistent with the new strategy. The intention was to reduce or exit these businesses to reduce risk in a timely manner. Several of these businesses derived income from outside the UK, but this represented only a small proportion of Abbey's income (<10%).

Since Abbey divested most of its overseas assets and following its acquisition by Santander in 2004, Abbey is now primarily a UK domestic business with the vast majority of income generated by UK retail and commercial banking activities.

6. *What was the share of bonuses in total remuneration 20, 10, and 1 years ago?*

We have no comparable figures from 10 years ago (before Santander's acquisition of Abbey) or 20 years ago (when Abbey was a building society). In 2008, 10.5% of Abbey's total salary bill was made up of incentive payments to all staff.

Santander believes in a high performance culture where employees are rewarded and recognised for their performance and ability. That performance has to be linked to the medium and long term sustainable success of the business.

In 2005, Abbey's senior executives were granted a conditional award of Santander stock, which was linked to certain medium term performance conditions. The number of shares awarded to executives depended on Abbey's positive performance over a three year period versus a peer-group benchmark. At the time, Abbey's three year plan focused on turning the business around from a cost and revenue perspective in order to challenge the incumbent UK banks in their core retail markets. This focus on reward, which is linked to the successful and sustainable performance of the business over the medium-to-long term, aligns management and shareholder interests.

7. *Did you stress-test your balance sheet against a scenario where the wholesale funding markets closed down?*

Abbey has a large retail deposit base which has been strengthened further following the acquisition of Bradford & Bingley's deposits. Around 75% of Abbey's commercial bank lending is funded through commercial bank deposits. Therefore we are not as dependent on wholesale funding as some of our competitors.

Stress-testing and scenario analysis form a part of the ongoing review of our funding plan and liquidity. As part of Abbey's capital adequacy review with the FSA, we stress-
test our three year funding plan for reduced commercial bank deposit inflows and negligible medium term issuance, to establish our ability to react to this situation.

In addition, Abbey maintains a buffer of liquid assets to cover an extreme scenario where access to the wholesale markets is not possible. This buffer would provide us sufficient time to package up securities for delivery to a central bank for encashment.

Consumers

8. *Bank Rate has fallen sharply. Please provide figures showing the extent to which you have passed through these falls to both savers and borrowers*

Throughout 2008 Abbey was consistently in the best-buy tables for mortgages. We wrote 1 in 3 mortgages on a net lending basis and our commitment to all mortgage customers is strong.

All Abbey's tracker rates for existing customers have been reduced in line with base rate. Abbey has also reduced fixed rates and tracker rates. At the time of writing, Abbey's best-buy fixed rate is 3.99% (for 2 years) and best-buy tracker rate is 3.69%.

Since November 2008, Abbey has passed on some of the base rate reductions to our standard variable rate (SVR) customers. SVR will continue to be reviewed in light of market conditions, competitor positions and overall risk and funding requirements. However, in any decision we make on SVR, we need to balance the interests of both our savings and mortgage customers.

Over the last three years we have been consistently high within the best-buy tables. In 2008, our business had more best-buy mentions than any other UK financial services business. This is in-line with out strategy of passing our efficiency gains back to our customers through value-for-money products.

Abbey's best-buy savings products include: Fixed Rate Monthly Saver at 4.50%; Super ISA at 4.25% AER; and Instant Access savings account at 3.0%. Abbey's best-buy current account has an in-credit interest rate of 5.5%.

9. *What impact do you foresee on your deposit base of interest rates remaining at historic lows, and will this impede your ability to lend?*

We do not believe this will impede our ability to lend, although we anticipate that demand for credit will decrease as the UK's appetite to take on and service debt is reduced.

10. *Given that the present crisis proves that large banks can fail, and that UK banks benefit from the assurance a deposit protection scheme gives to consumers, should the FSCS now be pre-funded?*

We do not believe that the FSCS should be pre-funded. In our view, pre-funding is not appropriate to the UK market given the relative concentration in this market. It is unlikely that any pre-funded deposit guarantee scheme would be able to amass sufficient funds to pay out to depositors in the event of a major bank specific failure. Even if it could, it is doubtful whether the existence of such a fund would actively prevent the bank's failure in the first place.

11. *How badly were you affected by the Irish decision to guarantee all deposits?*

We have seen limited impact. We announced in our 2008 full-year results that we had seen a significant uplift in deposit inflows from 2007—they increased by 80%. This excludes the £20 billion in retail deposits we acquired in September 2008.

In part, we believe this reflects our strategy to provide value-for-money products and the view of customers that Abbey, through Santander, is a safe haven for UK savers.

12. *How far is harmonisation of deposit limits needed across Europe?*

Harmonisation of deposit guarantee limits would help to avoid market distortion across Europe. Though we were not affected, the experience in 2008 of unlimited coverage in Ireland did have implications for others in the UK. Depositors transferred their money to branches of Irish-owned banks operating in the UK under EU passporting rules.

We support the existing level of protection of £50,000 in the UK under the FSCS. The British Bankers' Association's (BBA) analysis shows that this level already covers the overwhelming majority (in excess of 97%) of relevant depositors.

We would urge caution on the costs and benefits of any move to a higher level of protection in the UK. We would prefer to see alternative measures that recognise the importance of continuity of service in the event of a bank failure and a focus on reassuring consumers about the security of their deposits. Ultimately, the focus of all our efforts needs to be on preventing a bank failure.

13. *Once this crisis is over, how different will the financial services landscape be to what consumers could have expected in 2006 and 2007?*

In the short to medium term, there will be a return to the values of "traditional" banking: a greater focus on credit funded by retail deposits, customer affordability, prudent lending criteria and a reduction in the ability to grow through leverage in respect of both individuals and companies.

We anticipate there will be focus on reducing complexity for consumers and in terms of structures and governance. However, it is worth noting that failures within the banking industry have not been specific to the complexity or size of an organisation, but to the strategy or business model. Northern Rock and Bradford & Bingley are clear examples on this point.

We are confident in our business model. It has delivered double-digit income growth in 2007 and 2008. We have a strong range of products and, as yet, we have not seen a radical change in the strategy of our part-nationalised competitors.

14. *What are you currently doing to manage consumers' expectations of what will be available in a post-crisis world?*

We remain committed to the UK market and our strategy. We will continue to be prudent in our lending criteria and focus on providing our customers with value-for-money products.

15. *What are you doing to rebuild consumer confidence in the banking system?*

Although Santander has been very successful since its entry into the UK retail banking market, we recognise that as an industry we need to rebuild our credibility. We believe there should be a combined and concerted effort from all parties, including the Government, regulators and trade associations, as well as the banks themselves.

For our part, Santander has conducted an extensive advertising campaign in the UK over the last few months. This has emphasised: (a) that Abbey, Alliance & Leicester and (the savings business and branch network of) Bradford & Bingley are now within the Santander group; and (b) the strength of Santander as a safe haven. We believe this will contribute to the process of rebuilding consumer confidence.

16. *Will you be reducing the level of potentially riskier lending to lower-income individuals?*

We will continue to pursue our prudent strategy which includes ensuring that lending decisions are based on sound risk criteria including affordability and an individual's ability to service debt.

The FSA

17. *How would you describe your engagement with the FSA before the current crisis?*

As a large firm Abbey had a high level of engagement with the FSA before the current crisis.

18. *Did the FSA ever express concerns to you about your business models, or request a slow-down in lending?*

No. Abbey's mortgage business is prime lending and we have historically maintained sensible margins and low loan-to-value (LTV). Our lending strategy has been consistent. Since September 2006, we have carefully maintained a balance between the margin of new business, lending criteria and our market share aspirations. Our prudent strategy has given us an opportunity. We held back our market share during H2 2006 and H1 2007 when margins were low or unprofitable.

19. *How has your interaction with the FSA changed since the crisis at Northern Rock?*

Abbey's experience is that, in the wake of the Northern Rock crisis, the FSA has acknowledged flaws in the way it operated and has sought to address these.

For example, the FSA publicly acknowledges that the current regulatory arrangements for liquidity risk are inadequate, both in terms of the quantum of liquidity that is required and the usefulness of reporting. Abbey is participating in weekly reporting and conference calls with the FSA as part of its on-going monitoring of larger UK banks. This is a significant increase in the intensity of supervision compared with 2007, before Northern Rock, when there was no regular dialogue with the FSA on liquidity risk.

20. *One of the features of the FSA's supervisory enhancement programme is that "there will be raised emphasis on assessing the competence of firms' senior management". Have you seen any evidence of that?*

We have not seen any evidence of this so far.

The Future of Banking

21. *Do you consider pro-cyclicality of capital requirements to be a problem?*

[see separate detailed submission from Abbey on this subject]

22. *Andrew Crocket, former general manager of the Bank for International Settlements, has suggested that it would be advantageous for higher capital ratios to be imposed on institutions that were more reliant on short-term funding. Do you agree?*

In general we agree that higher risk banks should have higher capital ratios. In this precise example, this so-called "duration mismatch" risk could be dealt with as an element of the Capital Requirements Directive (CRD) Pillar 2 requirement, but it needs to be dealt with in the context of the overall funding mix. For example, compare two banks:

- Bank A has 90% of its wholesale funding less than three months, but 80% of its overall funding requirement provided by retail sources.
- Bank B has only 50% of its wholesale funding less than three months, but only 30% of its overall funding requirement provided by retail sources.

In this example Bank A is likely to be more stable than Bank B.

23. *The FSA has brought forward proposals on liquidity regulation, including an Individual Liquidity Assessment, and a "liquidity buffer" specific to each firm. Are you confident that their proposals amount to an effective way to assess and limit the liquidity risks which individual institutions face?*

We agree in principle with the FSA's proposals for strengthened liquidity regulation in the UK, including Individual Liquidity Assessments. Relative to the old regime, the proposals are more representative of the way that UK retail banks monitor and manage their liquidity in practice.

However, there are concerns over the effectiveness of the liquidity buffer, particularly the restrictive eligibility criteria. These criteria appear inconsistent with the new, permanent, Bank of England facilities which now accept a far wider range of collateral. The liquidity crisis has demonstrated that markets in particular financial instruments, including government paper, can close (albeit temporarily) to participants. Also, to the extent that the new arrangements force banks to hold significantly larger portfolios of government bonds, that will restrict their ability to rebuild capital and to boost lending in the way in which the Government would currently wish.

Overall, the new regime should increase the FSA's dialogue with banks about the management of their liquidity risks and give the FSA the tools to remediate risk control deficiencies.

24. *Paul Tucker and Charlie Bean have both suggested that the Bank of England should have some kind of macro-prudential risk instrument to guard against sector-wide risks. What form do you think such an instrument could reasonably take?*

Regulators already have an appropriate macro-prudential instrument to guard against sector wide risks in the shape of their ability to increase capital requirements if they see unacceptable trends developing. We would argue that this is a powerful lever for discouraging undesirable behaviour, and can be used at any time and for any purpose. However, as Paul Tucker points out, it is important that this lever is used in a co-ordinated way across national borders to avoid regulatory arbitrage.

25. *How far do you agree with Jon Moulton that "Supervision and regulation will only work if it is within the capabilities of the people involved to actually discharge those duties"?*

The Tripartite system of financial supervision in the UK has been challenged by the events of recent years, but the emphasis now should be on making existing arrangements work better rather than further extensive reform. The Tripartite Authorities have worked together more effectively in the wake of the demise of Northern Rock, but this is an ongoing process and their relationship will improve further as a result of their continued dialogue and the better definition of their respective roles.

26. *Do you think that the FSA can properly regulate you as you are currently configured?*

Yes. As stated above, Abbey is primarily a UK domestic business with the vast majority of income generated by UK retail and commercial banking activities. We are well capitalised and have capital resources in excess of current regulatory requirements. We do not have a business model where we carry significant risks on our balance sheet. We do not engage in selling complex products and we have a relatively small treasury function. Abbey is regulated by the FSA, but since we are part of the Santander group, the FSA then liaises with the Spanish regulator, the Bank of Spain, on important issues concerning Santander's businesses in the UK.

27. *What are the strongest reasons both for and against the separation of traditional, narrow banking activities from riskier trading and investment banking activities by your organisations?*

Diversification can result in greater security for banks, but at the expense of complexity. There is therefore a trade-off to be made between being bigger but more complex and being smaller. Northern Rock and Bradford & Bingley demonstrate this point: they were relatively small banks, lacking diversity, but they proved not to be secure.

Santander is an example of a large, diversified bank that it is predominantly retail focused and funded. One of Santander's main distinguishing features is its international character, which is reflected in the diversification of its operations (Continental Europe, the UK, Latin America and now the US), with a balanced position between mature and high-growth emerging markets.

Abbey National plc

February 2009

Supplementary memorandum from HSBC

A. Background Information

Financial Data

Having acquired a 14.9% interest in Midland Bank plc in 1987, HSBC purchased the remaining interest in 1992. In order to meet regulatory requirements HSBC's head office was transferred to London from Hong Kong from 1 January 1993. Attachment 1, an extract from HSBC Holdings Annual Report and Accounts for 2008, shows the history and development of the HSBC from 1865.

Please note that the data for 1992 and 1997 has not been restated to reflect accounting standards and policy used in the 2007 and 2008 report and accounts which were prepared in accordance with IFRS. The report and accounts for 1992 and 1997 were prepared in accordance with UK GAAP.

HSBC manages its business through two customers groups, Personal Financial Services and Commercial banking, and two global businesses, Global Banking and Markets (previously Corporate, Investment Banking and Markets) and Private Banking. The structure of the Group has changed over the period 1992 to 2008 and it has not therefore been possible to provide the business sector data on a consistent basis over this period.

As at 31 December 1992, HSBC had:

- in excess of 3,000 offices in 66 countries;
- 99,148 employees;
- dual primary listing on the London and Hong Kong stock exchanges; shares held by more than 170,000 shareholders in over 80 countries;
- pre-tax profit in 1992 of US$2,591 million including the profits of Midland Bank since its acquisition half-way through the year. UK accounted for 18%. Segmentation by business sector is not available;
- tier 1 capital ratio 7.4%, capital ratio 12.3%, balance sheet total US$258, 232m and loans and advances to deposits ratio of 76%.

As at 31 December 1997, HSBC had:

- more than 5,500 offices in 79 countries and territories;
- 132,285 employees;
- pre-tax profit of US$8,143m of which the UK accounted for 36%. Investment Banking (responsible for advice and financing, equity securities, asset management and some private banking and trustee activities of the Group) accounted for 4%;
- tier 1 capital ratio 9.3%, total capital ratio 14.2%, balance sheet total US$471,686m and loans and advances to deposits ratio of 82%.

As at 31 December 2007, HSBC had:

- more than 10,000 offices in 83 countries and territories;
- 330,000 employees;
- listings in London, Hong Kong, New York, Paris and Bermuda; shares held by circa 200,000 shareholders in over 100 countries and territories;
- pre-tax profit of US$24,212m of which UK activities accounted for 24%. Global Banking and Markets (Corporate, Investment Banking and Markets) business accounted for 25%;.
- tier 1 capital ratio 9.3%, total capital ratio 13.6%, balance sheet total US$2,354,266m and loans and advances to deposits ratio of 82%

As at 31 December 2008, HSBC had:

- more than 10,000 offices in 86 countries and territories;
- 325,000 employees;
- listings in London, Hong Kong, New York, Paris and Bermuda; shares held by over 210,000 shareholders in 120 countries and territories;
- pre-tax profit of US$19,871m excluding the goodwill impairment on the Group's North American Personal Financial Services business, of which UK activities accounted for 34%. Global Banking and Markets (Corporate, Investment Banking and Markets) business accounted for 18%;.
- tier 1 capital ratio 8.3%, total capital ratio 11.4%, balance sheet total US$2,527,465m and loans and advances to deposits ratio of 84%.

It is important to note that the definition of "Investment Banking" changed significantly between 1997 and 2008. By the latter date, it was much wider in scope. Therefore the shares of profit cannot easily be compared.

Remuneration Policy

HSBC's remuneration policy is to provide total remuneration (salary, bonus, long-term incentive awards and other benefits) that is competitive in relation to comparable organisations in each of the markets in which HSBC operates and, within this policy to:

- offer salaries and benefits that are typically targeted at the median of the market;
- offer variable pay that is performance related and that reflects careful discretionary consideration of both financial and non-financial factors which take into account annual performance and the sustainability of the business over the medium term;
- offer long term incentive awards in the form of shares to recognise high performance, retain key talent and provide alignment with the interest of shareholders; and
- follow a policy of moving progressively from defined benefit to defined contribution pension schemes.

HSBC has a Group Remuneration Committee with responsibility for determining the remuneration policy of the Group including the terms of bonus plans and long term incentive plans, and the individual remuneration packages of executive Directors, Group Managing Directors and other senior Group employees. The Group Remuneration Committee comprises non-executive directors only and met seven times in 2008. Following each meeting the Committee reports to the Board on its activities.

HSBC discloses the total cost of employee compensation and benefits but, with the exception of executive Directors and the five highest paid employees, does not split this down by category.

2007–08

In 2007 the Group Remuneration Committee conducted a comprehensive assessment of the remuneration arrangements of executive Directors and other senior executives to ensure close alignment with HSBC's business strategy. The following changes were made:

- the remuneration comparator group was amended to nine global financial institutions
- base salary is targeted at the market median of the comparator group;
- for executive Directors, shareholder approval was obtained in 2008 for a maximum annual bonus potential of four times base salary (of which 40% must be deferred as three year vesting restricted shares);
- vesting of the Group Performance Share awards made in 2007 is subject to two independent measures of Group performance, relative Total Shareholder Return (TSR) and growth in Earnings Per Share (EPS) over a three year period and awards are forfeited to the extent targets are not met. From 2008, these awards also include an Economic Profit (EP) measure. Executive directors, as with other participants in the plan, are eligible to receive awards of Performance Shares with a face value at grant of up to a maximum of seven times base salary;
- with effect from 2008, objectives to be set and performance evaluated using "a balanced scorecard" including financial and non-financial performance measures which are cascaded down from Board level to enable alignment across the Group;
- performance measures and vesting conditions attached to long-term incentive awards were amended to further align the reward of senior executives to the achievement of strategy and the interests of shareholders. From 2008 the vesting of awards under the long term incentive plan is based on TSR (40% of the award), EP (40% of the award) and EPS (20% of the award); and
- a greater proportion of total compensation to be share based and shareholding requirements for members of the Board were increased to 600,000 for the Chairman and Chief Executive, 200,000 other executive Directors and 125,000 for Group Managing Directors. Where the executive Directors and Group Managing Directors do not have the required shareholding, they are expected to achieve this within five years of their appointment. Their shareholdings are reviewed annually by the Committee.

The Committee committed to provide greater transparency going forward on both the performance measures and the achievement against targets together with a commentary on the resulting levels of bonus awards.

In 2007 the cost of employee compensation and benefits for the HSBC Group totalled US$21,334 million. The total emoluments of the Group Chairman, Group Chief Executive and the Group Finance Director amounted to £8.4 million of which cash bonuses accounted for 35%. Since 2007, the Group Chairman, at his request, receives variable compensation exclusively through awards of Performance Shares and is thus no longer eligible to receive annual bonus payments.

In 2008 the cost of employee compensation and benefits for the HSBC Group totalled US$20,792 million. The salaries of the Group Chairman, Group Chief Executive, the Group Finance Director and the Chief Executive of Global Banking and Markets and HSBC Global Asset Management amounted to £3.82 million. The Group Chief Executive, the Group Finance Director and the Chief Executive of Global

Banking and Markets and HSBC Global Asset Management asked the Remuneration Committee not to consider them for any bonus awards for 2008. No cash awards will be made to any executive Director for 2008. No Performance Shares awards will be made in respect of 2008.

Two executive Directors with responsibility for Asia whose salaries total HK$17.3 million (£1.6 million) received restricted share awards totalling HK$37.2 million (£3.5 million)

1997

In 1997 the Group Remuneration Committee gave full consideration to the London Stock Exchange's Best Practice Provisions relating to remuneration policy, service contracts and compensation.

In 1997 the cost of employee compensation and benefits for the HSBC Group totalled £3,660 million. The total emoluments of the Group Chairman, Group Chief Executive, Group Finance Director and other executive Directors amounted to £3.78 million of which bonuses accounted for 17%.

The restricted share plan in operation at that time was designed to reward the delivery of sustained financial growth of the Company and, in particular, was focused on rewarding sustained earnings growth.

Stress Testing

As part of its Risk Management policy, HSBC regularly applies a wide range of stress testing both on individual portfolios, business lines, legal entities and on the Group's consolidated positions. The Risk Management Meeting, Group Audit Committee and the Board receive a variety of regular and ad hoc reports on a number of key issues including stress testing results and recommendations.

HSBC's global policy is to manage our business on the basis of raising deposits first and lending second and not to be reliant on the wholesale markets for funding. Adherence to this fundamental banking principle is controlled through the Risk Committees.

B. Consumers

Strategy

HSBC's UK "Best Place to Bank" strategy comprises three principles: Make Better Products, Sell Them Properly and Keep Them Sold. This is reflected in the development and pricing of lending and savings products.

Throughout the turmoil of the past six months HSBC has continued to offer a range of market leading mortgages including tracker and fixed rate offerings to provide real choice for customers. By way of illustration we have recently introduced two new fixed rate mortgages; five year fixed rate special at 3.99% and 10 year fixed rate special at 4.98%. HSBC has received numerous industry awards for its consistent good value in the mortgage market including Moneyfacts Best Remortgage Provider 2008, Mortgage Finance Gazette Best Overall Lender 2009 and Mortgage Finance Gazette Innovator of the Year 2009.

94% of HSBC mortgages are trackers or fixed rate. The remaining 6% of our mortgage book is either on SVR or on discount rates linked to SVR. As at the beginning of October 2008 HSBC had one of the lowest SVRs in the market and since that time we have reduced our SVR by approximately 60% to 3.94%.

HSBC has pledged £15 billion for mortgage lending in the UK in 2008, double the 2007 level and 20% more than 2008. In December 2008 we also announced that £1 billionn of our US$5 billion global SME fund has been earmarked for the UK. We want to lend these funds subject to our credit criteria, unchanged since 2006, being met.

Unsecured lending rates for loans and overdrafts have not been generally reduced. Due to the dislocation in the securitisation market, the cost of funding and capital required to support credit cards has actually risen, and for both products credit loss expectations have risen. HSBC Bank plc has not been active in the sub-prime market.

In terms of savings products, a number of our instant access savings products have now reached the applicable floors. Our policy is to offer a range of high interest deposit bonds for three months, six months, one, two or three years with interest on a monthly or annual basis. HSBC expects to be able to maintain our commitment to make lending available although the cost could rise as a result of the need to generate deposits in the face of intense price competition in the savings market. We are being forced to offer loss making rates of interest to compete with those banks who were previously reliant on the wholesale markets. Balance attrition as a result of depositors investing in other financial products, property and National Savings and Investments is also likely to have an impact upon the ability of banks to lend and the cost..

Deposit Guarantee Schemes

HSBC does not support prefunding of Deposit Guarantee Schemes. Experience in other countries shows that it is not possible to build up funds large enough to cover anything other than failure of the smallest institutions. HSBC believes strongly that the key for depositors is continued access to banking services rather than payout by cheque by the FSCS.

HSBC saw little outflow of funds to the Irish banks as a result of the Irish Government's decision to guarantee all deposits.

Harmonisation of deposit limits across Europe would be consistent with the single market and would ensure a level playing field. However GDP per head of population varies to such an extent that a limit deemed to be adequate in one country could be too low to satisfy the needs of depositors in another. The significant currency movements seen recently would also complicate the situation. Consumer confidence is such that they are unlikely to be attracted to place deposits with little known banks in other countries where they are uncertain about (a) the existence of and (b) safety of a deposit guarantee scheme. HSBC does not consider that harmonisation is essential at this time. HSBC does not support the principle of a single EU wide deposit guarantee scheme.

Financial Services Landscape

The financial services landscape going forward will, as a result of takeovers and mergers, have fewer players including some of whom will have been nationalised. National governments will have significant shareholdings in others. The market will polarise between banks who have taken government support and those that have not. It is essential that these changes do not result in a distorted market. Many niche players will have exited the market. There will be increased prudential and conduct of business regulation. Those financial institutions that remain in the market will continue to compete on customer service together with competitive products and services. A period of low interest rates will reduce deposit spreads and banks' retail business models will be more dependent on transactional fees and lending margin.

Consumer Confidence

Financial education will be paramount to rebuilding consumer confidence in the banking system and our "What Money Means" programme demonstrates the importance we place on this issue. HSBC continues to offer a full and innovative range of products at competitive prices to meet their needs. HSBC considers that treating customers in financial difficulty fairly is also essential to restoring confidence. We encourage our customers to speak to us as soon as possible; we support and work closely with the free debt advice agencies and repossession is always a last resort. Responsibility for rebuilding consumer confidence does not rest with the banks alone—government, regulators and the media also have a key role to play.

In the long term, it is not in anyone's interest for there to be a lack of confidence in the banking system and the financial services industry in general.

3. The FSA

We have always enjoyed an open and constructive relationship with FSA, as with all of our regulators. Due to their relatively light level of resourcing it is clear that FSA had to be selective in where those resources were focused. During this period there was, for understandable reasons, a heavy focus on consumer related issues including the roll out of Treating Customers Fairly. A close and continuous approach to supervision has much to offer so long as supervisory teams are appropriately resourced both in terms of numbers and quality of staff. It is important to note that other jurisdictions with different supervisory models have also experienced problems.

As a consequence of our strategy and culture, rather than a specific regulatory requirement, HSBC has a tradition of being strongly capitalised, operating conservative lending practices, and managing our business on the basis of raising deposits first and lending second.

Since the crisis at Northern Rock we have seen an increase in supervisory activity, an increase in resources within the FSA, greater consistency of approach and increased requests for management information. There is a heavy and almost continuous focus on capital and liquidity.

HSBC's senior executive management team have many years of banking experience and the non executive directors on both HSBC Holdings Board and HSBC Bank plc are chosen for the wide industry experience they bring.

4. The Future of Banking

The principle of a risk-sensitive capital regime for banks is sound; but has proved flawed during the current economic turmoil, and has put the banking system into a self-fulfilling downward spiral. An internationally agreed counter-cyclical capital framework, which reduces the differences between treatment of banking assets & trading book, needs to be implemented rapidly. The procyclical nature of capital adequacy regime and the systemic effects of fair value accounting has hobbled many banks with spiralling capital requirements which actually restricts the ability of banks to lend more; particularly to higher risk customers.

There are lessons to learn for banks, regulators, governments, customers & investors. This has been a slow-burn global crisis that is complex in origin and unprecedented in effect and scale. There is a requirement to "upskill" regulators to ensure that they are able to make judgements on the sustainability of business models having undertaken market analysis.

Rules and regulations can only ever provide a framework within which to operate. Banking now needs to return to the sustainable values-driven culture of old, where products and services are provided not just because they meet minimum legal requirements, but because they are right for customers, shareholders and wider stakeholders and benefit the real economy.

HSBC interfaces with in excess of 500 regulators across the world. As well as regulating HSBC's activities in the UK, the FSA is the lead regulator for the HSBC group and chairs the college of Supervisors. HSBC believes that the FSA can properly regulate us as we are currently configured.

In this crisis, and historically in the US, it is the narrow banks—savings and loans and standalone investment banks—that have got into difficulty. The risk concentration in such instances is not sustainable. Groups with an investment banking capability are, subject to having appropriate control systems in place, able to meet larger corporate customers' total requirements as well as diversify risk.

Annex

HISTORY AND DEVELOPMENT OF HSBC

1865

The founding member of the HSBC Group, The Hongkong and Shanghai Banking Corporation, is established in both Hong Kong and Shanghai.

1959

The Mercantile Bank of India Limited and The British Bank of the Middle East, now HSBC Bank Middle East Limited, are purchased.

1965

A 51% interest (subsequently increased to 62.14%) is acquired in Hang Seng Bank Limited. Hang Seng Bank is the fourth-largest listed bank in Hong Kong by market capitalisation.

1980

A 51% interest in Marine Midland Banks, Inc., now HSBC USA, Inc, is acquired (with the remaining interest acquired in 1987).

1981

The Hongkong and Shanghai Banking Corporation incorporates its then existing Canadian operations. HSBC Bank Canada subsequently makes numerous acquisitions, expanding rapidly to become the largest foreign-owned bank in Canada and the seventh-largest overall at 31 December 2007.

1987

A 14.9% interest in Midland Bank plc, now HSBC Bank plc, one of the UK's principal clearing banks, is purchased.

1991

HSBC Holdings plc is established as the parent company of the HSBC Group.

1992

HSBC purchases the remaining interest in Midland Bank plc.

1993

As a consequence of the Midland acquisition, HSBC's Head Office is transferred from Hong Kong to London in January.

1997

HSBC assumes selected assets, liabilities and subsidiaries of Banco Bamerindus do Brasil SA, now HSBC Bank Brazil, following the intervention of the Central Bank of Brazil, and in Argentina completes the acquisition of Grupo Roberts, now part of HSBC Bank Argentina SA.

1999

HSBC acquires Republic New York Corporation, subsequently merged with HSBC USA, Inc, and Safra Republic Holdings SA.

2000

HSBC completes its acquisition of 99.99% of the issued share capital of Crédit Commercial de France S.A., now HSBC France.

2002

HSBC acquires 99.59% of Grupo Financiero Bital, S.A. de C.V., the holding company of what is now HSBC Mexico.

2003

HSBC acquires Household International, Inc., now HSBC Finance Corporation. HSBC Finance brings to the Group national coverage in the US for consumer lending, credit cards and credit insurance through multiple distribution channels.

HSBC acquires Banco Lloyds TSB SA-Banco Mùltiplo in Brazil and the country's leading consumer finance company, Losango Promotora de Vendas Limitada.

2004

HSBC Bank USA, Inc merges with HSBC Bank & Trust (Delaware) NA to form HSBCBank USA, NA.

The acquisition of The Bank of Bermuda Limited is completed.

HSBC acquires Marks and Spencer Retail Financial Services Holdings Limited, which trades as Marks and Spencer Money ('M&S Money') in the UK.

HSBC acquires 19.9% of Bank of Communications, mainland China's fifth-largest bank by total assets, and Hang Seng Bank acquires 15.98% of Industrial Bank.

2005

HSBC increases its holding in Ping An Insurance to 19.9%, having made its initial investment in 2002. Ping An Insurance is the second-largest life insurer and the third-largest property and casualty insurer in mainland China.

HSBC Finance completes the acquisition of Metris Companies Inc., making HSBC the fifth-largest issuer of MasterCard and Visa cards in the USA.

2006

HSBC acquires Grupo Banistmo SA ("Banistmo"), the leading banking group in Central America, through a tender offer to acquire 99.98% of the outstanding shares of Banistmo.

2007

HSBC's three associates in mainland China, Industrial Bank, Ping An Insurance and Bank of Communications, issue new shares. HSBC does not subscribe and, as a result, its interests in the associates" equity decrease from 15.98% to 12.78%, from 19.90% to 16.78% and from 19.90% to 18.60%, respectively. Subsequently, HSBC increases its holding in Bank of Communications from 18.60% to 19.01% for US$308 million.

HSBC agrees to acquire 51.02% of the issued share capital of Korea Exchange Bank for US$6.5 billion. (HSBC terminated the agreement in September 2008).

HSBC is named the successful bidder in a government auction to acquire the assets, liabilities and operations of The Chinese Bank in Taiwan.

2008

July, HSBC completes the sale of its seven French regional banks, Sociètè Marseillaise de Crèdit, Banque de Savoie, Banque Chaix, Banque Marze, Banque Dupuy, de Parseval, Banque Pelletier and Crèdit Commercial du Sud Ouest, for US$3.2 billion.

In October, HSBC enters into an agreement to acquire 88.89%of PT Bank Ekonomi Raharja Tbk in Indonesia for US$608 million in cash. The transaction is subject to regulatory approval.

Source:

2008 Annual Report and Accounts.

HSBC Holdings plc

Supplementary memorandum from RBS

This paper details RBS Group's response to the Treasury Select Committee's letter of 13 February requesting supplementary evidence in relation to their inquiry into the banking crisis.

The evidence is split into two parts, the first covers the information Stephen Hester agreed to provide during his appearance before the Committee on 11th February. The second part is RBS" response to the additional questions posed by the Committee in their letter.

Part One

Remuneration and bonus payments

On the 17 February RBS announced it had reached agreement with the UK Government as majority shareholder (through UK Financial Investments) on its approach to Pay and Reward for 2008–09.

The agreement reflects a fundamental reform of RBS" approach to pay and reward that reflects the reality of the situation the company is in. We fully recognise, as a company, that we have to change materially not just the business we do but also the way we do business.

We believe the agreement strikes an appropriate balance of some very difficult issues, recognising the public sentiment while considering how we retain, motivate and attract talented people to restore RBS to standalone strength.

The outline of the approach is as follows:

— No Reward for Failure: No bonuses or pay increases will be made to staff associated with the major losses suffered in 2008.

— Board Remuneration: As previously announced Board Executive Directors will receive no bonus for 2008 performance and no pay increase in 2009.

— Pay 2009: Agreement has been reached with Unite in the UK for staff which they represent below managerial grades. Ongoing discussions with staff representatives are taking place in other regions. This will mean a pay freeze for Directors and Executives in the Group worldwide, and for most staff in the US and the Global Banking & Markets division. On average, other staff will receive below inflation pay rises.

- Bonuses for 2008: No discretionary cash bonuses will be paid in 2009 for performance in 2008. Only legally binding guaranteed bonuses will be paid. Total cash bonus payments for 2009 will amount to £175m. Therefore total cash spend overall will have been reduced by more than 90%.
- Protection for lower paid staff: The existing Profit Share "bonus" scheme worth 10% of salary will not be paid for 2008, and will be terminated for all future years. An equivalent payment will be made as part of the existing monthly award package to staff below managerial grade, beginning in 2009. The average salary for this group is £18,979.
- Deferred awards: Staff who are essential to the bank's recovery and who might otherwise be at serious risk of leaving, and who remain with the Bank will receive a deferred award for 2008. The deferred award will be released in three equal annual instalments beginning June 2010 and payable in sub-ordinated debt of RBS ie not in cash.
- Claw back of deferred awards: In individual cases up to 100% of these deferred awards will be subject to forfeiture at the discretion of the Remuneration Committee and if future losses arise in relation to their 2008 activities. Awards will therefore be based on sustained long-term performance, not on short-term revenue generation.
- Deferred Amount: The total amount of deferred awards will be finalised following our forthcoming company announcement relating to the Group's Strategic Review. However, the total amount will represent a very significant reduction on the comparable prior year totals and the settlement overall will be as tough as that at any other comparable bank.
- Future Policy: RBS is undertaking a fundamental review of its approach to future remuneration to ensure that incentives are well aligned to the interests of shareholders over the long-term. The intention for 2009 is to follow the same approach and deferral periods as outlined for 2008 while ensuring the Group pays competitively overall with other international banks. More details will be provided in the Group's forthcoming Annual Report and Accounts.

Corporate governance of financial institutions

In reviewing the governance of financial institutions, the following key elements need to be taken into account:

- Nature and complexity of the business;
- Composition and operation of the Board;
- Risk management and control requirements;
- Interests of stakeholders; and
- Remuneration.

Nature and complexity of the business

An effective corporate governance model and the level of control it is designed to provide must be a function of the business it seeks to manage. The more diverse and complex the institution, including multiple jurisdictions, cultural mix and product range, the greater the requirement for clear and robust governance. There is potential conflict between traditional banking management structures and those found in modern investment banking.

The Glass-Steagall approach ie to separate the management of traditional banking activities from investment banking is not necessarily an ideal model. As we outline (Q27) 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.

Composition and operation of the Board

The composition of the Board of a diverse financial services organisation is key to the successful operation of the governance and control structure. Key requirements are that the Board:

- Operates as a unitary Board with a mix of Executive and Non-executive members, with the latter being independent and the majority of the membership;
- Is comprised of individuals with industry awareness and business knowledge, who can contribute and challenge effectively;
- Has an agenda that strikes a balance between long-term strategic and shorter-term performance issues; and
- Receives concise, informative papers and alternative courses of action proposed, with the associated risks highlighted.

During the Treasury Select Committee discussions, the specific question of whether the Boards of banks required different composition from boards of other organisations was raised. We would agree that specific investment banking experience is required of at least a proportion of Board members. While it is important to have a balanced Board with diverse background and experience, a core representation of relevant financial and investment banking experience is required given the complex nature of banking business and the potential risks.

A key appointment is that of the Chairman whose personal qualities and experience is a key factor in creating an open, challenging and supportive culture.

Risk management and control requirements

The effective Board:

- Has a well-defined strategy;
- Regularly reviews the progress of implementation of the strategy against performance measures and risks that were directly derived from it;
- Approves the group's risk appetite;
- Embeds sound risk management in all aspects of the group's activities;
- Determines its principal risks and ensures they are communicated to the business;
- Sets the overall policies for risk management and control; and
- Receives reports on a regular and timely basis on the management of key risks and taking appropriate follow-up action.

There is an argument for including, on the Boards of banks, an Executive who is personally responsible for the management of risk, who can challenge the Chairman, CEO and others to ensure consideration of risk is an integral part of decision making, although this can be achieved through an Executive Board with appropriate reporting to the Board.

In addition, it is essential for direct and unfettered access to the Board to be granted to a bank's risk management and internal audit functions.

The non-executive audit and/or risk committees of Boards also have an important role in effective governance and control. Their composition, relevant experience and independence should be complemented with clear terms of reference and defined responsibilities.

Stakeholder management

The effective Board:

- Is fully aware of institutional investors' views of the strategy and performance of the group and of the quality of its management and board;
- Oversees an effective investor relations programme by developing two-way dialogue with institutional investors, private investors and analysts; and
- Have procedures in place to manage relationships with shareholders, government, regulators, customers and staff in the event of a crisis.

Remuneration

General principles for remuneration policy are that:

- Pay and performance are fairly compared with that of a properly chosen peer group;
- High rewards are only available for outstanding performance;
- Excessive risk taking is not encouraged;
- Arrangements are in place to ensure the company does not reward failure; and
- There is a high level of transparency in publicly explaining how remuneration has been determined.

Furthermore, there are the following explicit expectations from the Government:

- There must be no reward for failure;
- Bonuses are not to be paid without evidence of sustainable performance;
- Bonuses that are paid can be clawed-back where performance is not sustained; and
- Remuneration must be linked to the effective supervision of the institution.

Remuneration policy and reward structures must support and reflect business objectives and avoid encouragement of excessive risk taking. From a governance perspective it would be helpful for the Remuneration Committee to include at least one Non-executive who has experience of investment banking given the potential levels of reward and risk inherent in investment banking reward structures.

Conclusion

Whichever governance framework is devised, the actual structure of boards, committees and reporting has been shown to have less significance than creating the right culture of questioning rigour throughout the business together with sufficient experience and expertise.

Additional information

There were two additional questions around RBS" derivative contract obligations and the control of risk which we will be able to say more on following our year end results on 26 February 2009. We will be happy to respond in more detail after this date.

Part Two

Background information:
1. *How rapidly did your bank grow from 1997? And for the 10 years before that?*
2. *How did tier one and two capital ratios change over both these periods?*
3. *What happened to holdings of British government securities over the two periods?*
5. *What share of business was domestic at the beginning and end of each period?*

Over the last 20 years RBS has changed as a business from predominately a small regional bank focused on retail banking in the UK, predominantly in Scotland and northern England.

During the 1980s the Group diversified, setting up an innovative car insurance company, Direct Line, in 1985 and acquiring Citizens Financial Group of Rhode Island in the USA in 1988. Citizens was established in 1828 in New England in the US. Following a series of acquisitions, it is now one of the largest US banks operating a branch network in 13 states.

In November 1999 RBS expanded its insurance business when Direct Line acquired Green Flag Group, which now operates as the business-to-business arm of Direct Line Insurance.

In 2000, RBS acquired the NatWest Group to create a much larger group with a highly diversified portfolio of services for personal, business and corporate customers. This includes the larger part of what is now our Global Banking and Markets (GBM) division and most of the non-UK businesses (including Greenwich Capital, Coutts and Ulster Bank). This was the point at which RBS became a major player in the global markets businesses which are the core of present-day GBM.

Since 2000, the Group has continued to evolve as we have bought First Active in the Republic of Ireland, Charter One in the US and Churchill Insurance in the UK, along with various other smaller businesses and of course most recently, in October 2007, RBS's share of ABN AMRO.

The table below shows the figures for how the business has grown, covering the specific areas of interest outlined by the Committee. Although we have not provided information for the years 1988-1996, these would be broadly consistent reflecting a steady growth of income and assets, with a small dip in 1992, while capital ratios were in line with the years shown. Information is included up to 2007 although 2008 data will be available when our annual results are published on 26 February.

RBS GROUP HISTORICAL INCOME AND BALANCE SHEET METRICS

Year	*Gross Operating Income (£ million)*	*Profit Before Tax (PBT) before goodwill, integration costs & exceptionals (£ million)*	*PBT (£ million)*	*Tier 1 Ratio (%)***	*Total Capital Ratio (%)***	*Assets (£ million)*	*UK Operating Income (%)*	*Treasury bills and eligible assets (£m)*
1987	259	274	197	–	–	18,629	n/a	n/a
1988				7.1	13.0	19,400	n/a	n/a
1997	887	741	698	6.8	11.6	72,601	65	629
1998	1,313	981	944	6.6	11.2	79,676	72	639
1999	3,901	3,359	2,670	8.1	12.1	88,852	77	701
2000	5,046	4,401	3,327	6.9	11.5	320,004	75	3,316
2001	6,769	5,778	4,252	7.1	11.5	368,859	64	10,136
2002	7,885	6,540	4,852	7.3	11.7	412,000	67	11,459
2003	8,562	7,068	6,076	7.4	11.8	454,428	71	4,846
2004	8,698	7,108	6,543	7.0	11.7	588,122	67	6,110
2005	9,958	8,251	7,936	7.6	11.7	776,827	63	5,538
2006	11,292	9,414	9,186	7.5	11.7	871,432	65	5,491
2007	11,392	9,288	8,962	7.3	11.2	1,900,519	78	18,229

Note:

All Income provided on a proforma basis, includes NatWest from 1999.

** Basel 1 and Total Capital ratios introduced in 1988.

4. *What happened to the size of investment banking relative to "high street" banking over the two periods?*

As mentioned above RBS was predominately a regional retail bank until it acquired NatWest Group in 2000. After this RBS remained predominately a retail banking business with some wholesale banking functions although it is not possible to identify what proportion.

In 2005 the business was restructured and our Global Banking and Markets (GBM) division was created which includes most of our wholesale banking activities. GBM is a leading banking partner to major corporations and financial institutions around the world, providing an extensive range of debt financing, risk management and investment services to its customers. It also includes our Global Transaction Services (GTS) which offers corporate transaction banking and merchant acquiring activities. The acquisition of ABN AMRO in 2007 also included an investment banking franchise.

As a whole between 2005-2007, GBM contributed 36-40% of RBS Group's overall operating profit. The wholesale banking element would be significantly smaller.

6. *What was the share of bonuses in total remuneration 20, 10, and 1 years ago?*

The last 20 years have seen major changes in the UK's financial services sector—and in the nature of the RBS business itself which have impacted on bonuses.

Perhaps the most significant market change was the deregulation of the UK financial services sector which acted as a stimulus for the growth of London as a major international financial centre. As a result of this growth, and the influx of the US-based firms, compensation practices across the sector changed markedly, from the old merchant banking model to today's investment banking model.

Looking at RBS itself 20 years ago, we were predominately a small regional bank focused on retail banking in the UK. Our compensation structures were typical of the UK banking industry at the time, with a bank-wide grade structure with incremental salary progression based predominantly on service. Annual adjustments were negotiated with the trade unions on an industry-wide basis through the Banking Federations. The operation of bonus plans was uncommon, and where these were operated the amounts were negligible.

In 1993, following a strategic review and restructure of the bank we moved to introduce pay structures where progression was determined by appraised individual performance. Additionally we introduced limited bonus opportunities at all levels across the UK Retail and Commercial bank, to directly support the achievement of the bank's strategy and specific business objectives. For clerical staff these allowed for annual bonus payments of up to 10% of annual salary; for middle managers 15% and for senior managers 30%. Average payments were well below these maximums and only made to high performers with a total spend equivalent to some 5% of the salary bill for these staff.

A step-change occurred when RBS acquired the NatWest Group in 2000. The acquisition of NatWest brought to RBS new lines of business, included the larger part of what is now GBM and most, if not all, of the non-UK businesses (including Greenwich Capital, Coutts and Ulster Bank). This was the point at which RBS became a major player in the global markets businesses which are the core of present-day GBM. The continuation and development of this business required the introduction in RBS of some reward practices more closely aligned to the US investment banks. The private banking businesses acquired such as Coutts are another area where reward practice sees bonuses at a higher level compared to salaries, though these are far lower than in the GBM businesses.

Since 2000, the Group has continued to evolve with further acquisitions. All of this means comparisons over time become less meaningful and due to changes in the HR information systems and the complexity of mapping data back through the integration of our acquisitions it is impossible to engineer on a like-for-like basis.

Whilst it is not possible to recreate the Group's structure or present data for 10 or 20 years ago, we are able to provide a comparison for GBM as far back as 2000, which was the point at which the NatWest investment banking operations were merged with those of RBS. For performance-year 2000, bonuses in the businesses that now form GBM totalled 213% of the corresponding salary bill. By comparison, for 2007 (the latest year available as proposals for 2008 have yet to be finalised) the bonuses totalled 172% of the salary bill.

If we then look across the Group, including the GBM business, the 2007 aggregate bonus spend represented 68% of the aggregate salary bill—primarily driven by the high level of spend in GBM (over £2 billion based on the then FX rates). This year's bonus spend is still undergoing the challenge and oversight process and we will be happy to provide more information on the figures for 2008 in due course.

7. *Did you stress-test your balance sheet against a scenario where the wholesale funding markets closed down?*

RBS ran regular stress tests that included the scenario of no access to key wholesale funding sources. In reality, the duration of the disruption has been extreme and that extended impact was not fully factored into any stress models.

CONSUMERS

8. *Bank Rate has fallen sharply. Please provide figures showing the extent to which you have passed through these falls to both savers and borrowers*

Both borrowers and savers are very valuable customers for us and we have 11 times more savers than borrowers. Therefore, it is very much in our interests to look after both types of customers.

Recent base rate changes have seen RBS attempting to balance the needs of savers and borrowers. This has been achieved by passing on only a proportion of the benefit from the base rate reduction to asset customers (primarily mortgages). The income generated from the remaining benefit of the rate cut is invested, to maintain rates on deposit balances.

It is important to note that the cost of funding is more closely related to LIBOR than to base rate and one of the factors over the recent 12 months has been the unprecedented divergence between LIBOR and base rate.

In recognition of the impact of the low base rate environment on pensioners and older savers who may rely on savings interest for income, we recently launched a new Pensioners Fixed Rate Account paying higher rates of 3.00–4.00% monthly.

To enable to the Committee to compare we have included two tables below which indicate the change in the Base Rate and our average customer rate since the beginning of 2008.

Borrowers

Change in average customer variable rate mortgage and Base Rate compared to the second half of 2007 (new business).

	Average Customer Rate	*Average Base Rate*
H1 2008	−0.59%	−0.54%
H2 2008	−1.05%	−1.63%
Jan 2009	−2.87%	−4.21%

Savers

Change in average customer savings rate and Base Rate compared to the second half of 2007 (new business).

	Average Customer Rate	*Average Base Rate*
H1 2008	−0.25%	−0.54%
H2 2008	−0.69%	−1.63%
Jan 2009	−2.48%	−4.21%

After all these changes are taken into account our rates remain very competitive.

9. *What impact do you foresee on your deposit base of interest rates remaining at historic lows, and will this impede your ability to lend?*

Low interest rates encourage households to review their financial commitments. Since 2008 we have seen a trend of debt repayment in household finances and we anticipate this trend will continue during 2009.

This could result in a reduction in deposit growth which coupled with a reduction in the financial return on deposits as base rate approaches zero, may potentially impede our ability to lend as both elements impact our capital base and funding.

We continue to aim to balance the needs of both savers and borrowers, while continuing to grow our deposit base in order to support our commitments to lend. To do so, we offer attractive customer rates on new deposits, and bonuses on existing deposit products, though this has reduced the income we generate from customer deposits.

10. *Given that the present crisis proves that large banks can fail, and that UK banks benefit from the assurance a deposit protection scheme gives to consumers, should the FSCS now be pre-funded?*

The FSCS has an important role to play in protecting consumers and in underpinning their confidence, which in turn can act as a general brake on panic withdrawals. Having said that, the limitations of the FSCS in a systemic crisis of the sort we have experienced have also been revealed by recent events. In particular, it is clear that allowing a significant market player to fail and relying on FSCS payouts is not a viable option, given the disruption to payment services and the wider economic and systemic impacts such a move would imply; rather, there has to be a focus on maintaining the operational continuity of banking services (as was seen with Bradford and Bingley, for instance).

We support many of the FSA's proposed changes to the FSCS, in particular simplifying the eligibility criteria and raising consumer awareness of the protection provided. However, pre-funding is in our view not particularly relevant to the issue of strengthening the FSCS. As has been demonstrated with the recent cases of bank failures, the alternative of the FSCS borrowing to meet its immediate liquidity needs, with repayment liabilities passed to industry over a period of time, achieves the same objective, without imposing a deadweight cost on industry of committing funding up front.

Pre-funding might also have the perverse effect of undermining consumer confidence in the FSCS, by showing the glass as half-empty: with retail deposits near £1trillion, and a major portion of those held by the main banking groups, any pre-funded pot is always likely to seem to be of token value. Pre-funding may make more sense in markets such as the US, where there are more frequent failures of small institutions.

11. *How badly were you affected by the Irish decision to guarantee all deposits?*

Deposits in Ulster bank showed an upward trend over the course of 2008. There was a fluctuation during the height of the disruption in the market when we saw a temporary reduction in balances; however, this had restored itself following the UK Government's support for recapitalisation.

12. *How far is harmonisation of deposit limits needed across Europe?*

The Deposit Guarantee Scheme (DGS) Directive will introduce a raised level of cover of €50,000, per legal entity, from 30 June 2009. Under the Directive, the limit may be further increased to €100,000 by December 2010, subject to an impact assessment.

Harmonisation of the level of cover across Europe is important to reduce consumer confusion and to improve understanding and awareness in protection schemes, thereby promoting confidence. It is also important in maintaining a level playing field for the provision of deposit taking facilities. Substantially different levels of deposit protection in Europe potentially create a cross border competitive distortion triggering a migration of deposits across borders. We support a harmonisation of coverage levels at €50,000 but do not believe it necessary to further increase this to €100,000.

The BBA estimates that a doubling of the guarantee limit would cover 16% more of total protected deposits by value. However, this would only raise the number of accounts covered from 98% to 99%—a mere 1% increase (based on BBA data). In our view this is a very marginal improvement of coverage against additional costs for the industry; if realised, it would place further pressure on resources during a challenging financial period.

We do not believe that the compensation limit alone is enough to address consumer confidence. For instance, the vast majority of Northern Rock customers who were sufficiently alarmed to queue outside branches, held deposits that fell well within the £35,000 compensation limit operating at the time. We continue to believe that, rather than focusing on further increases to the compensation limit, consumer confidence is more effectively improved by actions which consumers can see contribute to the stability of the EU banking system, and which increase awareness of the compensation schemes.

13. *Once this crisis is over, how different will the financial services landscape be to what consumers could have expected in 2006 and 2007?*

The combination of historically low base rates and the divergence of LIBOR from base rate has significantly affected the profitability of many Retail products, including Current Accounts, Savings and Mortgages. In response there has been a reduction in certain product ranges as the pricing of variable rate products at commercially sensible rates has been challenging, eg a reduced number of tracker rate mortgages. As LIBOR and Base Rate re-converge the fuller range of products are likely to be restored, albeit at reduced overall profitability.

There are a variety of other pressures on profitability such as the trend towards paying off debt while reducing deposits, challenges to historically important fee lines and increased bad debts, and multiple new regulatory regimes. Such pressures have inevitable consequences on our capacity to lend and may undermine

the viability of lending to some consumers. These trends also increase the risk that UK providers may need to introduce charges that are common in most other countries (eg monthly account charges for current and savings accounts, charges for high cost transactions).

RBS will continue to remain focused on meeting the needs of our existing customers and seeking opportunities to build strong new customer relationships.

14. *What are you currently doing to manage consumers" expectations of what will be available in a post-crisis world?*

We will continue to deliver high quality products and services to our customers and are actively seeking to assist customers who may be facing difficulties in current environment through initiatives such as our recently implemented MoneySense adviser programme.

We are also working with various government departments and agencies to ensure that the range of regulatory and legislative changes in course will not have any unintended adverse affect on consumers.

15. *What are you doing to rebuild consumer confidence in the banking system?*

The Government's support has been critical in reassuring customers—giving a clear signal that the Government will not allow us to fail. Going forward, it is up to us to restore confidence with our customers by providing good service and products.

RBS has introduced a number of positive initiatives in recent months to regain the public's confidence in the Group:

- We have placed independently trained MoneySense advisers in 1,000 branches across the country offering free, impartial financial guidance.
- NatWest and RBS have committed not to increase overdraft pricing for small businesses, with effect from 1 December 2008, as well as pledging to continue to provide committed overdrafts to businesses. Consequently, our overdrafts are not repayable on demand and so our customers' facilities stay firmly in place for 12 months from the date they are agreed.
- For business customers, their committed overdraft pricing will also be guaranteed for 12 months from the day it is agreed and at renewal time, NatWest and RBS promise not to increase it unless there has been a rise in the risks associated with lending to them. This price promise will stay in place until at least the end of the year.
- The Group has also committed not to start repossession proceedings for a full six months after a customer first falls into arrears. The Bank has given a guarantee that will help ease the pressure on those homeowners struggling to meet their monthly repayments and give them more time to talk and work with the Bank and gain the support and advice they need.

16. *Will you be reducing the level of potentially riskier lending to lower-income individuals?*

RBS is a supporter of the Banking Code which sets standards of good banking practices for financial institutions. This includes a key commitment to lend responsibly by ensuring that the customer can afford to repay the borrowing on an ongoing basis before we lend any money or increase credit limits. It is not in anyone's interests to lend money to those who are unable to repay it.

We provide a range of banking products to suit different needs. RBS is one of the main providers of basic bank accounts, through which we enable customers to build a credit history.

The FSA

17. *How would you describe your engagement with the FSA before the current crisis?*

Our relationship with the FSA leading up to the current crisis was, and indeed remains, a good one based on open dialogue and a good understanding of the Group.

18. *Did the FSA ever express concerns to you about your business models, or request a slow-down in lending?*

The FSA's commentary since the commencement of their ARROW assessment process has been focussed more on ensuring that management has the bench-strength to manage the increasing franchise and upon the development of risk tools commensurate with the risk profile, rather than upon intervention in business models. The FSA did not request a reduction or slowdown in lending.

19. How has your interaction with the FSA changed since the crisis at Northern Rock?

Our relationship with the FSA, we believe, was and remains a good one. As the FSA has strengthened its focus on prudential supervision, we have seen the resources devoted to major groups such as ours increase; we expect the level of interaction to increase further going forward.

20. *One of the features of the FSA's supervisory enhancement programme is that "there will be raised emphasis on assessing the competence of firms' senior management". Have you seen any evidence of that?*

The FSA has focussed with renewed vigour on Significant Influence Approved Persons, exercising its right to pre-interview new Board members and requiring one-to-one meetings with incumbent non-executive Board members.

The Future of Banking

21. *Do you consider pro-cyclicality of capital requirements to be a problem?*

We remain concerned about how Basel II operates in a downturn, given the pro-cyclical effects inherent within the new capital framework. Any solution needs to solve two problems—making sure that firms can forecast (and effectively manage) capital; and ensure that any solution does not inappropriately constrain lending. In this regard, we support the FSA's countercyclical approach, as long as this works in a symmetrical fashion—ie that capital requirements are also reduced in a down-turn.

In the medium to longer term, policy makers need to understand the dampening effects of any change during periods of economic growth. Policy makers also need to consider the total quantum of capital requirements—which are increasing given other changes to regulatory requirements being proposed by the Basel Committee, especially in the trading book. The economic impact of all these changes should be considered together.

22. *Andrew Crockett, former general manager of the Bank for International Settlements, has suggested that it would be advantageous for higher capital ratios to be imposed on institutions that were more reliant on short-term funding. Do you agree?*

Whilst higher capital charges might restrain balance sheet growth, the problem of over-reliance on short-term funding must properly be solved by increasing the level of term funding and holdings of liquid assets. Higher capital ratios are not a direct or effective tool for managing short term liquidity exposures.

23. *The FSA has brought forward proposals on liquidity regulation, including an Individual Liquidity Assessment, and a "liquidity buffer" specific to each firm. Are you confident that their proposals amount to an effective way to assess and limit the liquidity risks which individual institutions face?*

Yes, we believe that the Individual Liquidity Assessment process should be an effective framework for assessing liquidity risk as it focuses on the risk drivers and their performance under stressed conditions. Holding liquid assets will be one component in building an effective risk mitigant to liquidity stresses.

The FSA framework set out in its consultation paper CP08/22 "Strengthening Liquidity Standards" which is the right kind of approach to strengthen banks' liquidity practices.

24. *Paul Tucker and Charlie Bean have both suggested that the Bank of England should have some kind of macro-prudential risk instrument to guard against sector-wide risks. What form do you think such an instrument could reasonably take?*

We support the notion that macro-prudential supervision should be strengthened; one of the lessons to be learnt from the crisis in our view, is the need to achieve a better balance between micro- and macro-prudential supervision.

The future regulatory system should remain risk-based; it should also continue to allow for innovation, as well as encouraging transparency and proper alignment of incentives.

25. *How far do you agree with Jon Moulton that "Supervision and regulation will only work if it is within the capabilities of the people involved to actually discharge those duties"?*

The current issues with supervision are issues of execution more than of design. A key element of this execution capability is the ability of the regulator to attract, retain and motivate talented people—so they can engage credibly with those people in the regulated firms with whom they face off on a daily basis. Much focus in recent times has been on getting cost savings in the regulatory system by trading headcount for quality. In the event, we suspect the headcount has been lost without the quality being lifted sufficiently. Few

major institutions have called in recent times for cost cutting at the regulator. RBS Group contributes £12–16 million to the system in a typical year in the UK alone and is on record as being willing to pay more for an enhanced-quality regulatory engagement.

26. *Do you think that the FSA can properly regulate you as you are currently configured?*

Regulation should, in our view, be neutral to legal entity structure, and similar matters: the free market depends upon allowing firms to compete by means of differentiation and this in turn often depends on different blends of location, product offering, entity, and so on. It is the responsibility of the firm to give the regulator a clear and transparent view of their particular configuration, and the corresponding responsibility of the regulator to apply the requirements in a way which recognises commercial realities.

27. *What are the strongest reasons both for and against the separation of traditional, narrow banking activities from riskier trading and investment banking activities by your organisations?*

We would agree with Adair Turner that whilst careful thought needs to be given as to how to insulate deposit taking from riskier banking activities, it should not take the form of any absolute separation between institutions which do "narrow banking" and those which perform investment banking activities.

Although universal banks have been hit hard, non-hybrid retail banks (Northern Rock and Bradford and Bingley) and investment banks (Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs and Morgan Stanley) have been the biggest casualties. Allowing banks to diversify therefore offers the potential to reduce risk, so the restrictions of "Glass-Steagall"—type separation could actually have had an adverse effect, making the banking industry riskier rather than safer.

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. Whilst you could, in principle, run a pure retail bank without investment banking activities, it is much harder to divorce an established leading commercial and corporate banking franchise such as RBS's from these capabilities.

The issue, in our view, is not so much about the separation of these activities, than about the amount of risk taking relative to capital and the quality of risk management within individual organisations.

March 2009

Letter from the Chief Executive of the Isle of Man Financial Supervision Commission to the Chairman of the Committee

Dear Mr McFall

"Banking Crisis": Evidence of the Isle of Man

At the hearing of the Treasury Committee held on 3 February 2009, there were two areas where we agreed to provide additional information.

The first of these related to an exchange of correspondence with the FSA. In relation to our understanding of some of the limits applied in respect of various exposures. I enclose a copy of two letters of 21 May 2008 for your information (the letter from the FSA does not have a letterhead because it was printed as a copy from a computer); Individuals' names have been redacted for reasons of privacy.

On a second point, we were asked at the Committee hearing about the "Derbyshire Building Society. We were informed that the Derbyshire kept the FSA informed of their planned disposal of the Isle of Man subsidiary and that no objections were raised. It is also our understanding that there was no formal regulatory approval process to be followed in relation to the disposal from the perspective of the FSA Kaupthing Singer & Friedlander (Isle of Man) Ltd, which was regulated by the FSA for mortgage business only, also advised the FSA of the transaction under its relevant obligations at the time.

I hope that this is of assistance.

John Aspen
Chief Executive

13 February 2009

Annex 1

Letter from the Isle of Man Financial Supervision Commission to the Financial Services Authority, dated 21 May 2008

This information is provided under section 24(5)(b)(iii) of the Financial Supervision Act 1988 for the purpose of enabling or assisting the Financial Services Authority to exercise functions corresponding to any of those of the Commission under the Banking Act 1998. The information must not be disclosed to any third party without the prior written consent of the Commission.

Following our telephone conversation yesterday, I should be grateful if you could confirm the following:

1. Margin on Equity Repurchase Agreement arranged through Kaupthing Singer & Friedlander Limited ("KS&FL") (Referring to Point 1 in my letter of 13 May 2008 to Sadia Arif).

   This is treated as connected lending to Kaupthing Group.

2. Connected Lending

   You have already confirmed that connected lending to companies within the Kaupthing Group are limited (in aggregate) to 25% of KS&FL's LECB. You have also confirmed that included within this limit are any interbank placings (including those with a maturity date of less than one year) with Group banks.

3. Liquidity: (Referring to Point 2 in my letter of 13 May 2008 to Sadia Arif)

   The maximum liquidity mismatch, under UK FSA rules, that KS&FL is permitted to have in the "sight less than eight days" maturity band and in the "sight less than one month" maturity band. If any behavioural adjustments are permitted we would be grateful if you could state what they are. In particular we would be interested to know what different behavioural adjustments are applied to retail deposits compared to wholesale and Interbank deposits.

   In addition, do assets (including marketable assets such as CD's and Treasury Bills) held by KS&FL to meet its liquidity requirements in the "Sight less than eight days" maturity band all have to be free from all charges and/or encumbrances?

   4. Possible interbank placing by Kaupthing Singer & Friedlander (Isle of Man) Limited with KS&FL

   If Kaupthing Singer & Friedlander (Isle of Man) Limited was to make a large interbank placing with KS&FL maturing in the "sight less than 8 days" maturity band, would the UK FSA be in a position to confirm that adequate liquidity is maintained by KS&FL to repay that interbank deposit should it be requested to do so by Kaupthing Singer & Friedlander (Isle of Man) limited.

We appreciate your help with this and look forward to hearing from you.

Annex 2

Letter from the Retail Firms Division, Financial Services Authority, to the Isle of Man Financial Supervision Commission, dated 21 May 2008

Thank you for your letter of today's date, in which you asked for certain confirmations. I believe that the questions below will also answer the questions in your letter of 13 May to Sadia Arif.

I can confirm that:

(a) margin held on an equity repurchase agreement is treated as an exposure under our concentration risk regime;

(b) the aggregate exposures of KSF's connected exposures, regardless of counterparty and duration, are limited to the standard 25% of capital resources as in our prudential sourcebook (BIPRU 10.5.1R and 10.6.1R);

(c) the FSA applies cumulative mismatch limits to KSF of 0% at sight to 8 days and −5% at sight to a month; these limits apply to the whole of KSF's book and thus would cover any deposits received from KSF (IoM)—your question 4; and

(d) behavioural adjustments have been agreed with KSF—these all relate to KSF's "traditional" retail business only (ie not the new Edge internet accounts, although we do expect KSF to apply for an adjustment for these products too, or wholesale deposits).

Do contact me if you have any queries.

Supplementary memorandum from Lord Stevenson of Coddenham

As promised when we met on 10th February, I am writing to enclose a copy of the Report prepared by KPMG in 2003. As I explained when I appeared before the Committee, whilst HBOS was comfortable that everything in relation to Mr Moore's departure from the Company was handled properly, we took the allegations made by Mr Moore very seriously. As soon as the then CEO learned that Mr Moore was unhappy with the process that led to him not being offered the job as Risk Director and had concerns about the handling of risk management, the CEO told the FSA and the HBOS Board. As a result of the process of consultation that followed with the Chairman of the HBOS Audit Committee playing a major role, we asked KPMG to look in to those allegations independently. That is how the KPMG Report came about.

The scope of the KPMG review is set out in the five bullet points in paragraph 1.1, as well as the supplementary issue referred to in paragraph 1.2. As the Report makes clear, KPMG conducted about 80 hours of meetings and interviews involving 28 individuals, and reviewed large quantities of HBOS documents (in addition to the documents produced by Mr Moore). As a consequence, Mr Moore's allegations were not substantiated, and the Company's position was validated.

I do not believe it is necessary or appropriate for me to summarise the Report, which speaks for itself. You will have seen, however, the statement made by the FSA on 11th February 2009, which includes a number of quotes from or references to the conclusions in the KPMG report, including the following:

- — that the structure and reporting lines of Group Regulatory Risk were appropriate;
- — there was no evidence to suggest that Mr Moore was dismissed for improper reasons. There was simply no role for Mr Moore in the revised structure that followed the creation of the Group Risk Director role;
- — the process for identification and assessment of candidates for the GRD (Group Risk Director) role was appropriate; and
- — KPMG believed that the evidence reviewed suggested that the candidate (for the Group Risk Director role) was appropriately "fit and proper".

Separately, I understand that the Chairman of the Financial Services Authority may have written to the Chancellor of the Exchequer in very similar terms to the FSA 11th February statement.

If I can help the Committee with respect to any further information that it requires, please do not hesitate to let me know.

26 February 2009

Review of issues set out in the Outline of Case from Paul Moore

KPMG BOARD PAPER FOR HBOS PLC GROUP AUDIT COMMITTEE—28 APRIL 2005

1. INTRODUCTION

Background

1.1 Paul Moore raised a number of issues concerning the operation of the Regulatory Compliance control environment within HBOS plc ("HBOS") in the "Outline of Case" dated 13 December 2004. You have instructed us to undertake an independent review of the issues raised by Mr Moore. We held an initial clarification meeting with Mr Moore following which we agreed the scope of our terms of reference with you. These were shared with Mr Moore. In accordance with our engagement and scoping letters dated 17 and 24 January 2005 respectively we have undertaken a focused review of:

- — the Group Regulatory Risk ("GRR") relationship with the Board, the executive divisional management and relevant associated risk and audit committees;
- — the appropriateness of GRR structure and processes for fulfilling their oversight and monitoring responsibilities;
- — the chronology, methodology, reporting and follow-up resolution of the Mortgage Endowment Complaints ("MEC"), Corporate Bond Fund ("CBF"), and Sales Culture ("SCR") reviews performed in 2003/2004 and relevant recommendations set out in Appendix 1 of the PWC report on the risks management framework;
- — the appropriateness of the Group's processes for identification and assessment of candidates for the Group Risk Director and appointment of Jo Dawson; and
- — whether the Group followed its defined processes when making the position of the head of GRR redundant.

1.2 You subsequently asked us to consider whether the way in which the CBF, MEC and SCR reviews were approached, the reaction to them and the follow-up response are indicative of a Group that takes its regulatory responsibilities seriously.

Work performed

1.3 Our work has involved undertaking interviews and reviewing documentation provided to us by HBOS. We have focused our work on the areas highlighted by Mr Moore, in particular the reviews undertaken in respect of MEC, CBF and SCR. In the Outline of Case, there is also introductory references at paragraphs 3 and 4 (expanded in paragraphs 45–56) about the appropriateness of the appointment of Ms Dawson and we address the regulatory issues arising, below. We have not considered any other reviews undertaken by GRR within the Retail or other HBOS divisions.

1.4 In addition to the regulatory issues raised, the Outline of Case also raises employment issues (eg Paragraphs 5 and 6 of the Outline of Case). These fell outside our expertise and we have not considered any aspects of employment law, including reference to the Public Interest Disclosure Act, during the course of our work.

Interviews

1.5 We have undertaken around 80 hours of interviews and meetings with 28 individuals (see appendix 1) during the course of our work including a number of third parties. Following each interview and meeting we have prepared a record of the discussion and asked for comments from individuals concerned. Where individuals have provided amendments or additional comments we have considered the comments, revised and re-issued the transcript meeting note if appropriate.

1.6 We have undertaken the interviews and discussions on a confidential basis.

Document review

1.7 During the course of our work we have requested, reviewed and analysed a variety of documents. Appendix 2 lists the key documents. These documents have all been provided by HBOS, consequently we have not attached them to this report.

1.8 Throughout the course of our work we have made document requests and have relied upon the information provided to us and have not verified this information for accuracy. We have also assumed that all the documents relevant to the requests have been provided.

Reporting

1.9 You have requested we set out our findings in a short "board paper" style report. Our usual report format would be longer and detail all the information and documentation gathered during the course of our work together with our analysis of this information and documentation.

1.10 This report to the HBOS Group Audit Committee sets out our findings in respect of the work we have undertaken relating to each of the bullet points at paragraph 1.1. We reported our preliminary findings orally to the Group Audit Committee on 8 March 2005 and the content of this report it consistent with those findings.

1.11 We found that there were some discrepancies between the exact dates and chronology of events arising from the interviews conducted. On occasion we have used our best judgement to identify the relevant dates and chronology. However we do not believe that such judgements are critical in forming our views.

1.12 On occasion we have referred to certain classes of individuals within the report, for example the non-Executives. Where we have done so this should be taken to be individuals that we have interviewed which fall into that class rather than the whole of that class.

1.13 This report is confidential. It may not be disclosed, copied, quoted or referred to in whole or in part, whether for purposes of disciplinary proceedings or otherwise without our prior written consent. Such consent, if given, may be on conditions including, without limitation, an indemnity against any claims by third parties arising from release of any part of our report. KPMG will not be held responsible or liable to any third parties who may come to act upon this report without prior written consent of KPMG.

1.14 We have structured this report as follows:

- Section 2—GRR's relationships with key stakeholders.
- Section 3—GRR's structure and process for fulfilling their oversight and monitoring responsibilities. This section incorporates our consideration of the reviews undertaken in respect of MEC, CBF and SCR.
- Section 4—The appointment of the Group Risk Director.
- Section 5—The redundancy of the Head of GRR position.

2. GRR's Relationships with Key Stakeholders

Background

2.1 This section summarises the comments we have received concerning GRR's relationships with key stakeholders. Mr Moore's role as Head of GRR and his personality resulted in many people identifying GRR and Mr Moore as being one and the same. It should be noted that Mr Moore, as Head of GRR, was regarded as the natural point of contact and seen by many to have been GRR. As such most of the comments offered by interviewees are personalised to Mr Moore and perceptions of his performance in his role as Head of GRR.

Senior Executives

2.2 The views of the Executive Directors were mixed. Most recognised that Mr Moore had sound technical skills and that he gave GRR a sense of purpose. In particular it was felt that he created the right environment within GRR through recruiting strong individuals and building a team spirit. A number of senior Executives referred negatively to Mr Moore's behaviour and performance at meetings. Some also noted that increasingly throughout 2004 Mr Moore brought his deputies to meetings. There was a mixed view about his capability to successfully execute the role of Head of GRR. Concerns were expressed that Mr Moore was not able to step up to the more demanding role of Head of GRR from his previous position within IID.

The non-Executive Directors

2.3 By late 2004 the Non-Executive Directors interviewed had a consistent view of Mr Moore. Most considered Mr Moore to be an intelligent individual, technically strong with a great deal of experience. However, consistent negative comments were made regarding Mr Moore's personal behaviour and relationship skills. In particular, reference was made to Mr Moore's performance at various formal meetings in both 2003 and 2004, the most notable being the 8 June 2004 Group Audit committee meeting, which was commented on widely.

2.4 During 2004 Mr Moore held individual meetings with a number of non-Executives. Some of these were not comfortable with these meetings as Mr Moore had not always exhausted other reporting channels, they did not see this as a non-executive's role; and, he tried to impose an element of confidentiality to the meetings. In contrast Mr Moore did not have a private meeting with the Chairman of the Audit Committee until December 2004 after the announcement of his departure. This is despite requests being made by the Chair of the Audit Committee in March 2004 for a meeting to be scheduled to discuss whether the GRR team needed a different relationship with the Audit Committee.

2.5 The non-Executives interviewed lost confidence in Mr Moore at different times following a range of events. It is now clear that some were nervous about his appointment to the role of Head of GRR, while others became increasingly concerned following on from specific events during 2004.

The FSA

2.6 In January 2004, HBOS received an FSA Arrow letter which highlighted a number of key concerns: one key outcome being was the FSA's decision to raise HBOS's ICR by 0.5%. The significance of this signal was recognised by HBOS. Senior management were upset by the FSA's decision to raise the ICR at that time but the response to the concerns raised by the FSA was constructive. Mike Ellis (Group Finance Director— to whom the Risk functions reported) in particular was focussed on implementing the necessary corrective actions across the main business control functions. These, as noted in the outline of Case were Sales Cultural (Retail), Credit Process (Corporate), Embedded Value (IID) and Risk (Group Functions). The efforts by the senior management team were rewarded towards the end of 2004 when the FSA agreed to remove the 0.5% increase from the ICR.

2.7 Throughout this period the FSA wanted to develop a "close and continuous" relationship with HBOS whereby they could place increased reliance on the group control functions including all the risk functions and internal audit to mitigate the risks the Group opposed to the FSA's objectives. The Outline of the Case seems to indicate that this "close and continuous" relationship was special to HBOS. It is a general term used for all major groups supervised by the FSA and a feature of most large financial institutions' Risk Mitigation Programmes.

28. Mr Ellis retained ultimate responsibility for the FSA relationship as stated in his Management Accountability Plan ("MAP"). The FSA directed a number of its communications through the Divisional leadership. The pattern of meetings with the FSA led to Mr Moore being bypassed in respect of certain communications although a member of this GRR team attended the majority of FSA meetings. In the case of both the MEC and SC reviews, senior executives liaised directly with the FSA. This was consistent with the importance being attached to reducing the ICR. From the FSA's perspective in particular, James Davies is credited with developing a good relationship with the regulator.

3. GRR's Structure and Processes for Fulfilling their Oversight and Monitoring Responsibilities

Background

3.1 HBOS takes a devolved approach to regulatory risk management and adopts a "three lines of defence" governance model. The first line of defence rests with the Business/Operating division and includes the divisional risks teams. The second line of defence is provided by the Group Risk functions (including GRR) and the third line of defence is provided by Group Internal Audit. The devolved model of risks management in place at 30 April 2004 was subject to a S166 review by PWC. PWC concluded that the model used was conceptually well designed and appropriate for HBOS.

3.2 Paragraphs 9–11 of the Outline of Case summaries the responsibility of the Head of GRR to oversee the adequacy, effectiveness and compliance of the systems and controls in place within the HBOS Group, as the compliance oversight control function CF10. It is in this context that the Outline of Case goes on to raise a number of issues concerning the Regulatory Compliance control environment within HBOS.

3.3 The Head of GRR is clearly an important role within the Regulatory Compliance control environment; however, this individual does not carry sole responsibility for Regulatory Compliance. It is the responsibility of all senior management who are in a position of significant Influence to raise challenges and oversee systems and controls. This is consistent with the FSA's rules concerning Senior Management Systems and Controls ("SYSC") and in particular the code of practice for approved persons ("APER").

3.4 Within HBOS responsibility and accountability for systems and controls is set out within the MAPs. The MAPs set out the interaction of the senior management team. This interaction needs to work in practice to enable an effective governance structure. There is a good understanding of these responsibilities based on our discussions with the executives interviewed.

GRR structure and resources

Reporting lines

3.5 Prior to his appointment as Head of GRR Mr Moore was responsible for the Group Regulatory Risk function within the Insurance and Investment Division ("IID"), reporting to both Phil Hodkinson as Head of IID and Arthur Seiman as head of GRR. The IID Group Regulatory Risk ("IID GRR") team's remit included oversight of the Retail division's regulated products which were managed by the Retail Advisory Sales team.

3.6 In October 2003 Mr Moore was appointed Head of GRR (effective 1 January 2004) and the IID GRR function was subsumed within GRR. Prior to this restructuring, it is clear there was confusion concerning the role of the two Group Regulatory Risk functions and its oversight responsibilities. His confusion arose from there being:

- — no clear reporting or responsibility lines between GRR, IID GRR, Retail Regulatory Risk ("RRR") and/or Retail management;
- — no clear definition of the 'functional leadership' or 'oversight' role that GRR and IID GRR should undertake as referred to in the 'Overview of HBOS Corporate Governance' dated 18 September 2001 and Management Accountability Profiles; and
- — overlap between the two Group Regulatory Risk functions overseeing the Retail Division.

3.7 Appropriate reporting lines for the Group Regulatory Risk functions were in place during 2004. The Head of GRR reported in to the Group Financial Director and also had the right to escalate any key issues to the Divisional Chief Executives and where necessary the Group Chief Executive. In addition, the Chairman of the Audit Committee was also available to the Head of GRR.

3.8 Whilst the restructuring referred to above removed the confusion surrounding the interaction between IID GRR and GRR, confusion surrounding the remit of GRR remained during 2004 (see below). In addition, no further clarity was given regarding the definition of "functional leadership" or "oversight". Confusion arose, in particular, over the interaction between GRR and RRR. A draft Memorandum of Understanding existed between the functions. However, it is not clear what reference was made to it or reliance placed on it by GRR and RRR.

GRR Business Plans

3.9 One of the first tasks undertaken by Mr Moore on his appointment as Head of GRR was the preparation of the 2004–05 GRR Business Plan and Strategy document ("Business Plan") which was tabled at the 9 December 2003 Audit Committee meeting. This document was subsequently amended to take account of the FSA's views and outcome of the FSA Arrow Risk Assessments. It was re-presented to the Group Audit Committee on 9 March 2004. In addition, the Business Plan was further discussed as a private Audit Committee meeting held on 8 June 2004.

3.10 The 2004–05 GRR Business Plan and Strategy document is a high level document. A GRR conference was held in late February 2004 at which an oral presentation alongside the Business Plan seems to have worked well. The lack of risk assessment, detailed plans or operating methodology in the Business Plan would have made it more difficult to be cascaded as a stand alone document. By not actively rolling out the Business Plan to the Retail division management. GRR missed an opportunity to explain their assessment of the key regulatory risks facing the Retail division and action planned to address these risks. As a result GRR does not appear to have effectively engaged key stakeholders thereby missing an opportunity to address some of the confusion surrounding GRR's remit.

3.11 The 2005–06 GRR Business Plan and Strategy document was presented to the Retail Risk control Committee on 2 December 2004 and to the Group Audit Committee on 7 December 2004. This document is more detailed than the 2004–05 Business Plan and includes a section on risks detailing a timetable of work to be undertaken during 2005. We have received comments and agree that this document was a significant improvement on the 2004–05 Business Plan.

Communication and interaction between parties

3.12 Concerns were raised at the 8 June 2004 private meeting of the Audit Committee regarding the quality of the Business Plan. Comments refer to a lack of content, the self-promotion of GRR and it being to driven by the requirements of the FSA rather than the business. At this meeting Mr Ellis supported the document as "*a good motivational tool for colleagues within Group Regulatory Risk and the challenge remained to address the focus of resource and ease the tensions between GRR and the Businesses*". We have seen nothing to suggest that the comments raised at the meeting were communicated to Mr Moore. However, the fact that this meeting needed to be held was one of the contributory factors leading to the non-Executives losing confidence in Mr Moore.

3.13 It is not clear how the Business Plan was rolled out to the Retail or other divisional management teams. None of the relevant interviewees could recollect such a roll-out. The minutes for the group Management Board, Retail Risk Control Committee and Group Operational and Regulatory Risk Committee meetings which took place during the period November 2003 to December 2004 do not indicate that the 2004–05 GRR Business Plan and Strategy document was presented at any of these forums. Mr Moore has stated that the content of the Business Plan was orally explained to certain Executive Directors. In any case, the 2004–05 Business Plan did not address the confusion concerning GRR's remit.

3.14 The confusion concerning GRR's remit led to tension about the role of the first and second lines of defence. With strong communication and relationships between GRR, RRR and the Retail business the lack of clarity as to GRR's remit could have been overcome. As neither of these was present these difficulties were not addressed and were a recurring issue throughout 2004.

Resources

3.15During 2004 Mr Moore was supported by two deputies. The budgeted headcount for GRR was 130 individuals of which approximately 43 were to provide oversight and advisory services. In addition, GRR had access to external resources (advisory firms and contractors) when required, for example for the Advice Checking Team, CBF and SC reviews. No adverse comments regarding the resources available to GRR have been made to us. Parties external to GRR have commented on the high quality of the team recruited into GRR during 2004 and credit Mr Moore with this.

Performance of GRR's oversight function

3.16 Throughout 2004 and at the time of our review GRR did not have formally agreed the documented operational procedures and standards of practice in place. To an extent this can be attributed to the timing of the changes in leadership and strategic direction of GRR in late 2003/early 2004. The 2005–06 Business Plan recognised that improvements were needed in this area and this is now being addressed. Our consideration of the MEC, CBF and SC reviews has identified a number of issues regarding the process adopted by GRR. These fall into a number of areas as set out below. Notwithstanding the points noted below, comments have been made that Mr Moore made improvements within GRR in the areas of recruitment and development a more challenging review process.

Review identification and scoping

3.17 GRR split their work between three areas—Business as Usual, Group-Wide Themed and Operational Division themed. However, it is not clear how GRR decided what work was to be undertaken or the priority to be attached to the work. In addition, it is not clear whether GRR undertook a methodical risk analysis to identify areas to be addressed. If this did happen we have not seen any documentation.

3.18 The nature of Group-Wide and Operating Division themed reviews is not fully explained within the GRR Business Plans. Operating Division themed reviews has the most potential for overlap with the work undertaken by RRR, the Memorandum of Understanding between GRR and RRR does not explain GRR's approach in this area. If the terms of reference and scope of reviews are not agreed in advance it is possible to see how RRR's and divisional management's confusion regarding GRR's remit could arise.

3.19 The extent to which GRR communicate with RRR and considered RRR's work when planning their work for example on the CRF review is not clear, GRR did not share the terms of reference of their review with all key stakeholders; Jo Dawson (Head of Retail Advisory Sales) says she did not receive a copy, although RRR and some of her direct reports were aware of this review. Mr Moore finds it extraordinary that Ms Dawson was not aware of this review.

3.20 Similarly with respect to the SC review, it was not communicated clearly how the GRR work was to interact with, or build on, the work RRR had already commenced in this area. The lack of transparency concerning Operating Division themed reviews and in some cases product specific reviews (eg the CBF review) has had a detrimental effect on the trust and respect between GRR and RRR.

Reporting

3.21 The general consensus is that the substance of the overall findings and underlying work performed by GRR staff whilst carrying out the three reviews was of an appropriate standard to meet the scope. This is borne out by the nature of the changes between initial and final drafts of the reports, these are mainly factual and editorial and would be expected in such circumstances.

3.22 Other HBOS departments such as Internal Audit grade their reports and recommendations. The Retail Businesses' management assumed this style would be adopted by GRR. There are arguments both ways as to whether reports should be graded. GRR do not grade their reports. This left the reports open to misinterpretation by the divisions as to the importance of the issues and potential impact on the business. There was criticism about the style of the early drafts of the reports. This was accepted as a contributing factor to the tension over the CBF report by members of the GRR team.

3.23 Mr Moore considers that the views expressed in the final reports or board papers for the MEC, CBF and SC reviews were diluted compared to the views in earlier drafts. We do not believe that the findings in the final reports prepared in respect of the MEC, FBF and SC reviews differed significantly from the conclusions reached in earlier drafts, albeit there were some editorial change. This has been confirmed by the interviewees involved in these reviews.

3.24 Mr Moor stated that when drafting the MEC report, he allowed the criticism of the way Retail management had been running the mortgage endowment complaints to be "softened" by the Retail division. He expressed concern that as a result of the changes to the report the confidence of the FSA in him may have been damaged. Senior management thought he had been too hard on himself. As stated above the findings in the final report did not differ significantly from those in earlier drafts.

3.25 The FSA's findings from its own review of the MEC differed to those GRR, and initially the FSA reacted adversely. The main difference between the findings of the GRR review and the FSA's on-site review in January 2004 centred around the GRR conclusion that the rejection rate of complaints was justifiable. The FSA concluded from its own file review (based on a different sample) that there were grounds to believe that a significantly higher percentage of rejected complaints should have been upheld. In addition the FSA considered the GRR review concentrated on the process of complaints handling the FSA threatened Enforcement action if the matter was not addressed by HBOS. Senior management have expressed the view that Mr Moore felt "scarred" by the FSA response to the MEC work undertaken by GRR; this might be a relevant factor when considering Mr Moore's concerns regarding the CBF and CR reports.

3.26 James Davies and Andy Sheppard were involved in producing the five drafts of the CBF report. Whilst Mike Ellis prepared a paper for the GMB summarising the detailed Sales Culture report. Paul Moore and James Davies who was leading the SCR attended a meeting with Mr Ellis to confirm the wording of the GMB paper.

3.27 It is standard practice across the industry to agree the initial findings/draft reports for factual accuracy and context prior to presenting the findings to the business management. In the case of the CBF review these accepted protocols were not followed when Mr Moore escalated issues to the Divisional Chief Executive, Group Audit Committee and Group Chief Executive prior to findings being presented to or discussed with RRR or the Business. These briefings damaged GRR's relationship with RRR and the business, particularly with Ms Dawson, and created a tense atmosphere which increased the difficulty to agreeing the review's findings.

Senior management response to issues

3.28 Following all three reviews, action plans were drawn up and have been, or are in the process of being actively tracked by the business to address the issues raised and recommendations made by GRR. In addition, the recommendations included in Appendix 1 to the PWC report are being actioned by HBOS. We have not seen any evidence to suggest that senior management have not responded in an appropriate manner, that actions are not being addressed or that the Board and or FSA have not been kept appropriately informed of the firm's progress. With respect to the three reviews:

- Andy Hornby (Head of Retail Division) was actively involved in the resolution and tracking of the issues identified during the course of GRR's review of MEC and the FSA;'s subsequent review. Executive oversight of issues arising from Mortgage Endowment Complaints review is exercised through the Mortgage Endowment Steering Group;
- the agreed actions arising out of the CBF review, including a detailed customer contact exercise to confirm customer understanding of this product, have been carried out in accordance with the action plan. Jo Dawson as head of Advisory Sales provided a progress report to the Retail Board and the FSA in September 2004; and
- the issues identified and actions to address the issues identified during the SCR are covered within a Category 1 Project which reports regularly into the Board and is actively sponsored by Andy Hornby as Chief Executive of the Retail Division.

Other

3.29 Paragraph 31 of the Outline of Case refers to an interview Mr Moore held with Jack Cullen (Head of Risk Services, Retail) in May 2004 to discuss the culture on the Retail Sales division. Mr Moore attached a copy of the notes of interview to the Outline of Case. These notes were not agreed with Mr Cullen and were not included on the HBOS files. There is a difference in opinion regarding whether the notes are an accurate reflection of the discussion held. Mr Cullen has stated that some of the comments in the notes are taken out of context and may convey a misleading impression of his views. Rather than focus on these differences, what is important is that the context of the discussion was taken into account when preparing the GRR report and recommendations; and HBOS have implemented a Category 1 project to address the issues arising from the review. Hence, we consider that the concerns raised in the noted (sic) are being addressed.

4. Appointment of Group Risk Director

Background to the Group Risk Director ("GRD") role

4.1 In autumn 2003 Mike Ellis informed James Crosby that he wished to retire from HBOS. This acted as a catalyst for Mr Crosby to think about his senior executive responsibilities. He decided to split the Group Risk and Finance role. HBOS secured Mark Tucker for the role of Group Finance Director quicker than anticipated in April 2004. This left the position of GRD open to be filled.

Process for identification and assessment of candidates for the GRD role

4.2 In March 2004 the Group Management Board ("GMB") undertook their annual talent review of level 7 and 8 executives. This review identifies candidates that are likely to emerge as GMB members in the near future. Mr Crosby and Jackie Moore (Head of Executive and Organisational Development) held informal discussions to see if any individuals highlighted in the talent review were suitable for the GRD position. Ms Dawson, David Walkden, Dan Watkins and David Fisher were identified as such candidates. In addition Dr Andrew Smith was identified as someone with the right technical skills and knowledge. Mr Moore was not identified as a candidate.

4.3 Mr Crosby and Ms Moore decided to adopt a structured process using an external provider to identify the competencies required for the role and assess potential internal and external candidates.

4.4 Between April and May 2004 Mr Crosby discussed the GRD role with the senior team and articulated to them that he had considered Ms Dawson to be his strongest candidate, although this view was not shared by all members of senior management at the time. On 18 May, Mr Crosby informed the Nomination Committee of the need to appoint a GRD. It should be noted that the PWC S166 review was being performed at this time. The results of this review would potentially influence the new job specification and skills profile required.

4.5 In July 2004 Egon Zohnder International ("EZI") were appointed as headhunters. They held discussions with some senior executives and non-Executive Directors to identify the requirements and competencies for the role. During these discussions EZI sought suggestions for suitable candidates. In parallel Mr Crosby held discussions with the five internal candidates. Mr Crosby also spoke to Mr Moore for his views although it appears to be mutually agreed that Mr Moore was not a candidate.

4.6 A role competency was produced and during August and September 2004 Ms Dawson and other internal candidates were interviewed by EZI for this position. At this point the five external candidates were excluded. Four external candidates were considered not to be as compelling as the internal candidates when consideration of the cost of the recruit or the time candidates would take to get up to speed with the HBOS were taken into account. A fifth candidate was excluded as he was deemed to be conflicted from the position.

4.7 EZI confirmed the competencies required for the role in a telephone call with Mr Crosby in mid September. After undertaking screening interviews EZI then produced a report mapping the candidates onto a competency matrix. The matrix was supported by a one-page summary for each individual. These summaries provided: a synopsis of the individual's career; EZI's analysis of their capability for the role; EZI's assessment of their competencies against the role target; and, an assessment of their potential. Ms Dawson was identified as the clear lead candidate with the EZI report highlighting that she was a high achiever and supremely capable intellectually. It also noted some development needs concerning her abrasiveness and inflexibility noting that she lacked warmth. In conclusion it noted that no one at HBOS would be surprised to see her appointed to this role.

4.8 Ms Moore and Mr Crosby discussed the EZI findings and concluded that Ms Dawson was the lead candidate. Ultimately it is Mr Crosby who made the final decision to appoint Ms Dawson as GRD. The Nominations Committee were kept informed. It was decided that this position would be announced as part of the larger reshuffle which was announced in November 2004. In our view the process for the identification and assessment of candidates for the GRD position and appointment of Ms Dawson appears appropriate.

Appointment of Ms Dawson

4.9 At paragraph 3, which is further explained at paragraphs 53 to 56, the Outline of Case raises issues concerning whether Ms Dawson should undertake the GRD role. We consider below each of the issues raised:

(a) Lack of technical skills

4.10 KPMG does not believe that the GRD necessarily needs to have strong technical competencies in the wide range of HBOS generic risk categories (eg Market, Credit Insurance, Operations, regulatory, Liquidity, Interest Rates), especially if they are supported by individuals with the appropriate technical skills. This is consistent with Chapter 10 of the FSA's Supervision Manual concerning Approved Persons which does not prescribe the particular skills an individual undertaking a CF10 role is required to possess. It is key that the GRD recognises that technical skills are important and is willing to either be briefed or have an ability/ willingness to educate themselves. They must recognise that the rules and principles need to be adopted in spirit and be able to convince management that a strict interpretation of the FSA's Rules is not sufficient. Ms Dawson recognises that she will need technical assistance, either from external or internal advisers.

4.11 A number of individual Executives and non-Executives have also expressed the view that the GRR needs strong communication and relationship skills supported by the technical expertise of direct reports.

(b) Ms Dawson's attitude

4.12 The Outline of Case expresses concern regarding Jo Dawson's attitude to controlling risk and eliminating activities that run counter to the regulatory regime. In particular paragraph 28 states "Ms Dawson and her team made clear their resistance to responding positively and appropriately to matters of non-compliance raised by GRR".

4.13 As stated at paragraph 3.28, action plans were drawn up and actively tracked by the business in respect of all three reviews. Ms Dawson was centrally involved in the CBF follow-up during summer 2004. We have not seen any evidence to suggest that senior management have not responded in an appropriate manner, that actions are not being addressed or that the Board and/or FSA have not been kept appropriately informed of the firm's progress. Our assessment of the evidence in the CBF follow-up action does not support the assertion made by Mr Moore.

(c) threatening behaviour

4.14 Paragraph 54 of the Outline of Case refers to threats made by Ms Dawson to Mr Moore at a meeting on 30 July. It is clear that Ms Dawson was frustrated by Mr Moore's escalation of issues arising from the CBF review to the Divisional Chief Executive. Group Audit Committee and Group Chief Executive prior to discussing the findings with the business. These frustrations were apparent in meetings held on 24 March, 26 May and the July Meeting referred to by Mr Moore. Ms Dawson accepts that her language, on occasion, is robust and she does not preclude the possibility that she swore at Mr Moore.

4.15 Ms Dawson raised her concerns more formally in two particular emails dated 28 May and 4 June. It is not clear why Ms Dawson waited until the end of May and early June ie after GRR (21 April) and FSA reports (28 May) had been issued to express her concerns in this way.

4.16 Aspects of Ms Dawson's character were highlighted by EZI when the appointment decision was being made. In their assessment of Ms Dawson they stated: "Jo's absolute drive to succeed can make her demanding to work for and her tendency to be somewhat inflexible and a bit abrasive at times can inhibit her ability to build deep relationships across businesses. She has something of a track record of confrontations with HBOS and is not a natural diplomat".

4.17 It is generally recognised by the senior Executives that certain Ms Dawson's behaviour concerning the CBF was not appropriate. The escalation of matters to the Division Chief Executive Group Audit Committee and Group Chief Executive before engaging with her would be grounds for her to become infuriated. However, it is senior management's view, including the Group Chief Executive, that Ms Dawson has the ability, as summarised in EZI's analysis, to be effective in her new role.

4.18 We do not believe that the evidence reviewed suggests that Ms Dawson is not fit and proper to undertake the GRD role.

5. Redundancy of the Head of GRR Position

5.1 In this section we used the word redundancy. However we make no comment on the legal distinction between the words redundancy and dismissal. This is a legal issue. We do not believe that use of the term redundancy as opposed to dismissal makes any difference to a consideration of the regulatory compliance issues or the process followed.

5.2 At paragraph 4, which is further explained in paragraphs 46 to 52, the Outline of Case raises issues relating to the dismissal of Mr Moore. These paragraphs included aspects of employment law, which are outside the scope of our review.

HBOS' redundancy policy

5.3 The HBOS Job Security Agreement dated 28 January 2003 which was extended with Union agreement on 20 November 2003 to cover the year commending 1 January 2004 establishes the principles to be applied when dealing with potential redundancy issues. This document states "*This Agreement does not apply to colleagues above Level 5 or those colleagues working beyond their Normal Retirement Age . . .*".

5.4 Consistent with the Job Security Agreement, HBOS have confirmed that there are no defined processes for making positions at above Level 5 redundant. To put this in context, during the period November 2003 to December 2004 18 individuals at level 7 or 8 left HBOS at the Company's request and compromise agreements were concluded with all these individuals. There are approximately 150 people at level 7 or 8.

Factors leading to the redundancy of the Head of GRR position

Creation of the GRD position

5.5 During the process undertaken to define the GRD role consideration was given to the organisational structure that should be in place below that position. It was felt that Mr Moore could not continue as Head of GRR for two reasons which were explained to him in a meeting with the Group Chief Executive on 9 November 2004:

- the new organisational structure incorporating the role of GRD would not allow Mr Moore to undertake the role he wanted; and
- his influencing and relationships skills did not enable him to inspire sufficient confidence in the key stakeholders.

5.6 Whilst Ms Dawson had expressed a wish to continue to work with Mr Moore in her role as GRD, concerns were expressed elsewhere that this could not be possible due to previous difficulties in the relationship. Reference was made to occasions during 2004 when Mr Moore had stated that he could not work with Ms Dawson.

Mr Moore's performance

5.7 Numerous negative comments have been made regarding Mr Moore's performance in the role of Head of GRR. Whilst his technical abilities were general recognised as strong consistent reference has been made to Mr Moore:

- not inspiring confidence in GRR's stakeholders;
- not having sufficiently strong influencing and relationship skills;
- being overly verbose and full of self-importance;
- not being on top of the detail; and
- over-stating matters in an overly dramatic and theatrical way

5.8 In particular his behaviour on the following occasions was highlighted:

- 16 September 2003 HD Risk control committee—Mr Moore criticised the way the meeting was chaired. A number of individuals considered this behaviour to be inappropriate;
- 26 May 2004 Retail Risk Control Committee—Mr Moore was perceived as lecturing the committee in a patronising manner and offended individuals present with the style; and
- 8 June 2004 Group Audit committees meeting—Mr Moore expressed strong views in an overly aggressive manner, he was emotion and not reasoned, measured or coherent. His behaviour was described in different ways ranging from prickly to ranting to extra-ordinary to outrageous. Mr Moore's behaviour at this meeting was subject to a private meeting of the Audit committee on 23 July 2004.

5.9 In addition, reference was made to a number of private meetings that Mr Moore held with the non-Executives in which it was felt that his approach, his behaviour and the manner in which he escalated issues was inappropriate. In contrast he did not have a private meeting with the Chairman of the Audit committee until late 2004, although requests were made by the Chairman of the Audit Committee for such a meeting to be scheduled.

Loss of confidence

5.10 It is clear that senior executives and non-executive directors interviewed lost confidence in Mr Moore over a period of time and for different reasons. Some individuals expressed surprise that Mr Moore was appointed Head of GRR in 2003.

Decision to make Mr Moore redundant

5.11 Around October 2004 was decided that Mr Moore was to be made redundant. He was informed of this decision on 5 November 2004.

6. Conclusion

Initial conclusions

6.1 During 2004 Mr Moore strengthened the GRR function through the recruitment of strong individuals and by developing more of a team spirit within the GRR function. The 2005–06 Business Plan whilst still demonstrating areas for improvement did build on the 2004–05 Business Plan and indicates that the GRR function was refining the role of oversight. However, the confusion surrounding GRR's remit and the interaction between GRR, RRR and the Retail Business during 2004 were not dealt with.

6.2 With strong communication and relationships between GRR. RRR and the Retail business the lack of clarity as to GRR's remit could have been overcome. As neither of these was present these difficulties were not addressed and were a recurring issue throughout 2004. Whilst not specifically mentioned in the MAP, we believe that the opportunity to deal with these issues would naturally fall to the Head of GRR who could have taken steps to improve the clarity of GRR's remit and its interaction with other teams. It is apparent that relationships between GRR and its stakeholders as described in Section 2 deteriorated during 2004. It is clear that the relationship between Mr Moore and Ms Dawson was difficult for some time.

6.3 We consider that the structure and reporting lines of GRR are appropriate. As noted in Section 3, throughout 2004 and at the time of our review GRR did not have formally agreed and documented operational procedures and standards of practice in place. This matter is being addressed.

6.4 We consider that the process adopted for the identification and assessment of candidates for the GRD position and appointment of Ms Dawson to be appropriate. It is clear from EZI and Ms Dawson's own self assessment that she is a robust character. The quality of her relationships will be a critical success factor in her new role. However, we do not believe that the evidence reviewed suggests that Ms Dawson is not fit and proper to undertake the GRD role.

6.5 There are no defined processes relating to the redundancy of positions above level 5 ie the Head of GRR role at Level 8. We set out the facts leading to the redundancy of this role in Section 6.
Further conclusions

6.6 You subsequently asked us to consider whether the way in which the CBF, MEC and SCR reviews were approached, the reaction to them and the follow up response are indicative of a Group that takes its regulatory responsibilities seriously. It is inevitable that the Group, because of its size and diversity will continue to have ongoing regulatory issues that will need to be actively addressed. However, on the basis of

the limited work we have done (as set out in the preceding sections of the report) to meet our original scope, the evidence suggests that the Group does understand, accept and take its regulatory responsibilities seriously. This is supported by the findings of PWC's Skilled Persons report.

6.7 The redundancy of any approved person in a senior position, such as that of Head of GRR, will be of concern to the FSA as a matter of course. Their interest in the outcome of this project supports this view. On the basis of the work we have done we believe that the quality of Mr Moore's relationships with the key stakeholders, as set out in Section 2, was a key factor in him being asked to leave the Group. We have seen no evidence to suggest that Mr Moore's redundancy was in response to him performing his job too well, as suggested at paragraph 5 of the Outline of Case. The FSA will form their own judgement based on your discussions with them. However, in our view, we believe that it is likely that if the FSA have any residual on-going concerns arising from the issues set out in the Outline of Case they will deal with them as part of their on-going close and continuous supervision.

APPENDIX 1

INTERVIEWS/MEETINGS HELD

Non-executive Directors

Individual interviewed	*Date*
Sir Ron Garrick	28 January 2006
Coline McConville	7 February 2005
Tony Hobson	15 February 2005
Charles Dunstone	16 February 2005
Kate Nealon	16 February 2005
Louis Sherwood	16 February 2005
John Maclean	21 February 2005

Executive Directors

Individual interviewed	*Date(s)*
Mike Ellis	20 January 2005 & 22 February 2005
Phil Hodkinson	28 January 2005
James Crosby	14 February 2005
Mark Tucker	14 February 2005
Andy Hornby	15 February 2005

GRR

Individual interviewed	*Date(s)*
Paul Moore	19 January 2005 & 18 February 2005
James Davies	25 January 2005 & 18 February 2005
Tony Brian	26 January 2005
Susannah Hammond	3 February 2005
Andy Sheppard (contractor)	9 February 2005
Andy Gordon (contractor)	11 February 2005
Richard Mais (contractor)	18 February 2005

Other HBOS

Individual interviewed	*Date(s)*
David Walkden	3 February 2005
Jack Cullen	3 February 2005
Stephen Millington	3 February 2005
Jo Dawson	9 February 2005
David Fryatt	10 February 2005
Jackie Moore	14 February 2005
Andrew Smith	24 February 2005

Other External

Individual interviewed	*Date(s)*
Kirstie Caneparo	24 January 2005 & 11 February 2005
John Elacott	8 February 2005
Guy Bainbridge	14 February 2005

APPENDIX 2

KEY DOCUMENTS REVIEWED

Outline of Case and support documentation (Paul Moore Dossier)

Management Response

— Mike Ellis's response to case outlined by Paul Moore.

— Emails between PRM and Mike Ellis regarding CBF supervision visit and response to GRR review of CBF.

— Emails between PRM and Jo Dawson regarding GRR review of CBF.

— Emails between PRM, JaD and Mike Ellis regarding chronology of events surrounding CBF review—including schedule setting out CBF chronology.

— Emails between PRM, JaD, AH and Mike Ellis regarding rewrites of GRR Report on findings arising out of review of the retail sales culture and systems and control.

Minutes of Committee Meetings during 2004

— Minutes of the Meetings of the Directors from 25 November 2003 to 23 November 2004.

— Minutes of the Audit Committee meetings from 9 December 2003 to 7 December 2004 and 8 June 2005.

— Minutes of the Audit Committee Private Sessions from 9 December 2003 to 11 October 2004.

— Minutes of Business Banking Risk Control Committee meetings: 25 November 2003 and 27 January 2004.

— Minutes of Corporate Banking Risk Control Committee meetings from 18 November 2003 to 23 November 2004.

— Minutes of the Group Management Board meetings from 17 November 2003 to 21 December 2004.

— Minutes of International Operations Risk Control Committee meetings: 22 June 2004 and 26 October 2004.

— Minutes of IID Risk Control Committee meetings from 20 November 2003 to 3 November 2004.

— Minutes of the Nomination Committee meetings from 28 October 2003 to 26 October 2004.

— Minutes of Retail Risk Control Committee meetings from 21 November 2003 to 2 December 2004.

— Minutes of Treasury Risk Control Committee meetings from 13 November 2003 to 10 November 2004.

— Minutes of Group Operational & Regulatory Risk Committee meetings from 11 December 2003 to 7 October 2004.

— Minutes of Retail Board meetings from 20 November 2003 to 22 December 2004.

— Monthly Risk Reports within the Management Information Pack for "Blue Book", from November 2003 to November 2004.

GRR papers submitted to Risk & Governance Committees during 2004

— GRR papers submitted to the Group Management Board meetings from 17 November 2003 to 21 December 2004.

— GRR papers and Quarterly reports submitted to Audit Committee meetings from 9 December 2003 to 7 December 2004.

— GRR papers submitted to Retail Risk Control Committees from 5 February 2004 to 23 September 2004.

— GRR papers submitted to Treasury Risk Control Committees from 19 February 2004 to 19 July 2004.

— GRR papers submitted to Business Banking risk Control Committee 27 January 2004.

- GRR papers submitted to Corporate Banking Risk Control Committee 27 January 2004, 21 September 2004, 23 November 2004.
- GRR papers submitted to International Operations Banking Risk Control Committee 26 October 2004.
- GRR papers submitted to IID Risk Control Committee meetings: from 13 November 2003 to 3–4 February 2004, 15 June 2004, 3 November 2004.
- Reports to Group Operational and Regulatory Risk Committee (GORRC).

GRR Structure and Organisation

- Copy of document prepared by Paul summarising his view of the "key achievements" of GRR in 2004: "GRR working with their stakeholders to become A New Standard in Regulatory Risk Management" for discussion with Mike Ellis—2 December 2004.
- Draft Memorandum of Understanding between Group Regulatory Risk & Retail Division Regulatory Risk.
- Meeting Notes of One-on-Ones between Stephan Millington and Susannah Hammond.
- CVs for: Paul Moore, Tony Brian, Susannah Hammond, James Davies, David Walkden, and Dan Watkins.
- GRR Business Plans for 2004–2005: Draft presented to GAC 09/12/2003—Final version—2005–2006.
- GRR Team Structure Charts: 31/03/04, 02/08/04, 1/11/04, 01/02/05.
- GRR Retail Plans for 2004 & 2005 and retail division regulatory risk oversight plan for 2004 (draft).

Governance Framework

- Overview of HBOS Plc Corporate Governance—internal structure and governance arrangements pre and post merger and three lines of defence model.
- Revised Overview of Corporate Governance—following internal restructuring on retirement of Divisional Chief Executive responsible for Treasury Division.
- Board Control Manual—includes terms of reference for Audit Committee: Risk Control Committees and various Executive Risk Committees.
- Retail Board Control Manual—February 2003 and November 2004 version.
- Retail Division Governance framework.
- Retail Regulatory Risk structure chart.
- 2004 AGM Welcome Pack which includes a short biography of HBOS Board members.
- 11 November email re Senior appointments at HBOS attaching three announcements:
  - An email to the HBOS Executive explaining their new role.
  - An email to "Insiders" which sets out all aspects of the announcement.
  - The "HBOS Today" edition which communicates the changes to 65,000 colleagues across HBOS.

Documents related to s166 review of Risk Management

- PWC's s166 Report of Risk Management as at 30 April 2004.
- Table laying out s166 recommendations and management response.
- S166 Correspondence:
  1. Email from the FSA to Tony Brian re s166 report 15.02.04.
  2. Email and document re Draft Scoping document 8.02.04.
  3. Meeting notes between HBOS and FSA from 16.04.04.
  4. Formal requirement notice and final scope for report 28.04.04.
  5. Trilateral meeting to review report 23.08.04.
  6. Letter from the FSA to Mike Ellis re s166 report 23.09.04.
- Status of agreed actions arising from PWC s166 review:
  - Paper to the Audit Committee 7 December.
  - Recommendations and management response.
  - Group Risk Committee draft ToR.

  - — Table of Heads of Risk in each division.
  - — GRR report independence of LRMS from the Business Areas.
  - — Protocols on co-ordination between GIA and GRR.

FSA Arrow letters and Risk Mitigation Programmes (RMP)

- — Risk Mitigation Programmes (RMP letters):
  - — FSA correspondence re Risk Assessment from Kirstie Caneparo dated 13 January 2004 and response to FSA from James Crosby dated 11 February 2004.
  - — FSA correspondence re Risk Assessment—HBOS Retail Division from Kirstie Caneparo dated 1 December 2003.
  - — FSA correspondence re Arrow Risk Assessment: Letter from Kirstie Caneparo dated 21 December 2004 and Group Response to this dated 31 January 2005.
- — FSA letter of 6/11/03 that prompted the GRR review of mortgage endowment complaints.

Mortgage Endowments

- — The RRR report (August 2003) into Mortgage Endowment complaints and its terms of reference.
- — Various versions of the terms of reference (Nov/Dec 2003) for the GRR review of Mortgage Endowment complaints.
- — 3 drafts of the GRR review (dated 15/12; 17/12; and 19/12—the latter being the version sent to the FSA).
- — “Close out” letter dated 4/05/04 from the FSA to Andy Hornby..

Corporate Bond Fund (CBF)

- — GRR CBF Reports (Drafts 1 to 5)..
- — GRR CBF TOR.
- — GRR CBF—summary of 35 samples..
- — Corporate Bond Fund Actions.
- — FSA Corporate Bond Fund Review (27 May 05) and meeting note (21 Apr 04).
- — FSA meeting notes (13 September 2004).
- — Paul Moore (HBOS) Chronology.
- — Audit Committee Minutes (inc 9 March 2004, 8 June 2005).
- — CBF Sales Paper (6 September 2004).
- — Alarm over Bond Sales (Daily Mail Article—November 2003).
- — Lloyds TSB fine (24 September 2003).
- — Risk Assessment following the Lloyds TSB fine by FSA.
- — FSA action against Lloyds TSB—implications for HBOS (Paul Jackson).
- — CAG—Corporate Bond Sales (Tom Woolgrove).
- — CBF Assessment (1 September 2003—Paul Jackson).
- — Product information on CBF. Guaranteed Reserve Account Halifax Collective Investment Plan.
- — ACT Report.
- — Moneybox Investigation.
- — Numerous internal e-mails within HBOS relating to CBF.

Sales Culture Review

- — Terms of Reference.
- — Aide Memoire on initial findings by Paul Moore for discussion with Andy Hornby 11.06.
- — Emails between Paul Moore, Mike Ellis, Andy Hornby and Jame Davies dated 14.06.04—26.07.04, discussing rewrites of the draft SCR report.
- — Selected notes of branch visits and focus groups output—04.07.04.
- — SCR/s166 Management Programme pack.
- — Paul Moore’s note on meeting with Jack Cullen.
- — Jack Cullen’s response to Paul Moore’s note.

- E&Y review of Retail Internal Controls (March).
- Chronology of events of SCR by Richard Mais.
- Reports:.
  - First Draft—04.07.04.
  - Second Draft—13.07.04.
  - Third Draft—20.07.04.
  - Final Report—23.07.04.
  - Main Board Report by Mike Ellis (GMB Paper).
- Branch Visit Findings—Summary by A Gordon (Oxford Circus, 27 May 2004).
- Branch Visit Findings—Summary by A Gordon (London BOSIS, 9 June 2004).
- Branch Visit Findings—Summary by A Clarke (Skipton, 27 May 2004.
- Branch Visit Findings—Summary by T Townson (Worcester Park, South London, 28 May 2004).
- Focus Group Findings—Summary (North Region Branch Colleagues, 7 June 2004).
- Various HBOS—GRR Review Interview Notes. Interviewees: Jo Dawson, Ray Milne, Heather Cutts, Paul Stanley, Colin Turner, Paul Jackson..
- HBOS Sales Culture and Systems Controls Review Document Log.
- Diary view of interviews.
- Retail Division—Sales Culture and Systems and Controls Review Action Plan v 3.
- Retail Division—Sales Culture and Systems and Controls Review Terms of Reference (Draft).
- Sales Culture & Risk Management Project status report identifying key issues, dependencies and milestones.
- Retail sale culture and Risk management operational review pack prepared for a meeting of the Programme Steering Committee on 31.01.05 and minutes of the operational review/steering group meeting on 31.01.05.

HR documents/HBOS Appointment Policy

- HBOS Job Security Agreement 2003 & 2004.
- HBOS Disciplinary Policy.
- HBOS Recruitment and Selection Policy.
- HBOS Performance Improvement Policy.
- HBOS HR Standards dated January 2004.
- HBOS Executive & Organisational Development—Executive Framework 2004.
- The HBOS approach to Maximising Returns on External Coaching.
- HBOS Level 7 & 8 Succession Planning Procedure.
- HBOS plc Annual Report & Accounts 2003 extract on role of the Nominations Committee.
- HBOS Nominations Committee Terms of Reference.
- Executive Summary. Responsibilities of the HBOS Chief Executive.
- Confidential Executive Profile—Paul Moore.
- Executive Performance Management—IID Paul Moore dated 8 March 2004.
- Paul Moore: Highlights of his 360 feedback—2004 (Prepared by Jackie Moore).
- Executive Orientation—Initial Development Discussion—Paul Moore (2004).
- Paul Moore HBOS GRR 360 Feedback 2004—General Findings.
- Extracts from Paul Moore's personnel file.
- E-mail from Irene Brownlee to Jackie Moore dated 23 July 2004 re Paul Moore.
- E-mail from Irene Brownlee to Jackie Moore dated 1 September 2004 re Paul Moore.
- E-mail from Paul Moore to Jackie Moore dated 1 September 2004 re meeting with Paul Moore.
- E-mail from Paul Moore to Jackie Moore dated 12 October 2004 re Susannah Hammond.
- E-mail from Paul Moore to Jackie Moore dated 13 October 2004 re Susannah Hammond.
- Confidential Executive Profile—Jo Dawson.
- Appraisal—2003 Jo Dawson.
- Executive & Organisational Development report for Jo Dawson dated March 2003.
- EZI presentation on Group Risk Director dated 4 August 2004.

— EZI presentation update on Head of Group risk dated 15 September 2004.
— File note of conversation between Jonathan Skan of EZI and Tony Hobson re Group Head of Risk role.
— Email from Jo Dawson to Jackie Moore re appointment to see Jonathan Skan on 1 September 2004.
— Email from James Crosby to Dennis Stevenson and Sir Ron Garrick re reorganisation and likelihood of Paul Moore's departure dated 8 November 2004.
— Email from James Crosby to HBOS non-executives re Senior Appointments at HBOS dated 11 November 2004.
— Internal memorandum from James Crosby on Organisation announcement dated 11 November 2004.

Other documents reviewed

— Copy of notes which Andy Hornby and Phil Hodkinson used to communicate the approach to Regulatory Risk Management prior to Paul taking over as Head of Regulatory Risk Management:
  — Internal Memorandum dated 5 April 2002.
  — Paper on Risk Management Structures within the HBOS Insurance & Investment Division.
— Management Accountability Profiles including those for Tony Brian, James Corcoran, James Crosby, Jack Cullen, James Davies, Jo Dawson, Mike Ellis, Phil Hodkinson, Andy Hornby, Paul Moore, Stephen Millington and David Walkden.
— D Fryatt Paper to June Audit Committee—"Key questions for Board Audit Committee".
— E-mails from Charles Dunstone attaching details of RRCC minutes of 26 May and amendments thereto.
— E-mail from Dennis Stevenson to Charles Dunstone (forwarded by CD) acknowledging CD's feedback from meeting with PM in June.

Letter from Miller Mclean, Group General Counsel and Group Secretary, RBS, to the Chairman of the Committee

I am responding to your letter to Stephen Hester of 27 February 2009 and have set out below the answers to your various questions.

The matters on which you seek information fall, primarily, under the authority of the Chairman of the Board, not the Group Chief Executive. In any event, both have requested that I respond to you on behalf of the Company.

This response has been compiled on the basis of discussions held over the weekend of 29 February/1 March 2009 with the principal individuals involved at RBS at the time and after a review of notes and minutes. It has not been possible in the time available, however, to speak to all former and current members of the Board nor to take those we have spoken to through the supporting material. It should be reviewed in that context.

1. *The date on which the terms of Sir Fred's pension were agreed*

The terms of Sir Fred Goodwin's contractual pension entitlements are recorded in letters to Sir Fred dated 24 March 2003, 26 April 2004, 21 December 2007 and 13 October 2008. The terms, as they would apply on Sir Fred's departure from the Company, were subsequently recorded in a Compromise Agreement which was signed between midnight and 3.00am on 13 October 2009.

2. *Which individuals were party to these discussions both from RBS and HM Treasury*

Negotiations regarding the terms of the Compromise Agreement took place over the weekend of 10–12 October 2008. From RBS, the following were most directly involved in these discussions:

— Sir Fred Goodwin.
— Sir Tom McKillop (Chairman).
— Robert (Bob) Scott (Chairman of the Remuneration Committee and Senior Independent Director).
— Neil Roden (HR Director).
— Anne Sloan (Executive HR Advisor).

Their recommendations were approved at a meeting of the Remuneration Committee on 12 October 2008 and by the Non Executive Directors of the Board at the Chairman's Committee on 13 October 2008 (Stephen Hester not in attendance).

3. *At what stage in negotiations did Lord Myners and/or Treasury officials become involved*

By way of background, it was agreed on Friday 10 October by the Non Executive Directors of RBS, and subsequently by the Nominations Committee later that day, that Sir Fred Goodwin should leave the Company and that it was in the Company's interests for there to be an orderly handover to his successor (whose identity and availability had not been finally confirmed), Sir Fred Goodwin agreed to stay in post until his successor was appointed and available. Sir Tom McKillop and Bob Scott were delegated to negotiate the specific terms to implement this decision. During the course of 10 October 2008 they decided that this would best be accomplished through treating Sir Fred Goodwin as leaving at the request of the Company in accordance with the principles applied to other Directors leaving the Group and not being dismissed. No Treasury officials or other Board members were involved at this stage.

Lord Myners had discussions with Sir Tom McKillop, Bob Scott and Sir Fred Goodwin, during Saturday 11 and Sunday 12 October 2009 with respect to Sir Fred Goodwin's departure and his compromise package.

4. *Who agreed the pension settlement with Sir Fred*

Sir Fred Goodwin's pension arrangements (and other payments and benefits) followed as an automatic consequence of him being asked to leave at the request of the Company. The pension terms for executives leaving the Group are set out in the Company's Annual Report and Accounts. We are not aware of any specific negotiation in respect of these pension terms.

During the negotiation of the Compromise Agreement, Sir Tom McKillop, Bob Scott and Neil Roden were the only individuals from RBS engaged in direct discussion with Sir Fred Goodwin. Lord Myners also spoke directly with Sir Fred on the evening of 12 October 2008. RBS were legally represented by Linklaters and Sir Fred by Maclay Murray & Spens.

The proposed terms of Sir Fred's Compromise Agreement were approved at a meeting of the Company's Remuneration Committee on 12 October 2008. The Non Executive Directors at the Chairman's Committee on 12 October (Stephen Hester not in attendance) accepted the Remuneration Committee's recommendation; however there was no discussion of any alternative basis of departure to that set out in paragraph 3 above.

5. *What information was given to 8M Treasury, and on what dates, about the terms of the pension and whether or not there was contractual entitlement*

In a telephone conversation with Lord Myners on 12 October 2008, Bob Scott recalls he summarised Sir Fred Goodwin's pension terms for Lord Myners and, in relation to Sir Fred's pension arrangements, that he emphasised that the value of Sir Fred's pension fund would be a substantial figure (he then estimated to be in the range of £15 million to £20 million), and that the figure would need to be disclosed in the Company's Report and Accounts. These pension terms were a consequence of the basis upon which it had been agreed that Sir Fred would be leaving the Company, although we believe that no alternative basis for departure was discussed with Lord Myners.

Further discussions took place concerning aspects of Sir Fred Goodwin's compromise package on Sunday 12 October 2008 but we do not believe that there was any further specific discussion of Sir Fred's pension terms. Following signature of Sir Fred's Compromise Agreement subsequent discussions also took place on 2 November 2008 between Lord Myners and Bob Scott in respect of certain share option entitlements which resulted in Sir Fred waiving his entitlement to these options under the terms of the Compromise Agreement.

6. *What questions HM Treasury asked about the terms of the pension*

Details were provided about Sir Fred Goodwin's pension terms by Bob Scott to Lord Myners (see paragraph 5, above). The Company has no record of whether any specific questions were raised about the pension terms by Lord Myners.

7. *How Sir Fred's pension entitlement differs from*

— what would be the case if he had been dismissed by the Board

If Sir Fred had been dismissed in circumstances which were not characterised as retirement at the request of the employer, he would have received a deferred pension payable at age 60, or, with consent payable at an earlier date but subject to an actuarial reduction. The value of Sir Fred's pension is £703,000 per annum as at 31 January 2009. The approximate value of a deferred pension payable now would he £4 16,000 per annum.

— what would be the case if RBS had gone into administration

Assuming the administration did not lead to the survival of all or part of the Company but to insolvent liquidation, one possible scenario (of several) is that the Company's pension scheme would have been under funded and so would have transferred into the statutory Pension Protection Fund. This would entitle Sir Fred Goodwin to receive 90%, or his entitlement that would otherwise have been paid from the Company' s registered fund but capped at a current statutory maximum of £27,770.72. In addition. Sir Fred would be entitled to receive the remainder of his pension entitlement (or a pro-rata share thereof) from the Company's unregistered (FURBS) scheme to the extent that there were funds available to do so. Sir Fred would then be an unsecured creditor for the balance of his contractual entitlement which was not otherwise paid to him.

2 March 2009

Letter from Miller McLean, General Group Counsel and Group Secretary, RBS, to the Chairman of the Committee

I am responding to your letter of 4 March 2009, in which you formally requested that RBS provide further documents and information as part of the written evidence for the Treasury Committee's inquiry into the banking crisis.

Specifically you asked for (i) copies of letters referred to in our letter to you of 2 March 2009 (the "Pensions Letters") and (ii) full information on the timing, attendance, full minutes, documentation and accompanying papers which guided all directors at the Remuneration, Nominations and Chairman's Committees (the "Committee Meetings") for all discussions relating to Sir Fred's pension. We thought it most convenient to provide this information by way of the following appendices:

Appendix 1—Chronology of the principal meetings over the weekend of 10–12 October 2008.

Appendix 2—List of Attendees at the Committee Meetings.

Appendix 3—Index of Pensions Letters and other Documents.

On the basis of our inquiry we believe this is the material responsive to your request but if I can assist further please let me know.

APPENDIX 1

CHRONOLOGY OF THE PRINCIPAL MEETINGS

Date	*Time*	*Meeting*
10 October 2008	(approx) 10.00am	Non Executive Directors' Conference Call
10 October 2008	(approx) 1.00pm	Nominations Committee Conference Call
11 October 2008	5.00pm	Meeting between HM Treasury and RBS
11 October 2008	Following on from previous meeting	Supplementary meeting between HM Treasury and RBS
12 October 2008	(approx) 5.00pm	Remuneration Committee Conference Call*
12/13 October 2008	12.40am	Chairman's Committee Conference Call

* These were the only meetings at which we believe there was any substantive discussion of Sir Fred's pension forming part of his departure package. We have included the other calls and meetings because they form part of the relevant chronology. The Chairman's Committee Conference Call of 12/13 October 2008 is the meeting referred to in paragraphs 2 and 4 of RBS' letter of 2 March.

APPENDIX 2

ATTENDEES AT THE COMMITTEE MEETINGS

Nominations Committee Conference Call	*Remuneration Committee Conference Call*	*Chairman's Committee Conference Call*
10/10/08	*12/10/08*	*13/10/08*
Archie Hunter	Colin Buchan	**Executive Directors:**
Sir Tom McKillop	Janis Kong	Mark Fisher *
Robert (Bob) Scott	Sir Tom McKillop	Sir Fred Goodwin *
Peter Sutherland	Robert (Bob) Scott	Gordon Pell *
Miller McLean **	Peter Sutherland	Guy Whittaker *
	Miller McLean **	**Non Executive Directors:**
	Neil Roden ***	Colin Buchan

Nominations Committee Conference Call	*Remuneration Committee Conference Call*	*Chairman's Committee Conference Call*
10/10/08	*12/10/08*	*13/10/08*
		James Currie Lawrence Fish William Friedrich Stephen Hester * Archie Hunter Charles (Bud) Koch Janis Kong Joseph MacHale John McFarlane Sir Tom McKillop Sir Stephen Robson Arthur Ryan Robert (Bob) Scott Peter Sutherland Miller McLean **

* Did not attend the part of the meeting that discussed the terms of Sir Fred's departure package.

** In attendance as General Counsel and Group Secretary. At the Remuneration and Chairman's Committee Conference Calls Mr McLean was accompanied by a member of the RBS secretariat.

*** In attendance as Group Director of Human Resources.

APPENDIX 3

RELEVANT DOCUMENTS

Index to Appendix 4

1. Letters from RBS to Sir Fred Goodwin dated 24 March 2003, 26 April 2004, 21 December 2007 and 13 October 2008 and referred to in our letter to the Treasury Committee dated 2 March 2009.
2. Minute of Nominations Committee Conference Call on 10 October 2008.
3. Remuneration Committee Paper dated 12 October 2008.
4. Minute of Remuneration Committee Conference Call at 5.00pm on 12 October 2008.
5. Minute of Chairman's Committee Conference Call at 12.40am on 13 October 2008.

APPENDIX 4

1. Letters from RBS to Sir Fred Goodwin dated 24 March 2003, 26 April 2004, 21 December 2007 and 13 October 2008 and referred to in our letter to the Treasury Committee dated 2 March 2009

Letter from Neil Roden, Group Director, Human Resources, RBS to Sir Fred Goodwin, dated 24 March 2003

Dear Fred

Your Pension Benefits

As agreed, I am writing to document the pension benefits that will be paid to you and your dependants by the Group.

General Principle

The general principle governing the calculation of the benefits is to provide you with benefits calculated according to the rules of The Royal Bank of Scotland Group Pension Fund (the Group Fund) with two key modifications:

(a) benefits will be calculated ignoring the effect of the earnings cap (currently £97,200 a year).

(b) benefits will be calculated assuming a notional start date of your 20th birthday.

In particular this means that if you remain with the Group until age 60 your pension will be two-thirds of your full basic salary.

If you do not transfer all pension benefits from previous periods of employment or self employment to the Group, any benefits left elsewhere will be deducted from the pension paid by the Group.

A more detailed description of the benefits is given in the appendix.

Benefits from the Group Fund

Of the total pension due, we will pay the maximum possible from the Group Fund. This amount is constrained by Inland Revenue limitations and is the following:

(1) 2/60ths of the earnings cap for each year of actual service with the Group (ie since 1 August 1998)

Plus

(2) 1/60th of the earnings cap times five years and 11 months, this being the credited service arising from the transfer from National Australia Group (assuming this transfer is completed in accordance with the recent offer from NAG).

The total of (1) and (2) cannot be more than two-thirds of the earnings cap (currently £97,200) less any benefits you have retained elsewhere.

The effect of the above is that as at the end of February 2003 you are credited with pensionable service of nine years two months (twice your actual service with the Group, reflecting the ability to provide you with a pension of 1/30th rather than 1/60th of salary for each year). In addition, the transfer from NAG will provide you with pensionable service of five years 11 months. Applying this pensionable service to the earnings cap produces a pension of some £24,400 a year. In addition you have three retirement annuity policies which might produce a pension from age 60 of around £35,000 a year.

To put this in context, your total accrued pension at the end of February 2003 is some £334,000 a year; this is calculated as 1/60th of your salary over the year to February 2003 times 24.5 (the number of years from your 20th birthday).

Remainder of the Benefits

At present there is no specific funding for the remainder of the benefits, although a small balance of some £12,000 is to be transferred from NAG to a funded unapproved retirement benefits scheme (FURBS) for you.

For the avoidance of doubt, the benefits set out in this letter, including the appendix, are a contractual entitlement and, to the extent that they are not met from the Group Fund or a FURBS, the Group has a legal obligation to pay these benefits to you. Also for the avoidance of doubt, this letter may be relied upon by your wife or other dependants who are entitled to benefits in the event of your death as set out in this letter and appendix.

The Inland Revenue has proposed changes to the taxation of pension arrangements, these are currently in a consultation phase. Implementation is planned for April 2004, although there have been suggestions that they may be delayed until April 2005. The proposals for the treatment of FURBS under the new arrangements have not yet been published by the Inland Revenue and it may be that the proceeds from a FURBS will be subject to additional tax. On the other hand, there may be more scope than at present to fund your pension through the Group Fund. We would therefore suggest that no further action be taken to fund the part of your pension which is not to be provided through the Group Fund until the Inland Revenue proposals are clarified further, expected to be later this year.

If this is a concern to you, then I think it would be appropriate for you to discuss this directly with the Chairman of the Group and the Chairman of the Remuneration Committee.

Yours sincerely

Neil Roden
Group Director, Human Resources

Appendix to letter dated 24 March 2003

Pension

1. The level of pension payable on your retirement or leaving service will be calculated as follows:

   (N/60ths x Final Pensionable Salary) less Retained Benefits and less the State Pension Adjustment.

   "N" means the number of years between your 20th birthday and the date you cease to be employed by the Bank (complete months counting proportionately).

   "Final Pensionable Salary" means your highest average basic annual salary from the Bank (except director's fees, bonuses, special cash payments, grants, overtime and allowances and other similar payments) over any 12 consecutive months in the last ten years of your employment with the Bank reckonable for pension.

"State Pension Adjustment" means 1/40th of 30% of the basic State Pension for a single person for each year between your 20th birthday and 31 December 2001 (complete months counting proportionately) and is not deducted from your pension until you reach age 65.

"Retained Benefits" means any pension benefits you have accrued in respect of periods of employment or self employment prior to joining the Bank, except to the extent you have transferred them to a pension arrangement of the Bank.

If you retire at age 60, this pension will be payable immediately. If you leave service before age 60, this pension will become payable at age 60, although it may be possible for you to elect for the pension to start at an earlier date. The conditions for early payment and the reduction, if any, applying will be those in force at the time within the Group Fund.

2. If you suffer from Incapacity as a result of which you have been absent from employment for at least five years and six months and you cannot return to your employment nor can you take up any other employment, you will be able to retire with an immediate pension calculated as in (l) above but where "N" is set at 40.

If you have been absent from employment as a result of Incapacity for less than five years and six months, then you may elect to retire with an immediate pension calculated as in (1) above. For the avoidance of doubt, in this case "N" will be set as the number of years between your 20th birthday and the date you cease to be employed by the Bank (complete months counting proportionately).

"Incapacity" means physical or mental incapacity preventing you from following your normal occupation or seriously impairing your earning capacity. The decision of the trustees of the Group Fund as to whether you are suffering from Incapacity at the date you retire shall be final.

Benefits Payable on Death

1. Should you die whilst employed by the Bank:

— A lump sum will be payable under a discretionary trust. The lump sum will be equal to four times the annual rate of your basic salary (excluding any director's fees, bonuses, special cash payments, grants, overtime and allowances and other similar payments) from the Bank at the date of your death, and

— Your Spouse will receive a pension equal to half of the pension that would have been payable to you had you remained employed by the Bank until age 60.

2. Should you die as a deferred pensioner your Spouse will receive a pension equal to half of your deferred pension that would have been payable to you at age 60.

3. Should you die as a pensioner your Spouse will receive a pension equal to half of the pension you would have been receiving at the date of death if you had not commuted any pension for lump sum at retirement.

"Spouse" means your legal spouse, or where you are not survived by a spouse, someone nominated by you in writing to the trustees of the Group Fund and who was co-habiting with you for at least six months before your death and financially dependent on you at the date of your death. The decision of the trustees of the Group Fund as to whether such a person shall count as your Spouse shall be final.

4. If you are survived by any Eligible Children (as defined in the rules of the Group Fund) pensions will be payable to them in the same circumstances and in the same proportions applying under the Group Fund.

Other Provisions

1. At the date your pension starts, you will be entitled to exchange a proportion of the pension for a lump sum. The conversion rate will be that applicable in the Group Fund at the time.

2. Your pension, and that of your Spouse and Eligible Children, will be increased at the same percentage rate as applies to pensions payable from the Group Fund.

Letter from RBS to Sir Fred Goodwin, dated 26 April 2004

Dear Fred

Your Pension Arrangements

I understand you are agreeable to the broad principle of what was proposed in our draft letter of 22 March 2004, ie to fund your pension (over and above that part which will be provided by the Group Pension Fund) by setting up a Funded Unapproved Retirement Benefits Scheme (FURBS) in April 2006 once the new pensions tax regime has been introduced. As requested by Bruce Saunderson of Maclay Murray & Spens in his letter to Peter Hurcombe of 7 April 2004, I am writing to clarify some issues. I would first like to make two general points:

(a) The amount of the benefit due in any of the circumstances set out below would be as set out in our letter of 24 March 2003.

(b) The over-riding intention of what we are proposing is to provide security for your pension benefits, and those of your dependants, which is comparable with that provided to other employees whose benefits are provided entirely through the Group Pension Fund.

1. I note that your intention is to draw benefits in the form of an income rather than a capital sum. I confirm that this is acceptable and indeed reflects the nature of the pension promise given to you. Further you should note that under the proposed legislation at most one quarter of the fund could be taken as a lump sum.

2. The Group would review the funding of the FURBS on an annual basis, and immediately increase the level of funding, if required, in line with the actuarial methodology and assumptions applicable at the time of review. This would apply whilst you remain in service and after leaving for any reason. Notwithstanding this, you will appreciate that it is not possible to say with absolute certainty that the fund would be sufficient to provide your pension benefits as this will depend upon experience relative to the funding assumptions used.

The Group would intend that the methodology and assumptions used for determining the required level of funding would be in aggregate consistent with those used at the time for the actuarial valuation of the Group Pension Fund (unless the Group acting on actuarial advice considered this to be inappropriate), as adjusted to reflect the different tax status of the FURBS. Any initial assumptions or changes would be subject to review by your advisers.

3. At the point you start to draw your pension, one option would be to purchase an annuity to provide your pension (and a contingent widow's pension), with allowance for future pension increases. Alternatively, the pension could be paid directly from the FURBS. In the latter case, the Group would continue to review the funding of the FURBS on a regular basis and provide additional contributions if necessary. At the point at which all the liabilities have been secured, either by purchase of an annuity, or because you and all eligible dependants have died, any surplus funds would revert to the Group.

4. In certain circumstances, particularly if you die in service, the value of the liabilities may increase; because your widow would be entitled to an immediate pension rather than a pension payable when you are age 60. In such circumstances the Group would promptly review the funding and provide additional contributions if necessary. If you die in service before April 2006, the Group would purchase annuities to provide pensions to your widow and children, including future increases. Any lump sum payable on death in service would be paid directly by the Group (to the extent it was not payable from the Group's tax approved pension fund).

5. If you are forced to stop work through ill-health, you will be eligible to receive benefits through the Group's long term disability scheme until you have been off work for five years and six months. At the end of that time, you would be eligible for an ill-health retirement pension. As this point would be after April 2006 (even if you had to stop work before that date), the Group would have already set up a FURBS to secure your pension. At the point the pension becomes payable the Group would review the adequacy of the funding in the same way as on death in service.

6. If you leave service for any other reason before April 2006, it would be the intention of the Group nevertheless to set up a FURBS for you in April 2006. We have received legal advice that setting up a FURBS for an ex-employee to fund a liability that has been incurred whilst that employee was still in service should be permissible. There is a possibility that the eventual legislation for the post-2006 regime will make setting up a FURBS for an ex-employee either impossible or inappropriate for tax or other reasons. If this proves to be the case we will discuss with you alternative ways of securing your pension, which might for example be a commitment to setting up a FURBS under the current tax regime immediately before your departure.

7. In the event that any of the above proves to be impossible because the legislation, when published, differs from the guidance given by the Inland Revenue so far, we would discuss the issues with you immediately to agree a suitable alternative.

The above arrangements are intended to fund the pension to which you and your dependants are entitled as set out in our letter of 24 March 2003. They are not intended to change your/their entitlements to a pension and the other benefits in any way. If these arrangements prove inadequate the Group will still be responsible for providing the full entitlements.

I would be happy to discuss this further with you once you and your advisers have had the chance to consider it.

Letter from Neil Roden, Group Director, Human Resources, RBS to Sir Fred Goodwin, dated 21 December 2007

Dear Sir Fred

PENSION ARRANGEMENTS

I am writing further to letters dated 24 March 2003 and 26 April 2004 (the "Letters") which set out your pension promise from the RBS Group. The purpose of this letter is to provide a further clarification as to the nature of the promise. It constitutes a "Letter" for the purposes of the FURBS established for you.

1. *Basis of promise*

The basis of the RBS Group's promise to you, as set out more fully in the Letters, is that the amount payable should be the amount which you would have received in line with the rules of The Royal Bank of Scotland Group Pension Fund (the "RBS Fund") as if the earnings cap did not apply to you (and also allowing for notional pensionable service from age 20).

In other words, you should be in exactly the same position as a member who had joined the RBS Fund prior to 17 March 1987 with the same salary and pensionable service as yourself.

The changes introduced by the Finance Act 2004, and applying from 6 April 2006 ("A Day"), apply to all pension scheme members, and not just those who joined a scheme after A Day. However, some degree of transitional protection was available to those who had built up benefits before A Day. Consistent with the general principle set out above, we will therefore provide you with benefits as if you had taken advantage of any transitional protection, but not to provide any mitigation against unavoidable adverse consequences of this legislation which would have applied to a member who had joined the RBS Fund prior to 17 March 1987.

2. *Delivery of the promise*

The Letters give RBS discretion as to how to deliver the pensions promise. We have, however, agreed that:

(a) Benefits (including benefits payable on or in respect of your death) up to the "lifetime allowance" (as defined in the Finance Act 2004, and after making allowance for any benefits from former employment which you retain outside of the RBS Fund) will be provided from the RBS Fund, but only to the extent that this does not result in any adverse tax consequences to you or in a reduction in the payment otherwise due to you. This replaces our previous commitment set out in the Letter of 24 March 2003 that benefits up to the maximum permissible under (pre A Day) limits imposed by HM Revenue & Customs should be provided from the RBS Fund; and

(b) additional benefits will be provided via a funded unregistered retirement benefits scheme ("FURBS") which the RBS Group will establish for you (as set out in the Letters).

The documentation governing the FURBS has been provided to your legal advisers and we understand that they are content with it.

For the avoidance of doubt, we acknowledge that the agreement to provide benefits through the FURBS does not replace the RBS Group's obligations to provide the total benefits described in the Letters (as clarified by this letter). In the event that the RBS Fund and the FURBS together did not provide the promised benefits in full, we would continue to be liable to provide the balance of the benefits.

We reserve the right to increase the benefits provided from the FURBS and reduce the benefits provided from the RBS Fund accordingly (or vice versa) provided always that:

(i) you continue to receive the total promised benefits; and

(ii) we must ensure compliance with Section 3 of this letter.

3. *Increase in benefits*

We acknowledge that the tax treatment of the proportion of benefits payable outside of the RBS Fund (including benefits payable to yourself and benefits payable on or in respect of your death, and whether paid from the FURBS or directly by the Bank) may be different from the position which would have applied if the same benefits could have been paid from the RBS Fund. In particular, we acknowledge that the retirement lump sum payable under the RBS Fund is, under current law and subject to certain limits, payable free of tax while a lump sum paid outside the Fund will be taxable in your hands.

We will increase benefits payable outside of the RBS Fund (including benefits payable to yourself and benefits payable on or in respect of your death, and whether paid from the FURBS or directly by the Bank) to take account of this to the extent consistent with the general position that you should be placed in the

same position as if all benefits had been paid from the RBS Fund and you had joined that Fund before 17 March 1987. We will not increase benefits to take account of tax or other charges which would have been payable even if you had received all benefits from the RBS Fund.

This will operate as follows.

(a) we will assume that benefits accrued prior to A Day would have been calculated in the same way as for a member who joined the RBS Fund before 17 March 1987 ie without reference to the earnings cap but subject to the other limits on benefits imposed by HM Revenue & Customs prior to A Day for members who joined the RBS Fund before 17 March 1987.

(b) We will assume that you would have registered the amount calculated on this basis as at 5 April 2006 for "primary protection" as described in the Finance Act 2004. The effect of doing so would have been to create a personal lifetime allowance equal to the registered amount. We calculate that the amount which could have been registered would have been, £10,113,880 ie the total benefits due in accordance with the Letters as at 5 April 2006. We refer to this amount (increased as mentioned in (c) below) as your "notional personal lifetime allowance".

(c) Your notional personal lifetime allowance will then be assumed to increase at the same rate (as prescribed by legislation) as the standard lifetime allowance (ie in the same way as if you actually had been able to register this amount for primary protection).

(d) When benefits become payable, for the purposes of assessing any amounts by which we will increase the benefits payable, we will compare the total benefits payable net of tax with the amounts which would have been payable (again net of tax) if your actual personal lifetime allowance was deemed to be your notional personal lifetime allowance. We will then increase the benefits paid from the FURBS (or directly by the Bank) accordingly.

(e) In particular, you will be entitled to draw a retirement lump sum from both the RBS Fund and the FURBS. For the purposes of (d) above, the maximum lump sum which could have been drawn from the RBS Fund if you had received your total benefits from the RBS Fund, is 25% of your total benefits (ie 25% of lump sum plus capital value of the residual pension calculated on a 20:1 basis) ie the standard "pension commencement lump sum".

(f) In making the assessment described at (d) above, we will take into account income tax, capita! gains tax, inheritance tax, national insurance contributions and the lifetime allowance charge, together with all other amounts referred to as "Tax" in the rules governing the FURBS.

(g) If you choose to make AVCs or pay additional contributions via RBSelect in the future to the RBS Fund, or to any other registered pension scheme, or to receive benefits accrued under any arrangement after you leave the RBS Group before your RBS Group benefits come into payment, then these will count against your notional personal lifetime allowance in the same way as they would have counted against an actual personal lifetime allowance. This means that we will not increase benefits under the FURBS to take account of increased tax or other charges due as a result of your choosing to make these payments or receive these benefits.

For the avoidance of doubt, we will not increase any benefits payable under the FURBS to take account of tax payable on the benefits which would have been due if you had joined the RBS Fund before 17 March 1987 and your total benefits had been payable from the RBS fund. However, neither will we reduce benefits to allow for the fact that, had you been a member who joined the RBS Fund before 17 March 1987 and all benefits were paid from the Fund, then part of your benefits would have been subject to the lifetime allowance charge.

We will not be responsible for any lifetime allowance charge that may arise on any pension benefits you have other than those to be provided by the RBS Group, nor will we increase benefits from the RBS Group to allow for such a charge.

Two examples to illustrate the principles set out above are attached as an appendix.

Yours sincerely

Neil Roden
Group Director, HR

EXAMPLE CALCULATIONS

Assume retirement at age 60 in August 2018

Assumed pensionable salary (averaged over final year of service): £2.1 million

Assumed standard lifetime allowance in 2018–19: £2.2 million

Assumed commutation factor at age 60 in August2018: 12:1

Standard lifetime allowance in April 2006: £1.5 million

Calculations

Notional personal lifetime allowance	= 2.2 / 1.5 x £10,113,880
	= £14,833,689
Total pension benefit	= 40 / 60 x £2,100,000
	= £1,400,000 pa

The maximum lump sum that could be taken tax-free within the notional personal lifetime allowance = 25% x £14,833,689
= £3,708,422

Scenario 1

Sir Fred wishes to take a lump sum equal to the maximum that can be taken tax-free within the notional personal lifetime allowance

The reduction in pension required	=£3,708,422 / 12
	=£309,035
Leaving a residual pension	=£1,400,000–£309,035
	=£1,090,965 pa

The maximum benefits that may be taken from the Group Fund and retained benefits without triggering a lifetime allowance charge (assuming maximum tax free cash is taken from the Group Fund) are:

A pension of £82,500 pa, plus

A lump sum of £550,000

[For statutory purposes these benefits will be valued as:

20 x 82,500 + 550,000 = £2,200,000 ie the standard lifetime allowance

The lump sum is 25% of this]

The remaining benefits would be paid from the FURBS (or direct by RBS):

A pension of £1,090,965—£82,500 = £1,008,465 pa, plus

A lump sum of £3,708,422—£550,000 = £3,158,422

Under current legislation, the lump sum of £3,158,422 will be subject to income tax. In accordance with section 3 of this letter (and in particular 3(e)) we will increase the benefit paid to £5,264,037 (assuming the tax rate remains at 40%) so that the amount received net of income tax is £3,158,422.

Scenario 2

Sir Fred wishes to take a lump sum of £4,500,000

The reduction in pension required	= £4,500,000 /12
	= £375,000
Leaving a residual pension	= £1,400,000–£375,000
	= £1,025,000 pa

The maximum benefits that may be taken from the Group Fund and retained benefits without triggering a lifetime allowance charge (assuming maximum tax free cash is taken from the Group Fund) are the same as in scenario 1:

A pension of £82,500 pa, plus

A lump sum of £550,000

The remaining benefits would be paid from the FURBS (or direct by RBS):

A pension of £1,025,000–£82,500 = £942,500 pa, plus

A lump sum of £4,500,000–£550,000 = £3,950,000

Under current legislation, the lump sum of £3,950,000 will be subject to income tax.

Had the benefit been paid entirely from the Group Fund (and allowing for the notional personal lifetime allowance), a lifetime allowance charge would be payable on the excess of £4,500,000 over £3,708,422.

This would be	= 55% x (£4,500,000–£3,708,422)
	= £435,368

Therefore in accordance with section 3 of this letter (and in particular 3(e)), we will increase the benefit paid so that the lump sum received after income tax is
= £4,500,000–£435,368
= £4,064,632

Assuming the tax rate remains at 40%, we will therefore increase the lump sum payable to £6,774,387, so that net of tax the lump sum received is £4,064,632.

The value of the total benefits (pension and lump sum combined) exceeds the notional personal lifetime allowance. Therefore had the benefit been paid entirely from the Group Fund, a lifetime allowance charge would also be payable in respect of the pension. However, as the pension net of tax would be lower from the Group Fund than from the FURBS, section 3 of the letter does not apply.

Note: these examples assume that the Trustees of the FURBS are not liable to deduct any inheritance tax from the benefits payable. If they are, the payments will be grossed up accordingly.

Letter from Sir Tom McKillop to Sir Fred Goodwin, dated 13 October 2008

Dear Fred

PENSION ARRANGEMENTS

I am writing further to letters dated 24 March 2003 and 26 April 2004 and a further letter which RBS believes was signed on 21 December 2007 (together the "Pension Letters") which together set out your pension promise from the RBS Group.

This further letter is given in connection with the Settlement and Compromise Agreement into which you and RBS intend to enter on or around the date of this letter. If you and RBS do not enter into a Settlement and Compromise Agreement on 13 October 2008, this letter shall have no effect. Subject to that, this letter shall be a "Pension Letter" for the purposes of the Settlement and Compromise Agreement and a "Letter" for the purposes of the FURBS.

In this letter:

"FURBS" means the funded unapproved retirement benefit scheme established for you by The Royal Bank of Scotland plc by a deed dated 20 December 2007;

"RBS" means The Royal Bank of Scotland plc;

"RBS Fund" means The Royal Bank of Scotland Group Pension Fund;
"Termination Date" has the same meaning as in the Settlement Agreement referred to above.

POSITION UP TO AND INCLUDING TERMINATION DATE

Until the Termination Date:

(a) you will continue to accrue pension benefits and service as calculated in accordance with the Pension Letters; and

(b) you will continue to be entitled to lump sum death in service benefits on the basis described in the Pension Letters.

POSITION AFTER TERMINATION DATE

At the end of the day which is the Termination Date, you will be treated as leaving service for all purposes of all RBS pension arrangements of which you are a member. In particular:

(i) you will not accrue any further pension benefits under the RBS Fund or the FURBS after the Termination Date; and

(ii) no lump sum death in service benefits will be payable if you die after the Termination Date.

EARLY RETIREMENT

You may choose to start receiving an immediate pension calculated on the basis described in the Pension Letters with effect from the day immediately following the Termination Date, and RBS hereby consents to this. RBS agrees that such retirement will be treated for the purposes of the RBS Fund as "retirement at the request of the Employer" and that therefore the pension will be paid without any reduction for early payment.

If you do not choose an immediate pension from the Termination Date, you will become a deferred member for the purposes of the RBS Fund and the FURBS, and may only draw pension in accordance with their applicable rules (including, without limitation, any requirements for consent, any restriction on the age at which payment may start and any provisions for reduction for early payment).

CONFIRMATION

RBS confirms that the position outlined in this letter, in so far as it relates to early payment of benefits under the RBS Fund, is consistent with RBS' usual practice where employees leave service in circumstances similar to yourself.

CONDITIONALITY

The matters described in this letter are subject to the conditions specified in Clause 17 of the Settlement and Compromise Agreement.

Yours sincerely

Tom McKillop
Group Chairman

2. **Minute of Nominations Committee Conference Call on 10 October 2008**

Minutes of Meeting of the Nominations Committee of the Board of Directors of The Royal Bank of Scotland Group plc held by telephone on Friday 10 October 2008.

Present

Sir Tom McKillop, in the Chair
Mr R A Scott
Mr A S Hunter
Mr P D Sutherland

In attendance

Miller McLean, Group General Counsel and Group Secretary

6. At the Chairman's invitation, Mr Scott reported on the discussion of the Non-executive Directors he had chaired earlier in the day. It had been acknowledged, with regret, and having regard to investor sentiment, that there was a need for a change of Group Chief Executive.

The Non-executive Directors had also unanimously reaffirmed their support for, and confidence in, the Chairman and that it would not be in the interests of the Group and shareholders for there to be a change at this stage.

The Committee discussed the process for selecting and appointing a new Group Chief Executive but recognised that this should take account of the need to ensure management stability and a smooth handover.

It was agreed that it would not be possible to go through a normal executive search process.

A number of scenarios was explored, including appointing an interim Group Chief Executive but it was agreed that this would not achieve stability during the important recapitalisation process. The Committee therefore concluded that Mr Hester would be its recommendation as Group Chief Executive and the Chairman confirmed that he would canvass the views of the remaining Non-executive Directors. If there was support for Mr Hester's nomination the Chairman would discuss the proposed appointment, its timing and the required announcements with Mr Hester.

The Committee also considered the position of Mr Cameron and agreed to recommend to the Board that he be requested to stand down from the Board with effect from the announcement of the proposed recapitalisation.

Secretary's Note

Following confirmation from the Chairman of the Non-executive Directors' support for Mr Hester and his willingness to take up the role of Group Chief Executive, the Committee agreed to recommend to the Board that:

(a) Sir Fred Goodwin step down as Group Chief Executive and be replaced by Mr Stephen Hester;

(b) Sir Fred should continue as Group Chief Executive for a short period until Mr Hester was released from British Land to allow a smooth handover at both companies;

(c) Sir Fred should resign from the Board at a date to be agreed, at which time he would also resign as a Director of The Royal Bank of Scotland plc and National Westminster Bank Plc; and

(d) that Mr Johnny Cameron should resign from the Board, and as a Director of The Royal Bank of Scotland plc and National Westminster Bank Plc.

3. **Remuneration Committee Paper dated 12 October 2008**

GROUP REMUNERATION COMMITTEE

Board changes—Sir Fred Goodwin

Following the decision for Sir Fred Goodwin to step down from the Board, this paper sets out the terms of departure. The principle adopted in these arrangements is to treat him as we would treat any other Executive.

PROPOSED TERMS OF DEPARTURE

Notice Period	Continuation of employment up until 30 November 2008, with garden leave to Termination Date of 13 October 2009
Salary	Value Account payable up to and including the Termination Date
Annual bonus	No bonus payable for 2008 or garden leave period
Group profit share	Nil payment subject to reviewing the scheme rules As with any employee in this situation he can either:
Pension	Choose receipt of an immediate undiscounted pension with effect from the Termination Date Or become a deferred member and take a pension at 60, or earlier, with consent subject to reduction for early payment.
1997 & 2007 Sharesave Approved Scheme	Vested options exercisable in accordance with the plan Unvested options will lapse on termination of employment at the conclusion of garden leave.
1999 and 2007 Executive Share Option Plan	Vested awards exercisable in accordance with rules of plan, and will remain exercisable for 12 months following the Termination Date, but not so as to extend beyond 10 years from the Date of Grant. Exercise discretion to allow unvested share options to vest on the Termination Date and be exercisable subject to and in accordance with the rules of those plans for a period of 12 months. This is in line with our normal practice for all other employees.
Medium-Term Performance Plan	Vested nil-cost options exercisable in accordance with rules of plan. Exercise discretion to allow unvested nil-cost options to vest and be exercisable for 12 months subject to and in accordance with the rules of those plans, subject to pro rating for time and for performance. This is in line with our normal practice for all other employees.

APPROVAL REQUESTED

The Committee is asked to consider and, if appropriate, APPROVE the details of the arrangements laid out in this paper.

Bob Scott
Chairman of the Remuneration Committee

12 October 2008

4. **Minute of Remuneration Committee Conference Call at 5.00 pm on 12 October 2008**

Minutes of Meeting of the Remuneration Committee of the Board of Directors of The Royal Bank of Scotland Group plc held at 280 Bishopsgate, London and by telephone on Sunday 12 October 2008.

Present

Mr R A Scott, in the Chair
Mr C A M Buchan
Mrs J C Kong
Sir Tom McKillop
Mr P D Sutherland

Apology

Dr J M Currie

In Attendance

Mr M R McLean, Group General Counsel and Group Secretary
Mr N Roden, Group Director, Human Resources
Ms J Gargill, Senior Assistant Secretary

36. New Appointment Chief Executive Officer
[redacted]

37. Departure of Sir Fred Goodwin

Following the decision that Sir Fred Goodwin would step down from the Board, Mr Scott set out the terms for his departure by reference to the paper circulated ahead of the meeting. The principle would be to treat him as the Committee would treat any other departing Executive.

Proposed Terms of Departure

Notice Period

12 months Notice. Sir Fred Goodwin would step down at a date to be agreed (the "Termination Date") and be on garden leave until the end of his notice period).

Salary

Value Account payable up to and including the Termination Date.

Annual bonus

No bonus payable for 2008 or garden leave period.

Group profit share

Nil payment subject to reviewing the Scheme rules. As with any employee in this situation he can either:

Pension

Choose receipt of an immediate undiscounted pension with effect from the Termination Date or become a deferred member and take a pension at 60, or earlier, with consent subject to reduction for early payment.

1997 and 2007 Sharesave Approved Scheme

Vested options exercisable in accordance with the plan rules. Unvested options will lapse on termination of employment at the conclusion of garden leave.

1999 and 2007 Executive Share Option Plan

Vested awards exercisable in accordance with rules of plan, and will remain exercisable for 12 months following the Termination Date, but not so as to extend beyond 10 years from the Date of Grant.

Unvested share options vest on the Termination Date and are exercisable for a period of 12 months or 42 months from date of grant, whichever is later. For options granted from 2007 onwards, the number of shares which vest is subject to pro rating for time and for performance This is in line with our normal practice for all other employees.

Medium-Term Vested Performance Plan

Vested nil-cost options exercisable in accordance with rules of plan.

Exercise discretion to allow unvested nil-cost options to vest and be exercisable for 12 months subject to and in accordance with the rules of those plans, subject to pro rating for time and for performance. This is in line with our normal practice for all other employees.

It was noted that the departure terms which had been considered by the Committee represented Sir Fred's contractual entitlement. Mr Roden reported that discussions with Sir Fred Goodwin were ongoing and that a compromise agreement was being prepared which stated that the Termination Date was subject to mutual agreement. The Committee discussed the question of mitigation, and it was noted that during the period of garden leave, salary would be paid monthly and the payments would cease should Sir Fred take up alternative employment.

Approval

After consideration, the Committee APPROVED:

1. The proposed remuneration arrangements for Mr Hester;
2. The proposed arrangements for the departure of Sir Fred Goodwin; and
3. That the Group General Counsel and Group Secretary and Group Director, Human Resources be authorised to take whatever actions are required to implement the arrangements for Mr Hester and Sir Fred Goodwin.

There being no further business, the meeting concluded.

Secretary's Note

Subsequent to the meeting discussions with Sir Fred continued and a compromise agreement was entered into. Under that agreement Sir Fred agreed that he would waive an element of his notice period.

5. **Minute of Chairman's Committee Conference Call at 12.40am on 13 October 2008**

PLEASE RETURN TO SECRETARY AT THE CONCLUSION OF MEETING

Minutes of a meeting of the Chairman's Committee of the Board of Directors of the Royal Bank of Scotland Group plc ("RBS") held by telephone on Monday, 13 October 2008 at 1.30 a.m.

Project Blade

1. Background to the Meeting/Up-date for the Board
   [redacted]
2. Purpose of Meeting
   [redacted]
3. Joint Sponsors and Placing Agents
   [redacted]
4. Details of the Fundraising and Timetable
   [redacted]
5. Tabled Documents
   [redacted]
6. Responsibility for Contents of Documents
   [redacted]
7. Resolutions
   [redacted]
8. The Fundraising Committee
   [redacted]
9. Final Approvals
   [redacted]
10. Executive Changes

The Directors agreed that Sir Fred Goodwin would step down as Group Chief Executive and be replaced by Mr Stephen Hester. Sir Fred would continue for a short period as Chief Executive until Mr Hester was released from British Land to allow a smooth handover at both companies. At the appropriate time, Sir Fred would cease to undertake the role of Group Chief Executive and would resign from the Board at a date to be agreed, at which time he would also resign as a Director of The Royal Bank of Scotland plc and National Westminster Bank Plc.

The Directors also agreed that Mr Johnny Cameron would resign from the Board with immediate effect. In addition he would resign with immediate effect as a Director of The Royal Bank of Scotland plc and National Westminster Bank Plc.

It was noted that Sir Tom McKillop had agreed to continue in office to complete the restructuring of the Board and would retire at the Group's Annual General Meeting in April 2009.

11. Executive Remuneration

Finally, the Committee noted that the remuneration arrangements in respect of Mr Hester's appointment and Sir Fred Goodwin's departure had been considered at a meeting of the Remuneration Committee held on 12 October 2008. The Directors APPROVED the arrangements, details of which are contained within the Remuneration Committee minutes.

There being no further business, the meeting concluded.

Letter from Miller Mclean, Group General Counsel and Group Secretary, RBS to the Chairman of the Committee

I understand via Mr Woods of UKFI that there are further questions that you would like us to answer, as follows:

1. *Does Sir Fred Goodwin receive any benefit other than his pension benefit?*

There arc temporary security arrangements in place for Sir Fred Goodwin at his Edinburgh home which are linked to RBS' own security arrangements. These cost approximately £290 per month. It is normal RBS practice to provide such arrangements for departing senior executives and they will be reviewed in the coming months depending on the security situation. Apart from this and his pension benefits Sir Fred does not receive any ongoing benefits from RBS Group. I should, however, point out that all RBS pensioners are entitled to certain benefits such as access to competitive rates of private healthcare and banking facilities. These are not unique to Sir Fred.

2. *Sir Fred's entitlement to legal representation and legal expenses*

Sir Fred is contractually entitled to the benefit of the Group's Directors and Officers insurance policy and to the same indemnities as arc provided by the Group to all directors. These protect ions are all subject to the limitations contained in the Companies Acts. The main purpose of these arrangements is to protect directors against litigation by third parties. The protection afforded would include payment of Sir Fred's legal expenses in relation to third party claims against him in respect of alleged acts or omissions during his time in office including any criminal claims. If, however, Sir Fred is found guilty of any criminal offence, the cover docs not apply to the subject matter of the offence and any expenses already paid are repayable by him. This is standard practice.

3. *How is Sir Fred's pension funded?*

By way of background, I should explain that the basis of Sir Fred 's pension arrangements has been disclosed in the Directors' Remuneration Report contained in the Group's Annual Report and Accounts. For example in the 2007 Report and Accounts (page 109) it states:

> "All UK based directors, with the exception of Guy Whittaker, are members of The Royal Bank of Scotland Group Pension Fund ('the RBS Fund') and are contractually entitled to receive all pension benefits in accordance with its terms. The RBS Fund rules allow all members who retire early at the
> request of their employer to receive a pension based on accrued service with no discount applied/ or early retirement".

Specifically in relation to the pension arrangements for senior executives, the 2007 Directors' Remuneration Report also states (at page 114):

> "Sir Fred Goodwin and Gordon Pell are provided with additional pension benefits on a defined basis outwith the RBS Fund. The figures shown below include the accrual in respect of these arrangements. A funded, nonregistered arrangement has been set up to provide Sir Fred Goodwin's benefits to the extent they are not provided by the RES Fund".

In addition to the disclosures contained in the publicly filed Directors' Remuneration Report, Sir Fred's service contract has been made available for inspection in accordance with UK company law.

Turning to the funding question you have raised, Sir Fred's pension is funded partly through The Royal Bank of Scotland Group Pension fund (the Group's main tax-registered pension fund in the UK) and partly through an unregistered (FURBS) scheme. Approximately 97% of the pension is payable from the FURBS with the remainder payable from the Group Pension Fund. If, however, these two funds between them do not provide his full pension entitlement, the Group has a contractual obligation to pay the balance. Since a change in pensions legislation in 1989. the provision of a part of a pension outside of a tax registered fund has been common remuneration practice for senior executives in UK companies including RBS.

The "pension promise" from RBS to Sir Fred was a contractual commitment originally made when Sir Fred joined the Bank in 1998 and was subsequently calculated on the principle that Sir Fred should be in the same position as a member who had joined the Group Pension fund prior to 17 May 1987. As explained in the Pension Letter to Sir Fred of 24 March 2003, provisions of the Group Pension Fund in relation to matters such as cash commutation (ie the entitlement or the pensioner to elect to give up part of his pension for a cash lump sum) are deemed to apply to his total entitlement. whether paid from the Group Pension Fund or the FURBS. Whilst the pension arrangements agreed for Sir Fred (and represented by the pension promise outlined above) could not be classed as standard practice, they were considered appropriate arrangements for the Group to make in discharge of its contractual obligations.

Following further changes to pensions legislation in 2006, it was agreed that it was appropriate to set up a separate fund (the FURBS) to provide the balance of Sir Fred's pension that could not be provided from the Group Fund. The tax treatment of some benefits from the FURBS ie any cash lump sum taken at retirement, was less favourable than would have been the case for a benefit from the Group Fund. In the pension letter to Sir Fred of 21 December 2007 RBS agreed, *inter alia*, to carry through this principle as to how Sir Fred's pension promise would be met to the tax treatment of the part of his benefits which is paid from the FURBS. RBS therefore agreed to increase the total benefits to take account of any tax payable (for example on a commuted cash lump sum) but which would not have been payable had he been a member of the Group Pension Fund in the position described above. One result of this is that any commuted cash lump sum paid from the FURBS is increased to take account of tax which is payable (so far as consistent with the above position). For the avoidance of doubt, remaining pension benefits after payment of the cash lump sum will be subject to payment of tax by Sir Fred in the usual way.

In discussions between Philip Hampton and Sir Fred, RBS has suggested to Sir Fred that he waive his election to commute a cash lump sum from his pension which will be reinstated to its non-commuted form. Sir Fred was happy to consent to this in principle and appropriate arrangements are accordingly being put in place. RBS would like thank Sir Fred for his assistance.

Should you require further information, we suggest we discuss how best to provide this to you.

I trust this clarifies the position.

11 March 2009

Letter from Harry Baines, Company Secretary, Lloyds Banking Group to the Chairman of the Committee

Dear Mr McFall,

Thank you for your letter dated 11 March 2009, requesting details of the pension arrangements which apply to the former Chief Executive of HBOS, Andy Hornby and former HBOS Executive Director and Chief Executive, Corporate, Peter Cummings.

I am grateful for this opportunity to provide the Committee with accurate information and an explanation of the process undertaken by the HBOS Remuneration Committee in relation to the pension arrangements made for Andy Hornby and Peter Cummings.

It is important to note that the departure of members of the HBOS senior management team arose as a result of Lloyds" acquisition of HBOS. Those departures were therefore treated as departures by reason of "redundancy" and pension arrangements treated accordingly. The pension arrangements with respect to both Andy Homby and Peter Cummings reflect that approach, and are in line with HBOS policy and scheme rules. There were no discretionary payments.

At the time that these arrangements were settled, Lloyds did not own HBOS. All decisions with respect to the redundancy or severance terms applicable to departing HBOS senior executives, including pensions, were made by the HBOS Remuneration Committee or Board of HBOS, prior to the acquisition by Lloyds.

Background

In light of Lloyds offer for HBOS, it was acknowledged by HBOS that when Lloyds announced its top tier appointments it was highly likely that a number of HBOS executive directors would not be offered a role on the LBG Board. HBOS acknowledged that the termination arrangements for any affected executive directors were a matter which required approval by its Remuneration Committee. Hence work was commenced to determine the appropriate leaving arrangements.

The Group HR Director of HBOS prepared details of proposed redundancy terms, including pension arrangements arising in the redundancy situation, for consideration by the Remuneration Committee. Members of the Remuneration Committee were initially briefed for a meeting at that Committee on 28 October (briefing paper attached as Appendix 1).

Pension Arrangements

The briefing paper for the Remuneration Committee meeting on 28 October 2008 (Appendix 1) also set out the following terms in respect of pensions, which were relevant for Peter Cummings:

"(a) Those aged 50 or above 12 months after the effective date of leaving would be entitled to an immediate pension based on a nil actuarial reduction at age 56 and a 15% reduction at age 50 (with interpolations between those ages)" (see Appendix 1).

Further, Note 2, page 132 of the HBOS Annual Report & Accounts 2007 clearly sets out that "Executive Directors who have five years" service as an Executive Director have a contractual right to retire at age 55 or above with a non-reduced pension and aged 50 or above (but below age 55) with a reduced pension." Where an Executive Director chooses to retire before age 55, a 3% per annum early retirement reduction factor applies for each year below age 55 and above age 50.

Since Andy Hornby was not at or close to age 50 at the date of his departure, the above terms did not apply.

The briefing paper (Appendix 1) referred to these terms as reflecting HBOS policy and the Remuneration Committee approved their application in connection with the Lloyds transaction. A paper dated 17 May 2005 presented to the HBOS Group Executive Committee (HBOS Executive Committee Paper as Appendix 2) proposed these terms for all employer instigated terminations of senior executives until 2010, and this policy was approved and implemented.

For the specific individuals concerned, the pension arrangements agreed were therefore as follows:

Andy Hornby

At the time of his departure, Andy Hornby had accrued a pension of £240,389 payable per annum plus revaluation to the date when the pension comes into payment. He had not yet retired (and, because of his age, is ineligible to do so).

Like other executive director pension scheme members, Andy Hornby's pension benefits were above the "Lifetime Allowance" at "A-day" (April 2006) and in these circumstances there have been no further service accruals of benefits beyond April 2008 and no further employee contributions have been paid. Where there is no further service accrual of pension, executive directors (in common with other senior executives in a similar position) receive an annual non-pensionable taxable, cash allowance 25% of salary.

It was originally envisaged by HBOS that its decision in 2006 to cease further service accrual beyond the Lifetime Allowance would become increasing prevalent, and that a form of "cash in lieu" payment would become the norm in most major companies. That did not prove to be the case and, in most companies. Benefit accrual continues whether or not an individual's pension accrual exceeds the Lifetime Allowance and in the case of many Executive Directors, is at a level far in excess of 25% of salary.

In part due to his competitive positioning, and in part because the 25% of salary cash allowance did not adequately reflect Andy Hornby's contractual pensions entitlement. The Remuneration Committee of HBOS decided during 2008 that in relation to Mr Hornby it would be appropriate to increase his cash in lieu of pension allowance to 50% of salary, and that the increase to 50% (from 25%) should be backdated to April 2006 (when further service based accrual for Mr Hornby ceased). However, Mr Hornby subsequently decided voluntarily to forego any increase in his cash in lieu of pension entitlement and therefore this allowance remains at 25%, in line with all other directors and senior executives who have exceeded the Lifetime Allowance.

Peter Cummings

Peter Cummings retired by reason of redundancy on 16th January 2009 when his employment was terminated by HBOS plc.. He is entitled to receive an immediate pension of £352.402. Because Peter Cummings retired (by reason of redundancy) before the age of 55, his pension was reduced by 3% per annum for each year before the age 55, consistent with HBOS policy, but not for the period between age 55 and his normal retirement date in line with the HBOS's standard policy. The notional capital value associated with the period between 55 and 60 is in the region of £700.000.

In order to meet the Committee's timescales, it has been necessary to collate this information at very short notice. Whilst I believe that the details in this letter and enclosures constitute all the relevant information to meet the Committee's request, please do let me know if you feel that there is any addition information you require.

Harry Baines
Company Secretary

APPENDIX 1

AGENDA ITEM 6

For the Remuneration Committee—28 October 2008—Termination Arrangements

1. Purpose

The purpose of this paper is to set out some broad principles to apply when terminations arise and to seek the Committee's agreement to the approach suggested.

2. Background

[redacted].

3. Contractual Position

[redacted].

In addition, as "good leavers" (which these colleagues would be) they should be offered (as has been the case with senior terminations to date) enhanced pension terms—as are all other colleagues.

If aged over 55 this would be a pension with no actuarial reduction and, if over 50, a 3% per annum reduction for every year below 55. If during their twelve months notice period they would have reached 50 they would also receive the 3% per annum reduction when they become entitled to their pension. If the twelve month period would only get them to age 48 they would be treated as deferred beneficiaries (not fall into the good leaver regime for pension purposes)—and therefore they would receive a much greater actuarial reduction. A sliding scale would operate for those in between these ages. As is always the case, pension scheme funding would be required to implement this.

4. Recommended Approach

[redacted].

Where individuals are eligible for enhanced pension terms, these be made available. This has significantly different outcome for each ED but we can cover these off as and when we know which EDs are affected.

5. Incentive Arrangments

[redacted].

6. Conclusion

[redacted].

The Committee is asked to approve these recommendations.

APPENDIX 2

For the HBOS Executive Committee—17 May 2005—HBOS Executive Contract

1. Introduction

The purpose of this paper is to outline the content of the HBOS Executive Contract for all colleagues at Level 7, 8 and Executive Director (ED) a copy of which as attached. It is proposed that this new HBOS Executive Contract be introduced later this year, replacing an existing legacy contracts.

2. Background

[redacted].

3. The New HBOS Executive Contract

Clause 5—Pension and Life Assurance

This section refers to the communication we will shortly be issuing to all Level 7&8 colleagues in relation to pension benefits and life assurance, including our response to Pensions A Day.

[redacted].

4. Other Issues

[redacted].

In oldco parts of HBOS various custom and practices were applied in relation to pensions and actuarial reductions on termination. In this respect the new HBOS Job Security Agreement has introduced a clear and equitable approach to pensions for colleagues at level 6 and below.

It is important that we develop a similar level of clarity for colleagues at level 7 and above (for employer instigated termination until April 2010 when the early retirement age moves to 55). It is proposed that for those aged 45 or more, termination would be based on 12 months notice coupled with a pension uplift. This uplift will be via actuarial reduction based on 55 enabling a pension to be drawn with a 15% reduction at 50 years of age. Each case will require the approval of Chief Executive and Director Group HR.

HR will actively support colleagues through this change, covering both individual and HBOS contract queries as they arise.

5. Next Steps

[redacted].

Memorandum from Merrill Lynch

1. General

This response to the questions sent under cover of your letter dated 20 February represents a response from the combined organisation Bank of America Merrill Lynch and relates to its combined UK operations.

Bank of America is one of the world's largest financial institutions, serving individual consumers, small and middle market businesses and large corporations with a full range of banking, investing, asset management and other financial and risk-management products and services. The company provides unmatched convenience in the United States, serving more than 59 million consumer and small business relationships with more than 6,100 retail banking offices, nearly 18,700 ATMs and award-winning online banking with nearly 29 million active users. Following the acquisition of Merrill Lynch on 1 January 2009, Bank of America is among the world's leading wealth management companies and is a global leader in corporate and investment banking and trading across a broad range of asset classes serving corporations, governments, institutions and individuals around the world. Bank of America offers industry-leading support to more than 4 million small business owners through a suite of innovative, easy-to-use online products and services. The company serves clients in more than 150 countries. Bank of America Corporation stock (NYSE: BAC) is a component of the Dow Jones Industrial Average and is listed on the New York Stock Exchange.

Merrill Lynch is one of the world's leading wealth management, capital markets and advisory companies, with offices in 40 countries and territories and total client assets of approximately $1.5 trillion at 26 September 2008. As an investment bank, it is a leading global trader and underwriter of securities and derivatives across a broad range of asset classes and serves as a strategic advisor to corporations, governments, institutions and individuals worldwide. Merrill Lynch has approximately 50 percent ownership in BlackRock Inc., one of the world's largest publicly traded investment management companies, with approximately $1.3 trillion in assets under management at 30 September 2008.

2. Background

Our UK operations have grown significantly since 1997 and likewise in the 10 years before that. In addition to our UK investment banking and wealth management businesses we have a credit card business which has its European headquarters in Chester, UK. Our current combined UK headcount is approximately 11,100. Our European investment banking and wealth management operations are headquartered in London and as a result not all of the staff based in London or the UK as a whole are conducting business with only UK clients.

Investment banks perform a number of crucial functions for the economy, helping a wide range of enterprises to raise capital and to restructure balance sheets, facilitating smooth and liquid markets for investment and risk management, advising business and governments on their financial transactions, and providing advisory and risk management products for retirement saving and pension funds. Investment banks are complementary to retail commercial banks, whose activities they can help to facilitate.

Investment banks make a significant contribution to the strength of the UK financial-services sector, which is itself one of the leading sectors of the UK economy. This contributes to the UK economy not only through the number of people employed, the taxes they pay and the money they spend, but also because of the wide number of other businesses, from lawyers to taxis and caterers, that benefit from the financial-services industry. Without the strong investment banking presence, London would not retain its position as a global financial centre.

One of the key contributions investment banks make to the economy is in helping enterprises raise capital to finance their operations and growth strategies. The corporate finance division of an investment bank will give advice to companies on any merger or acquisition opportunities that might help better serve or grow the client base or existing market or expand in new markets. For example, a large multinational corporation may, as a result of such advice given by an investment bank, decide to acquire part of a small start up company with a good product. The start up receives the finance it needs to refine, manufacture and sell its product while the multinational corporation makes an investment in the region that it anticipates will yield good returns. Investment banks also provide advice to companies on how to list on stock exchanges thereby assisting them in raising capital from public investors.

Investment banks help companies sell their corporate shares or bonds to investors, either directly to other large institutions or to retail investors via an intermediary financial advisor network, or in secondary trading markets. Advice and underwriting of equity listings on UK and other exchanges by investment banks bring regional and global enterprises to UK investors, and are a significant factor in the role of London as a leading international financial centre. Debt financing is a critical planning and funding mechanism for not only the major institutions that manufacture goods and provide services in the UK economy, but also for national and local governments. Moreover, as government securities dealers, investment banks assure liquid markets for our governments' financing needs.

Financial assets across all asset classes traded for large companies, funds, and investors by investment banks acting as a broker, and trades by the bank itself to facilitate customer transactions or for proprietary purposes, provide liquidity to the financial markets, assisting investors, pension funds, and other funds to gain access to or to exit these markets efficiently and cost-effectively. Pension funds rely on investment bank capital to execute significant market transitions—for instance, a significant portfolio re-balancing—with a view to minimizing impact to markets and shareholder value. Their investment bank partners use their capital to enable a series of orderly trades (block trades) that minimize impact on investor value and market volatility. Governments rely on such market facilitation by investment banks as well.

3. Risk Management

Bank of America takes a comprehensive approach to controlling risk in our organisation. Risk planning is fully integrated with strategic, financial, customer and personnel planning so that goals and responsibilities are aligned across the company. Risk is managed in a systematic manner by focusing on the company as a whole, managing risk across the enterprise, and within individual business units, products, services and transactions.

Risk Definitions

To identify risk comprehensively, it is essential that risks be clearly articulated and consistently defined. We use the following definitions for the various risks Bank of America incurs during the normal course of business:

> *Strategic Risk*: The risk that adverse business decisions, ineffective or inappropriate business plans or failure to respond to changes in the competitive environment, business cycles, customer preferences, product obsolescence, execution and/or other intrinsic risks of business will impact the company's ability to meet its objectives.
>
> *Credit Risk*: The risk related to the inability of a customer, client or other party to meet its repayment or delivery obligations under previously agreed upon terms and conditions. Credit risk can also arise from operational failures that result in an advance, commitment or investment of funds.
>
> *Market Risk*: The risk that values of assets and liabilities or revenues will be adversely affected by changes in market conditions, such as market movements. These risks arise from positions taken for customers or for corporate purposes, such as liquidity management.
>
> *Operational Risk*:The risk of loss resulting from inadequate or failed internal processes, people, systems or external events. Operational risk also encompasses the failure to implement strategic objectives and initiatives in a successful, timely and cost-effective manner.

Structure Risk Governance

> *Systems Risk*:The risk arising from deficiencies, complexities or instability of systems or technology that support business activities. System initiatives can also involve both technology and execution risk.
>
> *External Events Risk*:The risk arising from factors outside of the company's normal span of control, including risks associated with vendors, alliances and service providers, as well as political, social, cultural, and environmental factors.

Regulatory and legal issues may impact any or all of the risk categories. In order for our objectives to be achieved, all risks must be proactively identified and managed.

While the above definitions address each type of risk individually, it is emphasised that these risks are interconnected. Our risk governance structure and processes reflect the significant interaction between these risks and are designed to manage all of them.

Any special insolvency regime (whether for commercial banks, investment banks or any other type of financial institution) needs to be designed with a view to it working alongside and in a consistent manner with similar regimes across the EU and in the US. The regimes would necessarily be different for UK-listed banks with UK depositors and UK subsidiaries of global firms, but the two would need to be designed with each other in mind.

4. Narrow Banks

Investment banks can operate in the same group or on a combined basis with retail banks. The two can successfully combine to offer a wider range of products and solutions to retail clients. Naturally, appropriate safeguards need to be in place in areas like segregation of information and conflict of interest. There also need to be separate capital requirements for retail Banks and investment Banks—and separate, appropriate levels of regulation.

We do not agree with the view that investment banking and retail banking need to be carried out in separate organizations. Pure investment banks (for example, Lehman Brothers) and pure narrow retail banks (for example, Northern Rock and Bradford & Bingley) have been amongst recent casualties. Indeed, it seems clear from the US experience that the "monoline" investment Banking model is no longer viable. A well managed universal banking group combining both retail and wholesale functions, can offer a broader range of services to customers, increase competition (and thereby offer better prices to customers), achieve strong capital and liquidity levels and diversify its risks.

5. Remuneration

Bank of America's remuneration programme is designed to attract and retain the highest quality employees and directly link their pay to performance. This pay-for-performance mandate results in a remuneration programme that aligns our employees' interests with those of our stockholders, provides pay that varies depending on performance and can be easily understood.

The investment banking business participates in Bank of America's broader pay-for-performance remuneration programme, which applies to all of our business units on a global basis and which will apply to the legacy Merrill Lynch organization as a result of our merger. Under this programme, employee remuneration at more senior levels in all business units is generally comprised of the following three components:

- Base salary.
- Annual cash incentive.
- Equity or long-term cash (LTC) awards.

Base salary levels reflect each employee's scope of responsibility and accountability within the bank and are intended to be part of a competitive total compensation package.

All employees are eligible for incentive awards. The portion of employees' compensation that is variable, ie, cash incentives and equity/LTC awards, as a percentage of total remuneration increases for more senior positions.

The portion of employees' total remuneration that is not paid in cash is delivered through equity or LTC awards, granted annually based on performance and vesting in equal installments annually over three years. We believe equity awards drive a longer term focus on the bank's results, align employees' interests with our stockholders and provide a significant retention incentive. LTC awards also provide a significant retention incentive.

We generally limit equity awards to our more senior positions (as opposed to broad-based awards). As a general rule, the more senior the position, the larger the portion of the total incentive opportunity that is provided in equity.

Individual performance goals form an important part of the performance review for making individual awards. As part of this review for making individual awards, how an individual achieved his or her results is just as important as the results themselves.

We do not readily have data to answer the question regarding bonus levels going back 10 to 20 years when the legacy Bank of America organization had a much smaller presence in the United Kingdom. There have been significant changes in the organization and structure of the bank's business over that time period. For 2008 at legacy Bank of America, bonus awards were down significantly over the prior year consistent with the pay-for-performance design of the remuneration program, with top executives receiving no bonus awards and the next tier of management having their annual year-end incentive awards cut by an average of approximately 80%, exclusive of any prior contractual guarantees.

Along with other industry participants, we have held discussions with the FSA on compensation structures and are participating in their exercise to review this area.

6. Securitisation and Complex Products

Securitization can perform a valuable role in diversifying risk and enabling a bank to increase lending. In the traditional banking model, where banks kept all the loans they made on their own books, they could end up with a concentrated degree of risk. Securitization spreads the risk between a much larger group of holders of the security, and may result in lower costs for the borrower.

Without the ability to securitize and spread risk, banks would be restricted from flexibly and economically managing their asset and capital bases under times of stress and thus risking further systemic problems. It would thereby limit an institution's risk management abilities and options.

The extent to which any bank keeps securitised products on its books will vary greatly depend on the type of product, the underlying reference assets and the purpose for which those products were created. Generally speaking, where such products are created on a bespoke basis to serve the needs of specific clients or client bases, distributors of those products would not expect to retain significant parts of the product on their own books (other than perhaps for market-making purposes where a product is expected to be widely-traded.

We comply with all applicable rules (including in this instance those of the UK FSA and EU legislation such as MiFiD) in treating our customers fairly and in assessing the suitability of those products for our clients and in ensuring they have adequate information to fully understand such products.

7. Management and Ownership Structure

Some investment banks have non-executive directors on the boards of the listed parent company but relatively few have them on the boards of their non-listed operating subsidiaries. In this context, the role of non-executives is the same as those on other public company boards.
Bank of America and Merrill Lynch have long been listed companies or part of a listed company. Compared to a partnership, a listed company potentially has access to a larger number of sources of capital, providing a broader base for the company. In addition, listed companies typically have more transparent external reporting arrangements. Not all investment banks were partnerships and we see no particular reason why they should consider such a change in status.

March 2009

Memorandum from Deutsche Bank

Background Information

How rapidly did your bank grow from 1997? And for the 10 years before that?

Overall, Deutsche Bank's revenues and profit grew strongly over the period 1997–ø2007. Over the 20-year period up to 2007, revenues grew almost five-fold. Growth was interrupted in the years 2001–03, following the collapse of the dot-com "boom" in 2001 and very difficult macro-economic and financial market conditions in 2002-3 after the attacks of 11 September 2001. The acquisition of Bankers Trust Corp, completed in 2000, contributed to DB's growth. After the 2001–03 period, growth resumed from 2004 to 2007, when Deutsche Bank achieved record profitability. Headcount also expanded during this latest period as we invested in our core businesses. The growth trend was interrupted in 2008, when DB posted a full-year loss, and when revenues were significantly and adversely impacted by mark-downs on positions in some investment banking product areas.

In the 10 years before that, the growth trend is positive, but less pronounced than in the period 1997–2007.

Are investment banks as crucial to the functioning of the economy as commercial banks are?

Investment banks contribute to the functioning of the economy by facilitating access to capital and funding (debt and equity) for governments, supranational bodies, corporations and institutions which need it, and by connecting those seeking to raise capital with investors throughout the world who have capital to invest. Capital market disintermediation does not face the same constraints as commercial banking because fund-raising can go beyond the limitations of the bank's own balance sheet. To the extent that the funding and capital-raising needs of the global economy go beyond the on-balance-sheet lending capacity of the world's commercial banks, investment banking is essential.

Furthermore, the proper functioning of major global equity, debt (including government debt), commodity and currency markets depends on access to liquidity. Investment banks play a vital role in providing liquidity and access to liquidity, and thus pricing transparency, for both issuers and investors.

Risk Management

How do you control the risks in your organisation?

Risk and Capital Management

The wide variety of our businesses requires us to identify, measure, aggregate and manage our risks effectively, and to allocate our capital among our businesses appropriately. We manage risk and capital through a framework of principles, organisational structures as well as measurement and monitoring processes that are closely aligned with the activities of our group divisions.

Risk and Capital Management Principles

The following key principles underpin our approach to risk and capital management:

(Note that we have a Supervisory and Management Board structure.)

- Our Management Board provides overall risk and capital management supervision for our consolidated Group. Our Supervisory Board regularly monitors our risk and capital profile.
- We manage credit, market, liquidity, operational, business, legal and reputational risks as well as our capital in a coordinated manner at all relevant levels within our organisation. This also holds true for complex products which we typically manage within our framework established for trading exposures.
- The structure of our integrated Legal, Risk & Capital function is closely aligned with the structure of our group divisions.
- The Legal, Risk & Capital function is independent of our group divisions.

Risk Management Tools

We use a comprehensive range of quantitative tools and metrics for monitoring and managing risks. As a matter of policy, we continually assess the appropriateness and the reliability of our quantitative tools and metrics in light of our changing risk environment. Some of these tools are common to a number of risk categories, while others are tailored to the particular features of specific risk categories. The following are the most important quantitative tools and metrics we currently use to measure, manage and report our risk:

- *Economic capital*. Economic capital measures the amount of capital we need to absorb very severe unexpected losses arising from our exposures. "Very severe" in this context means that economic capital is set at a level to cover with a probability of 99.98% the aggregated unexpected losses within one year. We calculate economic capital for the default risk, transfer risk and settlement risk elements of credit risk, for market risk, for operational risk and for general business risk. In 2008, we refined our economic capital modelling in particular by completing a Group-wide roll-out of our multi-state model for credit risk, which comprehensively captures the effects of rating migration. We further modified our economic capital framework to capture comprehensively profit and loss effects due to fair value accounting. As part of this model adjustment, we now report economic capital for traded default risk and all assets which are fair valued through profit and loss within market risk rather than credit risk. This enables us to also measure the price volatility of these assets within our economic capital. We use economic capital to show an aggregated view of our risk position from individual business lines up to our consolidated Group level.
- *Expected loss*. We use expected loss as a measure of our credit and operational risk. Expected loss is a measurement of the loss we can expect within a one-year period from these risks as of the respective reporting date, based on our historical loss experience. When calculating expected loss for credit risk, we take into account credit risk ratings, collateral, maturities and statistical averaging procedures to reflect the risk characteristics of our different types of exposures and

facilities. All parameter assumptions are based on statistical averages of our internal default and loss history as well as external benchmarks. We use expected loss as a tool of our risk management process and as part of our management reporting systems.

— *Value-at-Risk*. We use the value-at-risk approach to derive quantitative measures for our trading book market risks under normal market conditions. Our value-at-risk figures play a role in both internal and external (regulatory) reporting. For a given portfolio, value-at-risk measures the potential future loss (in terms of market value) that, under normal market conditions, will not be exceeded with a defined confidence level in a defined period. The value at risk for a total portfolio represents a measure of our diversified market risk (aggregated using pre-determined correlations) in that portfolio.

— *Stress testing*. We supplement our analysis of credit, market, liquidity and operational risk with stress testing. For market risk management purposes, we perform stress tests because value-at-risk calculations are based on relatively recent historical data, only purport to estimate risk up to a defined confidence level and assume good asset liquidity. Therefore, they only reflect possible losses under relatively normal market conditions. Stress tests help us determine the effects of potentially extreme market developments on the value of our market risk sensitive exposures, both on our highly liquid and less liquid trading positions as well as our investments. We use stress testing to determine the amount of economic capital we need to allocate to cover our market risk exposure under the scenarios of extreme market conditions we select for our simulations.

(see also Annex for Risk and Capital Management Organisation)

How many items are there on your risk register?
How often is your risk register reviewed and by whom?

We do not maintain a single "risk register". We produce numerous, frequently update reports on different types of risk.

Categories of Risk

The most important risks we assume are specific banking risks and reputational risks, as well as risks arising from the general business environment.

(i) *Specific Banking Risks*

Our risk management processes distinguish among four kinds of specific banking risks: credit risk, market risk, liquidity risk and operational risk:

— *Credit risk* arises from all transactions that give rise to actual, contingent or potential claims against any counterparty, borrower or obligor (which we refer to collectively as "counterparties"). We distinguish among three kinds of credit risk:

  — *Default risk* is the risk that counterparties fail to meet contractual payment obligations.

  — *Country risk* is the risk that we may suffer a loss, in any given country, due to any of the following reasons: a possible deterioration of economic conditions, political and social upheaval, nationalisation and expropriation of assets, government repudiation of indebtedness, exchange controls and disruptive currency depreciation or devaluation. Country risk includes transfer risk which arises when debtors are unable to meet their obligations owing to an inability to transfer assets to non-residents due to direct sovereign intervention.

  — *Settlement risk* is the risk that the settlement or clearance of transactions will fail. It arises whenever the exchange of cash, securities and/or other assets is not simultaneous.

— *Market risk* arises from the uncertainty concerning changes in market prices and rates (including interest rates, equity prices, foreign exchange rates and commodity prices), the correlations among them and their levels of volatility.

— *Liquidity risk* is the risk arising from our potential inability to meet all payment obligations when they come due or only being able to meet these obligations at excessive costs.

— *Operational risk* is the potential for incurring losses in relation to the actions of employees, contractual specifications and documentation, technology, infrastructure failure and disasters, projects, external influences and customer relationships. This definition includes legal and regulatory risk, but excludes business and reputational risk.

(ii) *Reputational Risk*

Reputational risk is the risk that publicity concerning a transaction, counterparty or business practice involving a client will negatively impact the public's trust in our organisation.

Other identified risks:

(iii) *Business Risk*

Business risk describes the risk we assume due to potential changes in general business conditions, such as our market environment, client behavior and technological progress. This can affect our results if we fail to adjust quickly to these changing conditions.

(iv) *Insurance-specific Risk*

We are primarily exposed to the following insurance-related risks:

— *Mortality and morbidity risks* are the risks of higher or lower than the expected number of death claims on assurance products and of an occurrence of one or more large claims, and the risk of a higher or lower than expected disability claims, respectively. We aim to mitigate these risks by the use of reinsurance and the application of discretionary charges. We investigate rates of mortality and morbidity annually.

— *Longevity risk* is the risk of faster or slower than expected improvements in life expectancy on immediate and deferred annuity products. We monitor this risk carefully against the latest external industry data and emerging trends.

— *Expenses risk* is the risk that policies cost more or less to administer than expected. We monitor these expenses by an analysis of our actual expenses relative to our budget. We investigate reasons for any significant divergence from expectations and take remedial action. We reduce the expense risk by having in place (until 2010 with the option of renewal for two more years) an outsourcing agreement which covers the administration of the policies.

— *Persistency risk* is the risk of a higher or lower than expected percentage of lapsed policies. We assess our persistency rates annually by reference to appropriate risk factors.

Was "collapse of wholesale markets" on your risk register as a potential risk and what were your mitigating controls?

DB regularly tests its market and credit risk exposures. Industry specific credit risk stress tests, such as for all financial institutions counterparties are conducted on a rotating basis across all sectors and assume an instantaneous 3 to 4 notch downgrade of all the existing exposure, which is more extreme than what has been observed so far in the overall "wholesale" market.

Nevertheless, based on observations made during the financial crisis, we have reviewed our stress testing framework and amended it in various aspects: The market risk scenario has been redefined and now reflects the systemic knock-on effects seen since mid-2007. Across all scenarios, we have added liquidity risk drivers (eg FX fungibility and secured funding) to cover sources of liquidity risk not accounted for by the previous methodology but which became obvious during the market disruptions. The downgrade scenarios have also been recalibrated to the most recent credit ratings of the Bank.

What improvements do you think are required to risk control frameworks in the banking industry?

Banks do, of course, differ in the quality of their risk control frameworks. What follows will be more applicable to some banks than others.

Risk and capital resilience

— Banks must ensure responsible risk-taking by their front offices and implement compensation policies which do not encourage excessive risk taking.

— Banks need more and better quality capital to strengthen their resilience. All banks should be subject, over the medium term, to Tier 1 capital adequacy requirements above current level.

Improved tools to capture risks and reduce pro-cyclicality

- — Value-at-Risk ("VaR") measures, as currently calibrated, understate the actual market risks in banks' trading book activities. By drawing on past market data over a time horizon of just one year, VaR only captures short-term volatility. VaR will need to be re-calibrated to a level that is commensurate with the worst loss experience over a much longer time horizon. Periods of severe stress will also have to be taken into account.
- — The conditions and criteria for determining which assets and securities can be included in banks' trading books and become subject to a VaR measure must be clarified.
- — Banks should be permitted to utilise a more flexible interpretation of the incurred-loss accounting model to smooth the pro-cyclical impact of loan provisioning. Expected loss or "dynamic" provisioning should be analysed by banks and policymakers.
- — Inappropriate application of fair value accounting contributed to pro-cyclical effects in both the upswing and downswing of the credit cycle. Standard setters and banks need to define and implement a simplified "mixed measurement" model which restricts the use of fair value accounting to circumstances where its application is appropriate.

Strengthened risk management and market infrastructure

- — Banks should move towards a fully integrated risk management function which is focused on the genuine sources of risks, in particular trading book, off-balance sheet, and liquidity risks.
- — Risk IT systems have to be upgraded to deliver timely aggregation of risk exposures on a group-wide basis.
- — Banks need to more carefully estimate liquidity under stressed conditions. Internal demand on liquidity has to be priced-in when risk positions are taken.
- — Banks must continue with their commitment and contribution to improved market infrastructure which reduces systemic and counterparty risks through safe clearing, payment, and settlement. For example, introduction of central counterparty clearing for eligible OTC Credit Default Swaps.

How many FTE staff posts do you have devoted to risk management, both as a number, and proportion of total staff?

We have 3,028 FTE in risk management, which is 3.77% of total staff (80,414). If this is extended to a wider interpretation to cover legal and compliance risk the number is 4544 FTE, which is 5.65% of total staff.

Did you stress test your balance sheet against a scenario where the wholesale funding markets closed down?

Pre-crisis, we had not incorporated prolonged shut-down of the wholesale sufficiently funding markets into our liquidity stress-test modelling. Additionally, we had not factored in additional risks that subsequently became apparent, including: repudiation of collateral in the repo markets, non-fungibility of currencies (eg, EUR into USD on frictionless terms) and a large pipeline of "stranded" syndications. More broadly, we believe "state-of-the-art" large bank liquidity stress-testing tended to undertake these risks, which emerged for the first time in scale in the current crisis.

Specifically in response to the freeze in the wholesale market which began in August 2007, we re-evaluated our wholesale market refinancing risk. We immediately adjusted our term-funding strategy to target long-term capital markets issuance well above our EUR 23bn full-year plan. Nearly contemporaneously, we also increased our emphasis on retail deposit-collecting.

Throughout the calendar year 2008, we continued to emphasise increasing our sourcing of stable funding and decreasing our reliance on wholesale funding, despite nearly continuously widening bank funding spreads.

During the crisis, we have also built a strategic liquidity reserve by creating liquidity portfolios, "pre-securitising" on-balance-sheet assets that are pledgeable at the ECB, segregating other assets that are Central Bank-pledgeable and establishing access to new government-sponsored funding programs. We have not tapped any part of this reserve at any time in the crisis to date.

We have updated our liquidity stress-testing to incorporate new liquidity risk drivers, such as those identified above. We will endeavour to continue to update our liquidity risk models to reflect the most current thinking on liquidity risks.

Should there be a special insolvency regime for investment banks as there soon will be for commercial banks? Would this prevent post Lehman type problems?

We note the current discussion related to the UK Banking Bill. We are a German banking group and this is not a question that we can comment on substantively in the UK context, as we are primarily subject to German law.

Narrow Banks

Do investment banks make natural partners for retail banks or is the culture too different?

Our experience is that retail and investment banking divisions within our Group have been and continue to be effective partners.

Properly managed, there are synergies between retail and investment banking which benefit clients, and the stability of the institution (and therefore its place in a stable banking system).

Investment banking contributes to retail banking by making capital market product expertise available to retail clients, and thus broadening options for their savings and investments. Not only product but also market expertise (for example, of a world-class research unit) is valuable to retail clients at times of turbulent and uncertain markets.

Retail banking helps investment banking by providing wider distribution for securities originated on behalf of corporate & institutional clients—the increased distribution reach means we can do more for these clients. Also, retail deposits contribute to a high-quality funding base, which gives us better access to funding at good prices which we can turn to the advantage of our corporate & institutional customers. Higher credit ratings, typically reserved for retail banking, help both sides of the business via their favourable impact on cost of funding.

No doubt at a high level it is possible to speak of different cultures both between retail and investment banks or between different operating divisions of each type of bank but we do not find their arguments for separation persuasive. The issue such as they are, may be mitigated through the creation of a "one-bank" culture, rather than trying to be a "one-culture bank". Our investment banking and retail businesses are reported separately so there is no lack of clarity on performance; furthermore, compensation details are handled by separate discussions at the business level before being aggregated at Group level. Premises and back offices are also separate. Within the same institution, investment banking and retail banking units can be good partners, provided both approach it in the spirit of mutual respect (and institutional pride) for the other sides' contribution, and both acknowledge that this partnership, well managed, enhances both business lines.

What are the strongest reasons both for and against the separation of traditional, narrow banking activities from riskier trading and investment banking activities by your organisations?

At the operating level, there are strong reasons for a degree of separation: adherence to strong Chinese walls arrangements and preservation of the confidentiality of information; the need for different risk management disciplines (credit and market risk); the need for specialised and highly (but differently) skilled mid-and back-office personnel for each of the two businesses; and differences in premises needs (money centres versus extensive branch networks). In addition, staff profiles may be different, so dedicated focus by the HR department on various determinants of culture (training, recruiting, compensation, team off-sites and team-building) is appropriate. This degree of separation can be achieved through structural and process discipline. It does not require separate legal entities.

On the other hand, considerable synergies exist which enhance the ability to add value to clients of both sides of the institution (as described above). Furthermore, shared overhead costs on HQ and central Group-level support functions (Treasury/capital management and funding, Finance, Risk, Legal, Compliance, HR) means more can be reinvested in supporting clients.

Diversified income streams enhance the stability in an integrated bank, and this has systemic importance. It is noteworthy that in 2008, the investment banking or 'broker-dealer' model virtually disappeared in the US: Bear Stearns and Lehman Brothers gone, Merrill Lynch taken over, and both Goldman Sachs and Morgan Stanley converted into Bank Holding Companies (in other words, able to take deposits). In good parts of the cycle, investment banking profits can be used to invest in services which benefit retail or private customers. We have noted above some of the other advantages to clients which can flow through integration.

Remuneration

What was the share of bonuses in total remuneration 20, 10, and 1 year ago?
Why do investment banks pay bonuses as a large part of take home pay when no other type of firm does?
How are these bonuses structured within your firm?
Why do they have this structure?

The level of bonus awarded is based on the capital position and financial performance of the Bank, whilst also considering the need to protect our franchise and the perspective of our external stakeholders. The share of bonus in total remuneration can vary significantly by business unit and employee seniority. In 2008, bonus represented less than 20% of the total compensation and benefits expense. Comparable statistics for 10 and 20 years ago are not available for the organisation in its current structure.

The bonus element of remuneration provides flexibility to align remuneration spend with the firms strategy and allows the pay-for-performance relationship that has been critical to the growth of the business and value creation.

Individual award determination is based on individual performance, firm performance, business unit performance and department performance. The performance measurement process looks at both qualitative ie adherence to company values and quantitative ie profitability factors to take a holistic view of performance.

Bonus is delivered as cash and, for selected employees, a portion of this bonus is delivered in the form of a restricted award. These restricted awards are designed to reward employees for their continued loyalty and commitment to the company, and their contribution to our long-term success. The vesting provisions of such awards were enhanced in 2008 to include an element of claw-back in addition to the service conditions.

Securitisation and Complex Products

What proportion of securitised investments do you keep on your own books? How has this proportion changed in the past 10 years?

We typically hold in our books EUR 4bn of asset-backed commercial papers issued by DB conduits. This represents 15% of total issuance, ie 85% are held by external investors.

We do not have historical or trend figures due to changes in internal structure and business models.

When you sell products on, do you consider whether they are suitable for and fully understood by your clients? If not, why not? If yes, give examples.

Yes. As a regulated entity we fully comply with existing laws and regulations around the sale of products to clients. The relevant conduct of business rules in this area cover the assessment of suitability and appropriateness across the full spectrum of investment products and for all types of client. In addition, we fully support regulatory actions, such as the FSA's "Treating Customers Fairly" initiative, that aim to enhance and promote good standards of market practice.

Management and Ownership Structure of Investment Banks

What is the role of non-executive directors in an investment bank?

Generally, the non-executive directors review conduct of business and business performance; play a key role in the nomination or removal of Directors and the senior executive officers; review compensation practices and decisions; review major strategic moves including large acquisitions and disposals; and monitor the nature and level of risk undertaken in the course of business. This is the role of the Supervisory Board in our two-tier Management Board/Supervisory Board structure at Deutsche Bank.

Directors and Senior Management

In accordance with German law we have a Management Board (Vorstand) and a Supervisory Board (Aufsichtsrat). The Stock Corporation Act prohibits simultaneous membership on both the Management Board and the Supervisory Board. The members of the Management Board are the executive officers of our company. The Management Board is responsible for managing our company and representing us in dealings with third parties. The Supervisory Board oversees the Management Board and appoints and removes its members and determines their salaries and other compensation components, including pension benefits.

The Supervisory Board may not make management decisions. However, German law and our Articles of Association require the Management Board to obtain the consent of the Supervisory Board for certain actions. For example,the Management Board must submit regular reports to the Supervisory Board on our current operations and future business planning. The Supervisory Board may also request special reports from the Management Board at any time.

Supervisory Board and Management Board

In carrying out their duties, members of both the Management Board and Supervisory Board must exercise the standard of care of a prudent and diligent business person, and they are liable to us for damages if they fail to do so. Both boards are required to take into account a broad range of considerations in their decisions, including our interests and those of our shareholders, employees and creditors. The Management Board is required to ensure that shareholders are treated on an equal basis and receive equal information. The Management Board is also required to ensure appropriate risk management within our operations and to establish an internal monitoring system.

Investment banks were once partnerships. Why did this change?
If investment banks go back to their traditional purely advisory role, should they revert to partnerships?

The partnership model for large investment banks became obsolete in the 1980s, when the capital required to compete in investment banking (for underwriting, financing, market risk positions, etc, not to mention the need for investment in global presence, technology, risk management and information management systems) favoured a public model. The importance of a substantial capital buffer in investment banking was demonstrated by the Barings/Nick Leeson episode. Result: the purchase of leading City institutions by American, Swiss, and German houses. The traditional model of the city of London merchant banking partnership disappeared in the 1980s, and the leading US investment banking partnerships (Goldman, Morgan Stanley) and others followed. Industry capital adequacy standards, which are being looked at in the wake of the credit crisis, will likely reinforce this point.

Some smaller advisory boutiques have done well under a partnership model. It is not capital intensive and smaller outfits can keep their overheads low. However, pure advisory is a relatively small part of the overall investment banking fee pool, compared to the more capital-intensive businesses of origination, sales and trading. The sheer capital involved in today's global investment banking industry, and the greater breadth of products and services (and financial commitment) which this capital can offer to clients, will likely place limitations on how big a role investment banking partnerships can play in the industry. Furthermore, another Barings type collapse would de-stabilise the financial system, which is more integrated than ever before. However, some aspects of partnership culture may be used (and already are used) in the design of investment banking compensation systems (eg payment in company stock, deferral of payouts, etc).

Annex

RISK AND CAPITAL MANAGEMENT ORGANISATION

Our Chief Risk Officer, who is a member of our Management Board, has executive responsibility for our credit, market, liquidity, operational, business, legal and reputational risk management as well as capital management activities within our consolidated Group and heads our integrated legal, risk & capital function.

Two functional committees are central to the legal, risk & capital function. The Capital and Risk Committee is chaired by our Chief Risk Officer, with the Chief Financial Officer being Vice-Chairman. The responsibilities of the Capital and Risk Committee include risk profile and capital planning, capital capacity monitoring and optimisation of funding. In addition, the Chief Risk Officer chairs our Risk Executive Committee, which is responsible for management and control of the aforementioned risks across our consolidated Group. The Deputy Chief Risk Officer reports directly to the Chief Risk Officer and is among the voting members of our Risk Executive Committee.

Dedicated legal, risk & capital units are established with the mandate to:

- ensure that the business conducted within each division is consistent with the risk appetite that the Capital and Risk Committee has set;
- formulate and implement risk and capital management policies, procedures and methodologies that are appropriate to the businesses within each division;
- approve credit risk, market risk and liquidity risk limits;
- conduct periodic portfolio reviews to ensure that the portfolio of risks is within acceptable parameters; and
- develop and implement risk and capital management infrastructures and systems that are appropriate for each division.

The Group Reputational Risk Committee (GRRC) is an official sub-committee of the Risk Executive Committee and is chaired by the Chief Risk Officer. The GRRC reviews and makes final determinations on all reputational risk issues, where escalation of such issues is deemed necessary by senior business and regional management, or required under other Group policies and procedures.

Our finance and audit departments support our legal, risk & capital function. They operate independently of both the group divisions and of the legal, risk & capital function. The role of the finance department is to help quantify and verify the risk that we assume and ensure the quality and integrity of our risk-related

data. Our audit department performs risk-oriented reviews of the design and operating effectiveness of our internal control procedures and provides independent assessments to the Management Board and the Supervisory Board Audit Committee.

March 2009

Memorandum from Michael Ewing

This sets out my observations to the answers given to Mr Thurso in Committee by Lord Stevenson during the week commencing 16 February:

(1) Risk Management

Lord Stevenson said Risk Management directors (at HSBOS) have access at all times to the main Board and Chairman. This implies that risk management is central to all decision taking. But I did not detect any detailed unpacking by Lord Stevenson of what is meant by "access".

In my experience, when dealing with large corporate loans, all banks' (not HSBOS alone) risk management largely relies upon bank lending teams complying with strict procedures—ie risk management is process and strategy based. The risk management team will only look at specific deals if called upon. Risk management will focus on risks to the bank's own loan book risk profile as much as (or more than) the risk of the underlying project. In the context of large corporate business loans this process will focus on three components all of which the board (in compliance with risk management team formats) will require be undertaken:

(a) First, identifying clients who have developed a strong reputation for prudent investment in their specific niche. This will include analysis of personal and business level CV's, inspection of their operating and compliance services on site, and development of personal relationship with senior staff as well as with principals to ensure there is a culture fit.

(b) Second, detailed interrogation of clients' business models and an understanding of how the client analyses and contains risk, and all appropriate KYC compliance enquiries. The business model will often be Microsoft excel based with sophisticated and elaborate formulas for "flexing" scenarios to allow the analyst to synthesise extreme situations. A bank's process at this stage is limited to assessing suitability of the base business model, not individual deals.

(c) Third, analysis of specific deals. This would require the client to present to the bank completed hi-level due diligence and a large part of all legal and financial due diligence; to incorporate all due diligence findings (or assumptions) in the business model; and to disclose all findings together with the business model, its flexing parameters, and of course a business plan for the target acquisition co.

To this extent, Lord Stevenson is correct that risk management is core to all decision making, for this process sets the parameters within which loan decisions may be taken. However, patently, such systems did not fulfil their purpose, albeit with hindsight. Nevertheless, given such hindsight, I note that no single or alternative potential error admissions were offered by Lord Stevenson. The weaknesses I have seen in current banking risk management are:

1. Possible over-reliance on the first two stages of the bank's risk analysis:

   This may manifest in an assumption that the client understands both the target co and the market in which it trades sufficiently well that there is no need to "look beyond the numbers". There is a temptation to downgrade the potential for some of the more extreme and damaging scenarios to emerge, and with reference to which—if a neutral stance were taken rather than a drive to see client expectations satisfied—a more rational conclusion to risk may be reached.

   This temptation is more prevalent where ageism denies teams access to experience of sequential cycles. A more realistic prognosis of risk may be attained by acknowledgement of the inevitability of cycles and that changing factors may curtail growth rates.

2. Shareholder value:

   The bank's Board will be focussed on delivering returns to shareholders through maximising business volumes. In the lending division, this translates into pushing their new lending budgets up. This generates pressures on the lending team to network as many potential clients as possible and to encourage the regular submission of target co deals for loan interrogation. Furthermore, in markets which appear to present sustainable growth, more participants are attracted to the market and it becomes easier for heads of lending to be persuaded to accept higher budgets in subsequent years.

   As markets become mature and changes in supply and demand in both related and apparently unrelated markets generate complexities, it is easy to loose sight of the bigger picture and miss something which in hindsight becomes clear. This danger is made all the more acute as markets mature because (1) developers (of property, of services or of products) fail to make correct

judgements in response to over-capacity dangers, and/or (2) as new suppliers (of services/products) come to the market, competition for opportunities leads to saturation and, in the short term, drives resource prices higher. Managers can be persuaded that investments with very marginal prospects will deliver high returns.

Pressure to meet or exceed budgets can therefore result in greater risk being accepted than may have been intended, despite complying with risk management processes. Indeed, and especially in a maturing market, those lenders struggling to get near their budget may seek to persuade boards to overturn risk management objections.

3. Remuneration policy:

   I wonder if this might be one of the more significant causal issues. There is no doubt that in having bonuses linked directly to business volume, fees and market share, there is an enormous risk that management heads have personal motives which must at some level enter into the business decision. This must have been a contributory factor in at least some of the deals witnessed in the markets. But business volumes also have relevance to board members' remunerations. This will generate a rich cocktail of motives on both sides of the board table and is a factor which we should be aware of for the future. I did not hear the whole questioning of Lord Stevenson, so do not know if this was an issue admitted by him.

4. Length of management structure:

   The head of lending will have equal access to the board as head of risk management. In truth, objections from risk management do not grow the business or personal wealth. Neither the head of lending, nor the head of risk management will have intimate knowledge of the target co or the market in which it seeks to trade, but will rely upon consultants who are fixed fee remunerated.

(2) Non-Executive Directors

I take more exception to the remarks made by Lord Stevenson on this issue. I am not myself a non-executive director, but I do understand the legal and commercial obligations of such. It is often said that complexities make the role of non-executives difficult or daunting to undertake, and I think he said that some of the issues would be too complex for them to understand; and/or to add value in the area of risk management. Sadly, this view demonstrates nothing other than arrogance. It is because such views are held by senior executive managers that non-executives are so vital.

Investment fund managers and bankers have developed many sophisticated means (such as "Quantitative Management") to assess value and risk and these are by nature wholly subjective and sometimes divert the manager from common sense issues which require more attention. The financial analyst will always pour scorn on the unsophisticated approach, which for the purpose of this paper I call the "gut feel" approach.

Analysts will place great weight on complex models within a process driven approach because they:

1. Demonstrate an in depth analytical approach to all contingent issues and allow flexing for sensitivities.
2. Are industry standard, accepted by all financial businesses and institutions, and become a benchmark of excellence within their own organisation, leading to a collective conclusion that they are very nearly infallible, albeit to the extent that the assumptions are correct.
3. Provide some reasonably high degree of "insurance" that use of processes and analysis will protect people and companies, and that problems arising must lay outside the team.

However, non-executive directors can ask the "stupid" questions and address the big picture issues in a way not open to others.

Conclusion

It is entirely possible that the bank Board and the Chief Executive may not always attain as close an understanding of lending risk as might be implied from Lord Stevenson's remarks.

If it is easy to see with hindsight that the markets advanced too much debt to ventures which were too risky, why was this not capable of being established before the events grew out of control? I suggest that the truth lies in these areas:

1. The banks adopt technical processes and make judgements in the context of their loan book risk structure profile, sometimes at the expense of engaging a gut feel approach. Such approach has often been criticised as being reactionary, redundant, and acting as unwanton restraint to business growth. This attack on ageism must be addressed.
2. Too much attention paid to the imperative of growth both of share value and market share.
3. Decisions are taken by directors many of whom are selected from business growth and development sectors of the industry, rather than from others who may have a more conservative

reliance upon traditional banking trained principles. It is inevitable that the more entrepreneurial directors will empathise with business recommendations from the head of their lending team, who will be of similar character.

4. Decisions will have certainly been influenced—at least at the margins—by remuneration policy.

March 2009

Memorandum from John Virgo

RECOUPING SIR FREDERICKS' PENSION PAYOFF

A search of the FSA Register now shows Sir Frederick Anderson Goodwin as "inactive", having surrendered his roles as inter alia director and chief executive officer of the Royal Bank of Scotland as from 21 November 2008. Having effectively been in charge of the bank for best part of a decade—a bank whose record is now distinguished only by an unprecedented accumulation of losses—some £24 billion and the largest in British history—it is unsurprising that his decision to accept a pension payoff of £650,000 per annum should have attracted such public debate—not least in so far as its timing coincided with the government's agreement to underwrite an estimated £325 billion of the bank's bad debt. It is also unsurprising that consideration is now being given to strategies for recouping this payoff.

In the above context it is suggested as important to bear in mind Sir Frederick's regulatory status at the time that his exit from the bank was being negotiated. First, as an "approved person" he was bound by the FSA's Statement of Principle 3 to the effect that: "An approved person must observe proper standards of market conduct in carrying out his controlled function". Secondly, as CEO of the bank (also with responsibility for apportionment and oversight) he was required by the FSA Handbook requirements in SYSC 7.1.2 R "to establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, which identify the risks relating to the [bank's] activities, processes and systems, and where appropriate, set the level of risk tolerated by the [bank]". This latter requirement included ensuring compliance with GENPRU 1.2.26 R which states that (here) a bank "must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due". It is difficult to see how Sir Frederick's conduct as CEO can be said to have demonstrated these regulatory requirements were met.

Moreover, SYSC 10.1.7R also provides that regulated firms—such as the bank—must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent such conflicts of interest from constituting or giving rise to a material risk of damage to the interests of its clients. SYSC 10.1.3R also required the bank to "take all reasonable steps to identify conflicts of interest between the [bank], including its managers, employees and … any person directly or indirectly linked to them by control, and a client of the [bank] that may arise in the course of providing any service".

Details of the funding of the pension payoff remain unclear—with estimates of the provision needed to meet the on-going liability if it subsists varying between £16.6 million and £32.7 million but it may be arguable that the acceptance of such an obscene level of payment against the background of the bank's unprecedented failure calls into question whether it is behaviour consistent with "proper standards of market conduct" and may involve a conflict of interest as between the bank and its clients—who presumably may be called upon (at least indirectly) to shoulder some part of the cost. Certainly, the event has done nothing to enhance the bank's reputation for observing proper standards of market conduct—as required by Principle 3 of the FSA's Statement of Principles for Businesses.

Under s382 of the Financial Services and Markets Act 2000 a court may, on the application of the FSA or the Secretary of State, make an order for restitution if it is satisfied that a person has contravened a relevant requirement, or been knowingly concerned in the contravention of such a requirement, and that profits have accrued to him as a result of the contravention or that one or more persons have suffered loss or been otherwise adversely affected as a result of the contravention. The court may order the person concerned to pay to the FSA such sum as appears to the court to be just having regard to the profits appearing to the court to have accrued or to the extent of the loss or other adverse effect. Reference to breach of a relevant requirement means any requirement imposed on an individual—such as Sir Frederick—by or under the 2000 Act.

It is arguable that by mismanaging the bank in breach of the SYSC requirements referred to above breaches of the above requirements arise; it is further arguable that by negotiating for and accepting such a seemingly unmerited payoff—with the reputational damage that it has engendered—again breaches of the above requirements have occurred. If that is right, one avenue for recovery might involve action under s382

of the 2000 Act—either to recover some part of the losses caused to investors and shareholders by Sir Frederick's possible mismanagement of the bank or to recover part of the pension benefit which has accrued to him in consequence of any breach of the above requirements.

John Virgo is a barrister specializing in financial services law and regulation.

March 2009

Memorandum from the Consumer Council

1. Introduction

Consumer trust and confidence in our financial system has been rocked. We welcome the Treasury Select Committee's focus on how we can rebuild confidence in a banking market that we can all feel part of, both on a local and national level. This is affecting all consumers—people are losing their homes, losing their jobs, having their savings cut and being overcharged. Consumers urgently need to see banks, regulators and the Government doing everything they can to keep people in their homes and the economy working. The need for change is clear and urgent. In particular, we want to see:

— Banks and other lenders demonstrating that they are doing all they can for consumers in mortgage arrears and those in financially difficulty. In 2008 there was a 64% increase in mortgage repossessions here compared to 2007.

— Banks passing on interest rate cuts to borrowers in full. Some households could be paying £1,600 a year more than they need to because the banks are dragging their heels[10]. It is unacceptable that banks are increasing their margins during a time of severe need for consumers who are in financial difficulty.

— Banks must not delay the OFT investigation into unauthorised overdraft charges[11] any further. This investigation must be allowed to proceed so that consumers can find out once and for all what a fair bank charge should be and get unfair bank charges refunded without any more delay.

— Government must ensure banking regulation is robust. Consumers must be able to have confidence in how banks do business and in the products they offer. They must also be sure that that their deposits and savings are safe and that Government money invested in banks is being spent wisely.

— The consumer voice must be heard and must count within a fair, affordable and sustainable financial market.

Northern Ireland consumers are not shielded from what is occurring on a national, European or global level, but their circumstances have been more difficult from before this crisis:

— There are lower levels of financial capability here compared to in the rest of the UK[12].

— Historically, consumers here have had poorer deals as evidenced by the Consumer Council's super-complaint which prompted a Competition Commission Inquiry because consumers were offered personal current accounts with higher levels of charges and paltry interest rates.

— There are higher levels of financial exclusion and greater receipt of benefits—16% of households here do not have a current account compared to 10% in the UK as a whole and 24% of households here don't have home contents insurance compared to 21% in the UK. Benefit receipt is higher in Northern Ireland (62% of benefit units) than the UK average (58%).

— Redundancies in Northern Ireland increased by 54% compared to the same time the previous year, there were 2,882 confirmed redundancies over the year to 31 January 2009.

— Higher levels of mortgage repossession orders, in 2008 there was a 64% increase in mortgage possession actions in Northern Ireland in 2007, compared to 4% in England and Wales.

— Cost of housing—the University of Ulster Quarterly House Price Index showed prices had fallen by more than 28% over the course of 2008. In terms of affordability at the end of 2008 an average house price paid by a first time buyer was still 5.8 times higher than average earnings.

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[10] The Financial Inclusion Centre calculated this snapshot estimate of the amount extra households will pay over the next year if the current margins are maintained, that is, if the banks aren't forced to pass on rate cuts. The SVR and tracker mortgages are compared to libor rates, as are the savings, overdraft and credit card. The fixed rate mortgage is compared to the SWAPS rate and is based on a new mortgage being taken. Rates are taken from Bank of England data.

[11] Seven banks and one building society were taken to court to see if their unauthorised bank charges could be tested for fairness. The court case has been ongoing since January 2008.

[12] *Managing Money*, the Consumer Council, 2007

— Historic restrictions on credit unions. Credit unions here can't offer the full suite of financial services offered by similar social banking models in the rest of the UK and the Republic of Ireland. This is now being addressed by the Northern Ireland Assembly and the Treasury.

The Consumer Council has, since June 2008, closely monitored the current cost of living compared with last year. The cost of living peaked in August when essentials for our average family cost £64 more a week than in August 2007. Since then the additional amount of weekly spending has reduced because the reductions in petrol, diesel and home heating oil have been passed on to consumers.

The Consumer Council has worked with the Committee for Finance and Personnel to ensure that the big four banks in Northern Ireland are doing all they can and are not allowed to pass under the radar.

We welcome recent changes to legislation which mean that consumers holding banknotes from the big four banks here have the same protection as consumers holding Bank of England banknotes. That issue was first consulted on in July 2005 and we are pleased that the legislation providing that protection came into effect last week.

What will the Consumer Council continue to do? We will continue to take a three pronged approach:

— Empower consumers so they can make the best decisions about their money.

— Provide information to consumers to help them make the best decisions about their money.

— Apply pressure to businesses and the Government to help consumers carry the load.

What can the Government do? The Government can put pressure on the banks and other lenders to do the right thing by their customers.

2. Response of the Big Four Banks

Standard Variable Rate mortgages

The graphs below illustrate the cuts made by each of the big four banks to their Standard Variable Rate in response to interest rate cut made by the Bank of England.

Only Ulster Bank passed on the first interest rate cut (in November) in full to their SVR customers. After that, only Bank of Ireland has passed on the subsequent interest rate cuts in full to their SVR customers.

Figure 1

ULSTER BANK

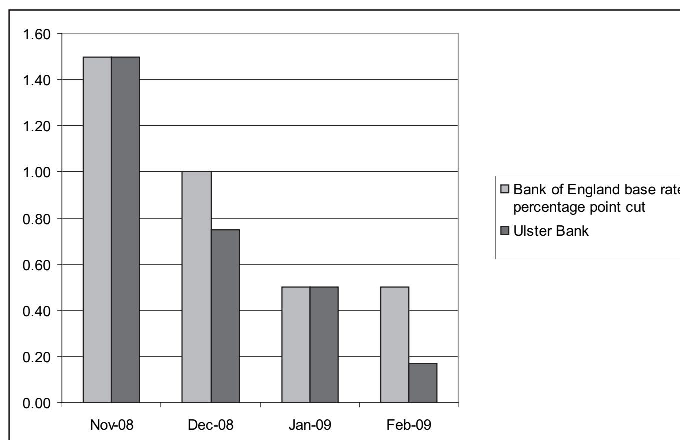


Figure 2

NORTHERN BANK

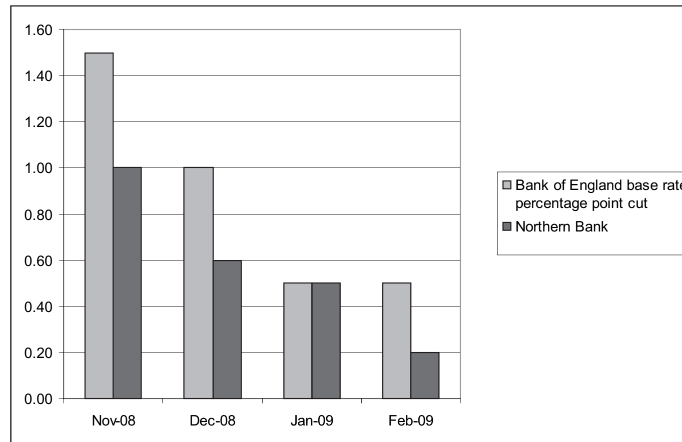


Figure 3

FIRST TRUST BANK

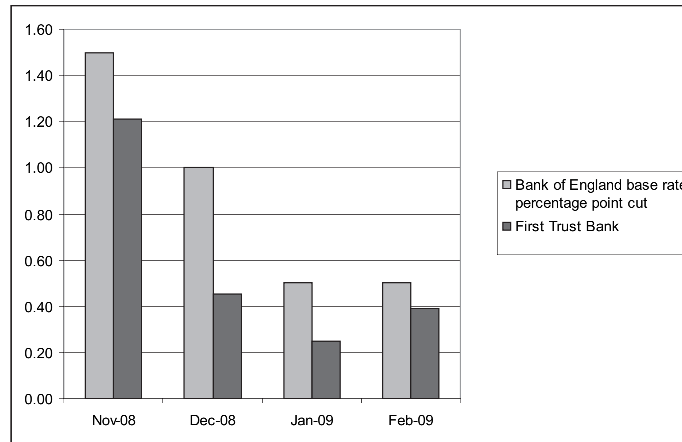
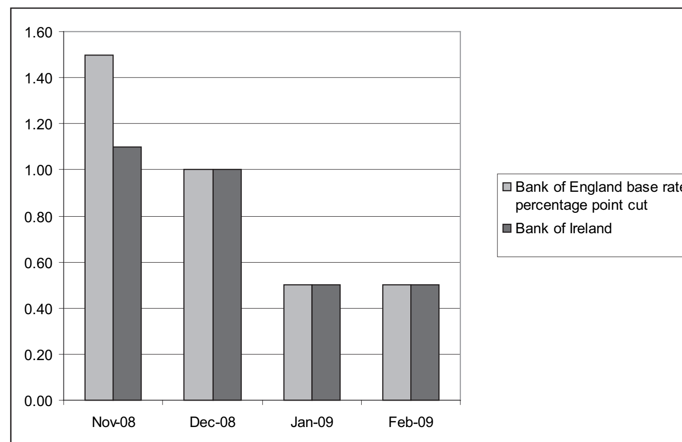


Figure 4

BANK OF IRELAND



Personal current accounts

All of the big four banks have made some cuts to the interest rates for authorised overdrafts in personal current accounts (PCAs) but the cuts do not reflect the cuts made to the Bank of England base rate, except for First Trust Bank. First Trust Bank's bank rate mirrors the Bank of England rate and their overdraft rates are based on their bank rate.

Some accounts have had their in-credit interest rates cut.

One bank (Ulster Bank) has not made any cuts to the unauthorised overdraft interest rate.

Personal loans

Ulster Bank has reduced the interest rate on an unsecured loan for £1,000 from 29.3% to 19.9% in February. Northern Bank and First Trust Bank have kept their interest rate the same and Bank of Ireland increased their interest rate by 0.2 percentage points in the last few months.

Credit cards

Three of the big four banks have kept their credit card interest rates the same. Northern Bank increased their credit card interest rate from 17.9% to 22.9%.

Household finances

The Consumer Council commissioned the Financial Inclusion Centre to provide us with a snapshot estimate of how much households may be losing or gaining this year if the banks do not pass on the full interest rate cuts. Not passing them on leaves a family scenario with a mortgage, savings, overdraft and credit card paying £1,600 more this year than they need to[13]. This calls for urgent and immediate action.

3. Possessions in Northern Ireland

In Northern Ireland in 2008, 3,628 writs and originating summonses relating to mortgages were received at the High Court. This is an increase of 64% on the year before.

In quarter four of 2008 there was a 73% increase in mortgage possession actions in Northern Ireland from quarter four in 2007. The comparable figures for England and Wales shows a decrease of 29%, most likely because of the introduction of the new mortgage pre action protocol (MPAP). It may therefore be better to compare figures for quarter 3 of 2008.

In quarter three of 2008 there was a 93% increase in mortgage possession actions in Northern Ireland from quarter three in 2007[14]. This compares to an increase of 8.8% for the same period in England and Wales.

The Housing Rights Service launched a new *Preventing Possessions Initiative* in February 2009 which will involve working with a range of stakeholders including the Consumer Council, the Assembly, lenders, Housing Executive and Housing Associations to secure positive changes to housing legislation, policy and practice. This project will also provide free advice and representation in situ at the High Court and County Court to people facing imminent threat of repossession.

The Consumer Council fully supports the principle of a mortgage rescue scheme. In relation to the consultation by the Department of Social Development we recommended that this scheme should be adequately resourced so that as many households as possible can be helped to stay in their own home.

We welcome government intervention to help families stay in their homes, for example, the Treasury's Homeowner Mortgage Support Scheme. Of the big four banks in Northern Ireland, only Ulster bank (as part of Royal Bank of Scotland) has confirmed they will be part of the scheme. The other three banks have advised that they are considering joining and will make a decision when the details of the scheme are finalised.

Ulster Bank, as part of RBS, has committed to giving a six month period of grace to home owners before beginning possession proceedings. It was announced last week that Bank of Ireland and AIB Group have agreed to delay issuing repossession orders on homes for 12 months in the Republic of Ireland as part of the Irish Government's bank recapitalisation plan. As far as we can ascertain, this repossession grace does not extend to Northern Ireland.

[13] The Financial Inclusion Centre calculated this snapshot estimate of the amount extra households will pay over the next year if the current margins are maintained, that is, if the banks aren't forced to pass on rate cuts. The SVR and tracker mortgages are compared to libor rates, as are the savings, overdraft and credit card. The fixed rate mortgage is compared to the SWAPS rate and is based on a new mortgage being taken. Rates are taken from Bank of England data.

[14] Northern Ireland Court Service

4. Financial Capability

Consumers in Northern Ireland are bottom of the UK league when it comes to financial know-how. A third of people believe they are only one month away from hardship if anything unexpected should happen. Half of people have no insurance for loss of income or property and more than a quarter don't get any independent information or help before choosing a financial service, like a mortgage.

Times like these shows the importance of investing in financial capability. We believe consumers must have skills and confidence to manage their money, shop around and choose financial products such as bank accounts, loans and mortgages and know where to get help if they are in financial difficulties.

The Financial Capability Partnership brings together representatives from the NI Assembly, banks, building societies, credit unions, community and voluntary organisations, education sector and others to ensure that there is a strategic and co-ordinated effort to help consumers get to grips with this very important issue. The Financial Services Authority provides much-needed research, input and resources.

The Consumer Council hosted a very successful Money Week in Northern Ireland in November 2008. Over 100 stakeholders attended the launch event at Coleraine Borough Council offices and over 20 events were arranged by partners throughout Money Week for primary and secondary school children, students in colleges and universities, teachers, consumers in community settings, employees in their place of work and parents and families. Throughout the week almost 3,000 people attended Money Week events and over 30,000 information packs were distributed to help consumers manage their money and make it go further.

5. Depositor Safety

The Consumer Council championed the need to protect consumers' savings and prepayments by briefing Brian Pomeroy, Chairman of the Treasury's Financial Inclusion Taskforce about the Consumer Council's research that identified gaps in consumer protection relating to retailers' saving schemes.

As a result the UK taskforce will look again at issues around the protection of deposits, prepayments and gift vouchers in relation to the changing economy where some businesses may potentially cease trading.

The Consumer Council welcomes HM Treasury announcement that they will conduct a review of the legislative framework for credit unions and industrial and provident societies in Northern Ireland. Credit unions have an important role in building responsible saving and borrowing habits and providing financial products to consumers who would otherwise not take up these products. The Consumer Council played a vital role in the recent Committee for Enterprise Trade and Investment Inquiry and recommends that the law be changed to put credit union members in Northern Ireland on an equal footing with those in other parts of the UK.

We welcome recent changes to legislation which mean that consumers holding banknotes from the big four banks here have the same protection as consumers holding Bank of England banknotes. That issue was first consulted on in July 2005 and we are pleased that the legislation providing that protection came into effect in the past month.

6. Insurance

Insurance provides vital protection, especially with today's uncertainty when the fear of unemployment and not being able to make ends meet is real to many. It is important that all consumers in Northern Ireland get a fair deal when it comes to insurance in terms of choice and cost, and have sufficient and affordable insurance cover.

The Consumer Council commissioned the Financial Inclusion Centre to undertake a research project to investigate whether consumers in Northern Ireland are paying more for insurance.

Our report will be launched in March.

Details of financial products are sourced from the banks and *Moneyfacts* and are subject to change.

February 2009

Memorandum from Dr Kirk Lovric

In reading on the current financial crises, I am amazed that the real estate industry and real estate speculation, upon which the UK citizenry gorged themselves over the last 10 years, has not in any way been criticised for its contribution to the current financial mess in the UK.

Over the last 10 years the UK citizenry have viewed the London and UK residential and commercial real estate markets as a giant casino. Irresponsible risk taking by UK mums and dads flipping apartments off the plan and purchasing houses to renovate on the cheap to sell within 12 months for a massive profit, is the

root cause of the current UK financial mess. The USA property market is in an even more dire mess than the UK, and unless the real estate industry is regulated, an even larger USA style mess will bestow itself on the UK into the future.

The key issues that must be addressed in this area are twofold. First, real estate agents give financial advice; they are agents of the seller and are supposed to outline the physical features of the property for sale. The reality is that during the boom years they did not inform you of the features of the property in question, but merely told you how good an investment it was and how much money you would make on it in a hurry. Real estate agents in the UK in fact behave as financial advisers but are not regulated as such. Real estate agents should in law be required to have duty to the seller and the purchaser, be required to avoid related conflicts of interest between purchaser and seller, and be regulated as a financial adviser. In short, they should be subject to the same laws that regulate brokers and investment advisers.

Second, the risk taking on property speculation (as with bankers' bonuses) should be subject to claw back to provide financial stability. A scheme should be developed, similar to claw back of bankers' bonuses, in which anyone who purchases a house and holds it for under two years and then sells it, must place the proceeds of the sale in excess of the original purchase price (plus costs) in a government controlled fund. This money should be held for three to five years (length of time depending on the economic cycle), and then only released if economy clearly shows that the gains realised by the real estate speculator can be sustained. If the house in question goes down in price, the person who purchased it at the inflated price should be entitled to claw that money back from the Government fund.

Third, as is the case on the Continent, the UK Government should restrict real estate borrowing to four times income and the Government should impose a regulated minimum debt to equity ratio of 85:15 on all real estate purchases, excluding costs. Recently, the UK real estate markets peaked at six times income and 125% mortgages were being used to purchase property. Allowing such borrowing levels is irresponsible of the Government and it should regulate so that no bank can give a loan in excess of four times income on the purchase of a house and provide regulation to ensure that purchasers provide a minimum 15% deposit.

As I have outlined, unless this issue of property speculation is addressed in the UK, the Government can attempt to re-regulate the banks and financial markets, but, it will not address the problem and this current crisis will repeat itself in the near future.

March 2009

Memorandum from James Clarke C.A., F.I.I.A.

C.A. Member of the Institute of Chartered Accountants of Scotland

F.I.I.A. Fellow of the Institute of Internal Auditors

Prior to Recent Retiral, also involved with the following

MBIM Member of the British Institute of Management

F. Inst. Directors Fellow of The Institute of Directors

C.I.M. Member of the Canadian Institute of Management

(past President of the Alberta Chapter for several years)

F.C.C.A. Fellow of the Institute of Chartered and Certified Accountants

Summary of Key Posts Held

Director of Audit, Department of Energy, Government of Alberta

Chief Internal Auditor, Lothian Regional Council, Fife Regional Council, and Clackmannanshire Council

Audit Senior, Price Waterhouse and Co.

I was also Chairman of The Scottish Local Authorities Chief Internal Auditors Group, following a spell as Vice Chairman.

I still serve on The Advisory Board of Public Concern at Work, the "Whistleblowers organisation."

Details of Submission

I have read the press and watched with interest, the questioning of the four main principals representing the Royal Bank of Scotland, and HBOS. The newspapers have also given substantial coverage, quite understandably, of the massive pension payments etc. that a number of these "villains" have received—morally all wrong, but legally probably incapable of any real challenge.

It strikes me, however, that there are several groups of people, who must have known of the impending crisis, long before it occurred, and who failed to highlight the debt issue at an early enough date to save the banks, the shareholders, and the government (who then had to pick up the pieces in "bail-outs") from losses greater than anyone could have imagined.

The three groups of people are as follows:

1. The Non Executive Directors (NEDS).
2. The External Auditors.
3. The Internal Auditors.

In theory, all three of these groups of people should have realised that a potentially serious debt situation was gradually developing, long before it all came to a head with such disastrous consequences. When considering, in each case, why none of these three categories apparently, gave sufficient warning, I realised that the common thread, that has bothered me for a long time, must have come into play in a big way.

The common factor is the issue of genuine independence (or a lack thereof) from the management of the banks concerned. I should immediately add that this same lack of genuine independence applies to all of three of these groups of people with all companies. A very worrying thought.

Why is this?

The fact is that all three of these groups of people are appointed by management, and rely on management for their audit fees or salaries. The company has the power to hire and fire, and that, in itself, automatically takes away any pretence of genuine independence.

I will comment, very briefly, on the situation regarding each category, prior to coming up with the ways of resolving the independence issues once and for all.

Non Executive Directors

This group should have been the first group to question management about the increasing debt situation, and, in particular about the nature of many of the debts. NEDS are supposed, as their main duty, to question management on any area of operations, as well as on strategic plans etc. If they did question them on this matter, it appears as if their concerns were ignored. I have not read any report which tells me what happened with the NEDS, which suggests that they did not properly fulfil their responsibilities. This is not particularly surprising, as many still regard being a NED as a sinecure, and a "don't rock the boat, chaps" atmosphere probably still prevails, particularly when many of the NEDS are well know to members of the main board.

Why is it that you will never see an advert in any newspaper asking for applications for the job of NED? The answer is clear—it is by invitation only—and someone like myself who would be qualified to ask, and very likely to ask, all of those "awkward" questions is NOT what is wanted

Solution: All NEDS should be appointed either by the Government or by the Audit Commission in England and Wales, or by the Government or The Accounts Commission in Scotland. Stop the appointment of friendly pals.

The External Auditors

As a qualified accountant and auditor myself, as well as someone who still marks examination papers for The Institute of Chartered Accountant of Scotland, you will appreciate that it gives me no pleasure at all in suggesting anything at all against any of my fellow auditors. I'd also just like to make it clear that the purpose of this criticism is not intended to be against any person or specific group of people—it is more about the mechanism for the hiring and firing of auditors. I'd find it hard to believe that none of the audit firms involved had absolutely no idea that high debt, as well as the type of debt involved, was likely to present future problems. I believe that any competent auditor would have spotted that as part of performing a routine audit. In cases like that, where debt is not yet considered bad, but is considered doubtful, or even very doubtful, a significant bad debt provision should have been created, and formed part of the audited accounts. If the concerns were seen as threatening the future survival of the banks (and we now know that they were), a note qualifying the accounts should have been inserted, and the note should also have explained that there were concerns about the banks continuing as going concerns—just as the auditors of GM have recently done.

This did not happen.

Why not?

Two possible reasons. First—a very poor, sub-standard audit was performed, in which insufficient questions were asked about the debt situation. Or, the second possible, scenario, is that there were some concerns, but, faced with the prospect of falling out badly with senior management (by inserting a qualification in the accounts) and possibly losing the audit, the partner (s) involved decided to take the risk of not inserting any qualification to the accounts, and thus retaining a lucrative audit (s)—both banks.

Solution

External auditors be appointed in the same way as the external auditors of Local Authorities and Health Boards are appointed in Scotland. The Auditor General appoints a firm for a three or four year term. The Local Authority has no say in the matter. Likewise, the LA cannot fire or change the external auditors. Thus, they are truly independent, and can fall out with management on key issues as much as is required, without any fear of losing the audit. That MUST HAPPEN.

Internal Audit

Again, I'd be very surprised to hear that either of the two Internal Audit Sections within RBS and HBOS were unaware of any debt problems. Even more so, when I read that the Risk Manager at HBOS was so convinced by the problem that he persisted just a bit too much in trying to convince management of the seriousness of the problem, that, as you will know—he was fired!! What a disgrace that is. I would find it hard to believe that none of his colleagues at HBOS knew what was going on, and I'd also find it hard to believe that the Risk Manager at RBS wouldn't have known. If the Risk Managers knew it is even more likely that the Chief Internal Auditors would know. So, once again—what happened here? I do not know, but, from my own personal experience as a Chief Internal Auditor, I do know how difficult it is when you report something that is correct—but that senior management do not want to hear about—let alone admit is correct.

Chief Internal Auditors are hired and fired by Finance Directors or CEOs. Again—they are, therefore, only independent up to a point!!!! (and few can afford to lose their jobs by being sacked for pushing their views too far.)

Solution

Chief Internal Auditors cannot be fired by any member of the senior management team. They can only be fired (eg for reasons of competence—not opinion) by the separate Audit Committee to which they should report. The Audit Committee should not have any members of the management team on this Audit Committee.

Final Comment

I trust that the views that I have expressed will be helpful to you in compiling your report on the banking crisis. I also hope that, if my suggested solutions are adopted, that the chances of any such future unexpected financial disasters will be significantly reduced.

March 2009

Memorandum from Rothschild

1. *How rapidly did your bank grow from 1997? And for the 10 years before that?*

Our advisory business has grown throughout the period from 1997, at a compound annual growth rate of 14%, evidenced by the more than fourfold increase in fees and commission income since 1997. There was an increase in the average number of employees from 635 to 995 over the same period. At the same time our balance sheet size has remained relatively stable.

In the preceding 10 years to 1997 total assets were relatively constant whilst the corporate finance advisory business grew steadily during the period.

2. *What happened to holdings of British government securities over the two periods?*

We have not held British government securities as part of our liquidity management or investment activities over the two periods. Activity in these securities over these periods has been limited to non-material occasional trading together with some limited gilt repo transactions undertaken as part of our day-to-day cash management activities.

3. *Are investment banks as crucial to the functioning of the economy as commercial banks are?*

Investment Banking is a generic term covering a very broad range of activities. These activities range from the provision of advice, the broking of transactions, asset management and principal trading activity (where, in the latter case, the bank risks its own capital). Each of these activities is important to the functioning of liquid wholesale markets and happen both within the large commercial banks and in the more specialist institutions normally called Investment Banks. In the case of Rothschild, we specialise in the provision of advice to corporations and governments and as explained above, are not involved in either broking or principal trading activities.

4. *How do you control risk in your organisation?*

Rothschild has adopted a risk governance model which requires that all businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group. This model distinguishes between functions owning and managing risks (the Board and executive management), functions overseeing risks (Group support functions including Risk, Finance and Legal & Compliance) and functions providing independent assurance (Internal Audit).

— *How many items are there on your risk register?*

Rothschild identifies and monitors its key risks through three interrelated processes, rather than by means of a single risk register:

(i) Individual businesses identify the key strategic risks to their business as part of a formal process of Risk Assessment.

(ii) Material risk types, eg credit, market, operational, liquidity risk, are identified as part of the Group's Internal Capital Adequacy Assessment Process (ICAAP).

(iii) The effects of specific stress scenarios are modelled to measure their potential impact on profits, capital and liquidity.

— *How often is your risk register reviewed and by whom?*

Each of the three processes described above is formally conducted at least once a year, and more frequently in adverse conditions.

The Risk Assessments are reviewed by the Group Risk Committee and the Group Management Committee, and the results are made available to the Group Audit Committee.

The ICAAP and stress scenario modelling are reviewed by the Group Assets and Liability Committee and approved by the NMR Board.

The Group Risk Director reports quarterly on risk to the board of Rothschild, and to the Audit Committee, which meets quarterly.

— *Was collapse of "wholesale markets" on your risk register as a potential risk and what were your mitigating controls?*

Our risk monitoring has specifically assessed the potential risk of an adverse Rothschild-specific liquidity event rather than a market-wide one. This is the basis for the liquidity stress scenarios and contingency funding plan that are formally in place. We adopt a Rothschild-specific approach for practical reasons given the difficulty of identifying the modelling variables for a market-wide event. We believe that our approach aligns with industry practice to assess idiosyncratic liquidity events.

— *What improvements do you think are required to risk control frameworks in the banking industry?*

Firms should put less reliance on models that are based solely on historical information and instead further develop scenario based modelling. Where possible, these scenarios should be firm-wide, to counteract the risk of a silo-based approach to risk management within firms, which underestimates the correlations between different risk types.

— *How many FTE staff posts do you have devoted to risk management both as a number and proportion of total staff?*

Rothschild's UK businesses have total FTE staff of 823. Group Risk is responsible for the development of risk management policies and procedures to identify, monitor and manage risk exposures. Responsibility for day-to-day management of financial and non-financial risks across the Group rests with the businesses themselves. Staff with specific responsibilities for risk total 15, on a FTE basis.

5. *Did you stress test your balance sheet against a scenario where the wholesale funding markets closed down?*

No, as explained above.

6. *Should there be a special insolvency regime for investment banks as there soon will be for commercial banks?*

NMR meets the definition of a bank under Article 91 of the Banking Act 2009, and will therefore be subject to the special insolvency regime. An insolvency regime for investment banks not subject to the commercial bank arrangements would need to provide a means for the orderly netting and / or unwinding of trading positions which in Lehmans' case were extremely large, complex and involved many different counterparties.

— *Would this prevent post Lehman-type problems?*

Orderly management of trading liabilities should reduce (but cannot entirely remove) the risk of a systemic problem, and the extremely damaging loss of confidence which this causes.

7. *Do Investment Banks make natural partners for retail banks or is the culture too different?*

Retail banking has never been part of our business model so we cannot comment on the compatibility of such cultures from experience.

8. *What are the strongest reasons both for and against the separation of traditional, narrow banking activities from riskier trading and investment banking activities by your organisations?*

We think this is a matter of risk management, not a matter of business model per se. We are not an integrated investment bank that conducts large trading operations or proprietary investment. Our business model is for the most part an advisory lead business model.

9. *What was the share of bonuses in total remuneration 20, 10 and 1oneyears ago?*

The share of bonuses in total remuneration at NMR last year, 10 years ago and 20 years ago was as follows:

2007–08 74%

1998–99 58%

1988–89 23%

The trend is in large part a reflection of the shift in our revenue mix from reliance on net interest income to mainly advisory fees, the former requiring financial capital and the latter not.

10. *Why do investment banks pay bonuses as a large part of take home pay when no other type of firm does?*

Many Investment Banks were formally partnerships where the individual partners in the firm received a portion of the profits each year and were wholly dependent on those profits. This style of remuneration, with small base salary and profit participation, has often persisted following the conversion of such businesses into limited companies. This structure of remuneration allows firms to flex their cost base as profits increase or fall.

Variable compensation, as many industries is driven individual revenue generation and contribution to firm performance. Some individuals make a very significant direct contribution to firm revenues and bonuses reflect this. The level of bonuses paid at investment banks reflects the external market and the importance of rewarding the best performers competitively for their contribution. This enables us to retain our talent, and at the same time control our costs by adjusting bonus levels as appropriate.

11. *How are these bonuses structured within your firm*

Bonuses are awarded on an annual basis with regard to the profitability of the firm, divisional, team and individual performance and market compensation levels. An element of bonus is deferred, subject to seniority and a threshold value. Deferred bonuses are subject to forfeiture.

12. *What proportion of securitised investments do you keep on your own books? How has this changed in the past 10 years?*

Securitisation is a small activity in our business. We currently hold exposures in three securitisation transactions of assets that were originally held on our balance sheet which have been distributed into the wholesale market as described as 13 below.

We hold less than 2% of notes issued in these securitisations on our balance sheet, the larget single holding amounting to US$10.3 million.

In 1999 we had undertaken no securitisation transactions and thus kept no such exposures on our balance sheet.

13. *When you sell products on, do you consider whether they are suitable for and fully understood by your clients? If not, why not? If yes, give examples*

We do not market or sell securitised or complex products to our clients. In the securitised transactions mentioned in Q12 above, we were advised by an Arranger who underwrote and sold the notes to the investors.

14. *What is the role of non-executive directors in an investment bank?*

We cannot comment on the role of non-executive directors in other institutions. At Rothschild, their role is to provide independent challenge to the executive directors, and to sit on and chair key committees such as the Audit committee and the Remuneration Committee. Executive Directors and other senior employees are also asked to draw on our non executive directors for guidance and advice on business and other matters affecting the firm.

15. *Investment banks were once partnerships. Why did this change?*

— *If investment banks go back to their traditional purely advisory role, should they revert to partnerships?*

We have not investigated the reasons for the change that you identified, but would expect that many partnerships needed capital to allow them to grow, and hence needed to access the equity markets. It is also likely that the nature and extent of the liability facing individual partners become too onerous. Furthermore, a large and diverse partnership can be difficult and cumbersome to manage, with each partner having a say in the running of a firm.

It is possible that some small purely advisory businesses will consider using limited liability partnerships to conduct some of their business (as the accountancy profession has done).

We hope that you find this letter of some help but if you would like to talk about any of our answers please do let me know.

March 2009

Supplementary memorandum from the Alternative Investment Management Association (AIMA)

Further to the appearance by the hedge fund managers and myself at the Treasury Committee's hearing on Tuesday 27 January I would like to make a few comments for the record in response to the conclusions that you drew after the evidence session as there was no opportunity given to us to respond at the time. I have commented against each of the six stated conclusions using the wording from the transcript.

Conclusion 1: Disclosure vs Banks

"In answer to Mr Mudie's question you have less disclosure than the banks"

Leaving aside the point that a direct comparison between the disclosure practices of a bank and an investment fund cannot be made—they are such different businesses—our evidence was suggesting the exact opposite of this statement since hedge funds are generally regularly marked-to-market for valuation purposes, leaving little scope for doubt about what investors' shares are worth. The balance sheets of banks, by comparison are extremely opaque and this has been one of the primary reasons for the erosion of market confidence in the banks' share prices.

Conclusion 2: Short Selling of Banks

"Large hedge funds are possibly destabilising banks by short selling"

Again, we argued the opposite. We were at pains to stress in our written and oral evidence that short selling did not destabilise the banks. They were in fact destabilised by weak risk management disciplines and loss of confidence in the quality of their balance sheets. During the period of the short selling ban on financial institutions between mid-September 2008 and mid-January 2009, the share prices of British banks plunged by up to 75% in the absence of any short selling. Additional securities lending data for the period leading up to the imposition of the short selling ban conclusively show t hat short interest had declined for all of the banks—in some cases from figures of over 10% to figures less than 3%.

CONCLUSION 3: NAKED SHORT SELLING

"I think you all agreed there was a need to ban naked short selling"

We argued that restrict ions on short selling should be considered as part of the review into the subject by t he FSA in its discussion paper DP 09/1. There is no accepted definition of naked short selling but we certainly agree that abusive practices whereby there is no intention of covering a position, of walking away from a sour trade or of seeking to short more than the issued capital should be banned.

CONCLUSION 4: INDUSTRY BODY

"You felt that there was a weak industry body and there is quite a long way to go there"

No. We pointed out that the global trade body that represents hedge funds is the Alternative Management Association (AIMA) which is well regarded by its members. The body that was under consideration by the Committee was the Hedge Fund Standards Board which is not a trade body and is a separate organisation from AIMA.

CONCLUSION 5: DISCLOSURE TO FSA

"You are waiting for the FSA to ask you for information. The question should be: why have you not thought of what you can tell them and engage more closely in that disclosure?"

We are activity engaged with a number of international regulatory organisations including the FSA regarding the appropriate provision of information to permit prudential supervision for financial stability purposes. This is a complex area with no obvious quick solution immediately available since it will require agreement of common definitions, de minimis threshold of disclosure and a mechanism sufficiently simple to allow for regular and speedy snap-shots to be of relevance.

If we mistakenly gave the impression that the industry knows the answers but is waiting for the FSA to ask the right questions before the information is divulged, then we can only apologise for the miscommunication.

CONCLUSION 6: PUBLIC IMAGE

"You have a poor public image and you have a long way to go"

I think we all agree that there is some way to go on our public image and that t his relates principally to misunderstandings about the role of our industry to its investors and to the economy as a whole.

AIMA, on behalf of its members, is devoting much of its time to increasing communications with the media, parliamentarians, policy makers and regulators in order to address many of the misconceptions surrounding the industry. Some of these initiatives include: the creation of newsletters specifically aimed at MPs; AIMA's annual MEP event in Brussels, hosted in conjunction with the European Parliament; AIMA's annual Regulatory Fora—unique events which bring together regulators from across the globe to discuss issues of common interest and the development of the hedge fund industry; and AIMA's ongoing work with its members to consider how we, as an industry, can engage more with the media and offer journalists the opportunity to speak to leading figures within the industry.

We are grateful for the opportunity to have made our points of views known to the Committee as it gathered its evidence and look forward to a continuing dialogue.

March 2009

Supplementary memorandum from Barclays

1. This note sets out responses to the additional questions sent to Barclays following John Varley's appearance before the Treasury Select Committee on 11th February. Should you require any further information please don't hesitate to contact our Group Public Affairs team on 020 7116 6228.

BACKGROUND INFORMATION

2. Barclays is a UK-based international business with over 300 years of banking and financial services experience. The £6.1 billionn profit we announced on 9 February shows that we are a well capitalised, profitable business.

3. However, as John Varley acknowledged in his evidence to the TSC on 11 February we are aware that the whole of the banking industry has to accept considerable responsibility for the events of the last 18 months.

4. Barclays is committed to helping the governments, customers and shareholders in the markets in which we operate find solutions to the legislative, regulatory and financial problems highlighted by recent events.

5. Over the last two decades Barclays has seen significant growth. We are now a UK-based international business. We have seen both organic growth in our traditional markets in Western Europe and Africa and more rapid growth through a range of different acquisitions. For instance, we have operated in France since 1917 and a number of African countries since the 1920s. In 1988 73% of our total assets were based in the UK, in 1997 this was 63% and in 2007 this was 35%. As a well capitalised, profitable bank the growth of our business has provided considerable benefits for our customers, shareholders and the countries in which we operate, particularly the UK.

6. We have seen growth in both the retail/commercial and investment banking elements of our business. This growth has brought net benefits to the UK with employment opportunities and contributions towards the UK's economic growth.

7. Barclays has seen considerable, sustained growth over the last 20 years based on sound management of risk. From 1988–1997 we saw compound annual growth of 9% and from 1997–2008 we saw 22%.

8. The severity of the events of the last 18 months have taken all stakeholders by surprise. Barclays took action in advance as part of our risk assessments to mitigate some of the larger risks. Our risk appetite is set and monitored by the Board. This doesn't mean we won't lose money on some portfolios but it does mean any losses should be within an appetite tolerance across a diversified business. Our business is structured so our risk division sits as an independent function. The risk team uses a range of models and techniques developed over many years and refined in consultation with the FSA for Basle II. We perform a number of stress tests, including downside scenarios that are materially worse than current conditions.

9. Neither the market nor the regulatory community foresaw the events of the last 18 months and the impact there would be on the wholesale funding markets. The FSA is currently consulting on the scope of liquidity stress testing and we are working with the FSA on that as well as further refining our in-house stress testing.

10. The Board Risk Committee plays a central role in managing our risk. At the end of 2006 the Committee requested that the US mortgage business be reviewed in early 2007 as one of the key risk issues. This was presented in March 2007 and included an analysis of stress loss scenarios under adverse market conditions. Management took decisions during the first half of 2007 to reduce limits in this business and, given the volatility in the credit markets during 2007, the Committee subsequently received regular reports on market conditions.

11. Additionally, at the start of 2008 we launched a formal programme to give greater protection to our credit portfolios in the UK, US, Spain and South Africa. As a result of our risk assessments we took more than 300 immediate actions, including changes to lending criteria, limits and collections. We also decided to take more than 100 strategic actions, including decisions to reduce market share and increased use of hedging. This work is being extended to our emerging markets business as the global economic downturn expands.

12. We fully recognise that the compensation environment has changed. Our approach is to pay for performance. When profit falls, variable pay falls. Our total pay bill in 2008 was down 10% despite taking on 20,000 more staff. Our profits for 2008 were down 14% but our variable pay bill was down by 48% (over 50% in Barcap).

13. We welcome the announcement on the Walker Review and will work with the authorities to ensure remuneration structures align with the long term interests of shareholders.

14. We are co-operating with the FSA in their on-going review and will consider incorporating any further guidance into our ongoing reviews of pay structures.

15. 75% of our compensation for Executive Directors in 2007 was performance related and 47% long term. Long-term incentives are linked to share price, economic profit and total shareholder return.

16. The average 2008 base pay for a cashier in our branches is £14,600, with a £800 bonus.

Consumers

17. We have a low-risk approach in our mortgage business. Our average residential loan-to-value ration in December was 39%. We don't offer sub-prime or self-certified mortgages. As a result of the contraction of the mortgage market we have however seen an increase in our share of new lending in the market.

18. At 70%, the vast majority of our mortgages are trackers which means rate changes are passed on. Customers with these mortgages will have seen a 4% decrease in their interest rate over the last few months. Approximately 25% of our existing mortgage customers are on fixed rate mortgages which will revert to a base rate tracker mortgage at the end of their mortgage term. Our recently announced Woolwich mortgage is available at a fixed-rate of 2.29%. This is the lowest rate in the history of the Woolwich. Only approximately 2.5% of our customers are on standard variable rates.

19. The table below sets out the changes customers will have seen in their mortgage rates since August 2007.

Month of BOE decision	*BOE Base Rate change*	*Barclays tracker change*	*Barclays SVR change*	*Effective Date* *For existing borrowers*
August 2007	+0.25%	+0.25%	+0.25%	1 August 2007
December 2007	−0.25	−0.25	−0.25	1 January 2008
February 2008	−0.25	−0.25	−0.25	1 March 2008
April 2008	−0.25	−0.25	−0.25	1 May 2008
October 2008	—	—	—	1 November 2008
	0.50%	0.50%	0.50%	
November 2008	—	—	0	1 December 2008
	1.50%	1.50%		
December 2008	—	—	—	1 January 2009
	1.00%	1.00%	1.15%	
January 2009	—	—	0	1 February 2009
	0.50%	0.50%		
February 2009	—	—	—	1 March 2009
	0.50%	0.50%	0.50%	
Total	—	—	—	
	4.00%	4.00%	2.15% (rate of 4.99%)	

20. Our low risk approach and effective approach to managing risks means we only repossessed 300 properties in 2008, which represents less than 1% of the industry total.

21. Barclays has always had very limited participation in the higher risk mortgage market and has never offered 100% loan to value, non-conforming or self certified loans. With increasingly negative house price expectations in October 2008 the maximum loan to value was reduced to 85% to help avoid future problems customers may have with negative equity.

22. Barclays is fully open for business and we expect to grow our savings balances in 2009. While the low rate environment could be perceived as making saving less attractive, we still expect some customers to save as a response to the wider economic situation. Since October we have passed on less of a reduction in our savings rates than there have been reductions in the Bank of England base rate. The table below sets out changes in savings rates since October 2008.

Month	*Bank of England Base Rate Moves*	*% of book where we have passed on less than base rate*	*% of book passed on full base rate*	*% of book where we have passed on more than Base Rate.*
October 2008	−0.50%	0%	100%	0%
November 2008	−1.50%	0%	100%	0%
December 2008	−1.00%	2%	88%	10%
January 2009	−0.50%	45%	55%	0%
February 2009	−0.50%	78%	22%	0%

23. Our experience throughout the recent financial turmoil is that there has been a flight to quality. As a well capitalised, profitable bank we saw no discernable impact on our deposits either in the UK or Ireland as a result of the guarantees provided by the Irish authorities. There was some modest movement of funds that would not have been covered by the FSCS, but these were not material relative to the balance sheet. We monitor personal customer balances on a daily basis, and if anything, there has been a marginal increase in those balances since the Irish announcement. We saw no discernable impact at Barclays Bank Ireland PLC, although we monitored the situation closely. At no stage did we consider asking the Irish Government to extend the guarantee to cover our Irish subsidiary.

24. Under normal circumstances there is no need for harmonisation of compensation limits. We have lived with significant discrepancies between national banking industries and within countries (between banking, insurance and investment schemes) for years without impact. Discrepancies in levels of compensation have not been an issue when individual banks fail in otherwise benign conditions.

25. Under normal circumstances, firms do not compete on the basis of their insolvency arrangements. In systemic crises, creating competition through deposit scheme limits can be destabilising, and it would be better that this was understood and avoided rather than further harmonisation of deposit limits. It is difficult to establish a limit that has a similar impact between Western and Eastern Europe, given different income levels. However, provided the principles leading to the development of proportionate compensation limits could be agreed, then we could see some advantage to having a harmonised limit.

26. As a result of the mergers, consolidations and collapses seen amongst both domestic and foreign players in the UK market in recent months, there are now fewer participants in the retail financial services market. The impact of this is already being felt by consumers through the disappearance of key players from the mortgages and business lending markets. Whilst the remaining institutions continue to lend to customers (and, in the case of Barclays Local Business, increase their lending), it is unsurprising that demand can exceed supply when players such as Northern Rock and the Icelandic banks that represented large proportions of the supply side of the market withdraw. Business lending supply fell by around 40% as a result of the reduction of lending from foreign and non-bank groups.

27. We think that the costs of developing a pre-funded compensation scheme considerably outweigh the limited benefits both for consumers and banks. We oppose a pre-funded scheme for a number of reasons:

(a) Immediate access to funds—The FSCS already has quick access to funds via the National Loans Fund (NLF) should it need these to make compensation pay outs. NLF funding was successfully used in the case of Bradford & Bingley.

(b) Failures to meet objectives—The objective of any pre-funded scheme must be that it can meet the compensation needs of any bank that collapses. This may work in certain countries but this will generally be those with smaller banks and in a more diffuse market. We do not believe that it is realistic to build up the very significant fund required were one of the medium or large UK banks to fail.

(c) Opportunity costs—HMT has estimated that the minimum funds in the pre-funding pot would initially need to be about £13 billion. We expect this figure would increase over time, especially if the compensation level continues to rise. Assessments by HMT suggest that the opportunity costs to the industry of losing this money would be between £236 million per annum and £118 million per annum.[15] We believe this to be unrealistic.

(d) Market impacts—Since the money invested by any pre-funded scheme would need to be in liquid assets there is also a risk that the significant amount of money invested in fairly liquid assets could distort markets.

28. In an already mature market, simple, transparent products and customer service are key for customers as the dust settles on the turbulence of 2008. Barclays is already on the front foot, with initiatives such as its innovative Personal Reserve service on current accounts to help customers through moments when money is tight, and the regular mystery shopping of service standards in our branches.

29. Throughout the market turbulence of the last six to nine months, Barclays has ensured our frontline colleagues have been equipped with messages and communications to reassure customers that their money is safe with Barclays and will continue to be safe with us, as well as answer any questions they may have. This has included an open letter from our Chief Executive to customers and messages in customers' monthly bank statements. We have also made this information available to customers on our website.

30. We have communicated effectively to make sure our small business customers are aware that we are not only continuing to lend to the sector but actually increased our lending to it in 2008 compared to 2007. Additionally, in December we committed to making at least a further £1.6 billion available to SMES in 2009, bring our total commitment to £16.5 billion. We were the first bank to sign up to the European Investment Bank scheme for lending to small businesses and also helped to shape, actively promote and make our customers aware of the Government's Enterprise Finance Guarantee. As a result, we have now processed 644 applications for a total sum of £34.5 million. 52% of these applications have been agreed, totalling £16 million at an average of £49,000 per loan.

31. We are maintaining our strategy of building all our products and services based on real customer needs and putting customers at the centre of everything we do. We have been working to this strategy for the last three years and that has already delivered great results for our customers. We ran over 500 savings and investment seminars for customers in 2008 with bank experts providing advice and guidance to customers on how to get the most out of their money in the downturn and tips on saving in a low interest rate environment. At least 1,000 more of these seminars up and down the country are planned for 2009. We have also added guidance on our website for customers on managing their money in the downturn. We believe that helping consumers improve their levels of financial know-how through initiatives such as these, alongside the objectives of the Government's financial capability action plan, have a crucial role to play in rebuilding consumer confidence in the banking system.

32. Barclays believes that financial inclusion and access to the banking system is even more crucial in times of market turbulence and so continues to work with the Government and the third sector to reach those that currently don't have a bank account. As part of this, we have undertaken many enhancements to our basic bank account product for new-to-banking customers, creating a proposition that is now market-leading. Cash Card Account customers can: choose between a debit card or ATM-only card; use any Barclays branch, Post Office, our Telephone Banking service or online banking to manage their money; benefit from the lowest unpaid fees in the market if a payment is returned due to insufficient funds, and rest assured that the account will not let them go overdrawn.

[15] HM Treasury, Banking Bill Impact Assessment, October 2008.

33. As part of our commitment to our small business customers, Barclays is providing practical support to help them through these uncertain times. This includes a programme of "Let's Talk" seminars, focusing on setting-up, surviving and thriving in the current economic climate. They are free, run in conjunction with the National Enterprise Network (NFEA) and open to all individuals either thinking about starting up or already running a business. In the past three years we have provided training to more than 40,000 business owners, giving them the essential skills to run a successful and profitable business and another 500 Let's Talk events are already planned throughout the UK in 2009.

34. We have also developed CREDITFOCUS for small businesses—a comprehensive and easy-to-use online credit management service that offers business owners the ability to check, monitor and chase the businesses they trade with, enabling them to protect their business from the risk and pain of late payments and bad debt.

The Financial Services Authority

35. Barclays was—and is—subject to close and continuous supervision by the FSA. This has meant that FSA had—and maintains—a close working relationship with senior management at Group Centre and in the businesses.

36. FSA has always adopted a probing and questioning approach, notably through the ARROW risk assessment framework, looking better to understand Barclays, its business and its plans.

37. If we are looking at our relationship with the FSA since the events at Northern Rock there is probably a need to distinguish between activities related to the crisis and the new "business model" of the FSA.

38. As is to be expected, there has been enormous amount of interaction related to the market turmoil. This relates both to Barclays as an institution and to the FSA seeking to understand market developments through contact with Barclays senior management and staff. Reporting and data flows are extremely significant and have increased dramatically as a result of the crisis.

39. It is a little early to discern all the changes that the FSA's new business model will bring, although we have noted an increased intensity of regulatory interaction. Our FSA supervision team has been reinforced in numbers and now only focuses on Barclays (it previously also supervised another major UK bank). FSA has always focused on senior management responsibilities and on probing management and the business. This has perhaps become more intensive, but is more a matter of greater emphasis, rather than a complete rupture with the past.

40. We note a greater assertiveness in how the FSA has dealt with third parties and in its presentation of policy and its own business plan. We also have noted the use of enforcement seeking "credible deterrence" and the increase in penalties imposed by the FSA.

41. With regards to the FSA's work on the competence of senior management we note the FSA's intentions in respect of interviewing certain members of senior management before confirming their appointment in future.

The Future of Banking

42. Any solutions to address the recent problems in the financial markets must find a way of addressing macro-prudential trends through more effective day to day regulation. There is an ongoing debate about the role the Bank of England should play in this respect. If the aim is to prevent macro-economic bubbles from being created then there is a role for counter-cyclical capital requirements. There would need to be some international consistency in defining these, although this will be difficult.

43. It is important that central banks and regulators communicate fully so all the available tools and data are used appropriately before rushing to create new tools. There is also a debate about the extent to which monetary policy tools could be used to support financial stability objectives and to prevent or burst bubbles.

44. We welcome the FSA's December consultation paper on liquidity and are currently considering our response. As a working draft, the proposals represent a degree of progress towards trying to establish a credible regime for liquidity regulation. However, they do not yet represent a complete solution with some areas requiring much more development.

45. The proposed Individual Liquidity Assessment and "liquidity buffer" are predicated on positioning a bank to be able to survive a name-specific and market-wide stress for a defined period of time. The quantification and form of the liquidity buffer will create significant issues for the banks and the economy more broadly and therefore this policy needs to be carefully thought through prior to implementation.

46. Liquidity risk usually crystallises as a result of some other risk event, and the approach taken by the FSA needs to fit with other measures to prevent crises. Regulators should not construe liquidity risk as a discrete item. What is important is the interplay between all risk types and the deployment of sensible risk controls in the round. Such an approach would allow for a more accurate calibration of "liquidity buffers" that balance the regulatory imperative with the economic drag otherwise implied by simplistic regulation.

47. The pro-cyclicality of Basel needs to be addressed because of the impact it has on banks in a recession. For instance, the amount of capital that a lender has to hold for each mortgage in arrears is between 30 and 80 times that of a new mortgage. Therefore in a downturn such calculations considerably reduce the lending banks can make.

48. We have seen a material increase in risk weighted assets during 2008. The increase has so far been seen primarily in the trading book but we expect to see an increasing impact in our commercial and retail banking operations as both the probability of default and loss given default increase. The retail and commercial element will to some extent reduce as a result of the recent change in approach by the FSA and the introduction of variable scalars.

49. This procyclical capital requirement is amplified by accounting practices that result in reporting losses, and reductions in capital, that do not necessarily reflect the underlying expectations on asset performance.

50. Capital should not be the answer to liquidity risk and will not prevent a bank getting into difficulty should its creditors lose confidence. Regulators should focus on the term structure of banks and encourage them through regulatory rules/financial incentives or penalties to reduce the risk in their funding profile. One of these incentives could be higher capital requirements, but it should be clear that such requirements are an incentive to change rather than a mitigant to risk. We think there are better ways of addressing the problems identified by Andrew Crockett and raised in the questions sent to us.

51. We have provided details about our capital levels since 1998 in Annex B.

52. Barclays is one of a few truly universal global banks, with the group diversified by business line (retail banking, commercial banking, cards, investment banking, investment management, wealth) as well as geography (UK, US, Europe, Emerging Markets).

53. The argument against separating traditional banking activity from investment banking activity focuses largely on how the model benefits customers, who derive significant qualitative benefits from Barclays structure.

54. For our customers, this universal model means they have access to all the expertise that the Barclays businesses have to offer through one relationship. For instance our UK commercial business customers in Barclays Commercial Bank benefit from the linkages with Barclays Capital. Barclays Capital is a global leader in risk management, providing risk management solutions to businesses to reduce their risks (eg from changes in interest rates, currencies or commodity prices). Barclays Capital's innovations in this area have brought risk management instruments to UK mid-market companies that were once available only to large corporates. This is increasingly important to our UK commercial customers given the current increased economic volatility.

55. The universal banking model provides considerable benefits for a wide range of stakeholders including medium and large corporate clients, governments and shareholders. The universal banking model helps diversify risks across sectors and geographies and therefore to reduce the risk of systemic risk. One of the reasons for Barclays continued profitability is the balance that our universal banking model has provided.

56. We obtain significant synergies from housing different banking operations under one roof in terms of risk management and effective, economic use of capital. These synergies provide significant benefits for our clients and shareholders, most of whom are pension funds.

57. Moves to separate retail and commercial banks from investment banks would have considerable negative impacts including reduced synergies between businesses, reduced product offerings for commercial customers and the increased concentration of risk. Such moves would also be likely to result in less competitive wholesale and retail markets and there is no evidence to suggest that market stability would be strengthened as a result.

58. If the UK were to seek a unilateral move to separate these operations there would be a significant negative impact on the UK's competitive position both because of reduced profitability in the financial services sector but also reduced financing options available for UK businesses.

59. For Barclays, the benefits of this diversification is a spreading of risk across sectors and geographies, which is evident in our resilient performance in the turbulent global markets of 2007 and 2008. It also allows us to benefit from synergies across the businesses in terms of risk management, shared global services and operations and an effective, economic use of capital.

60. Recent events in the United States have highlighted that the move from stand alone investment banks to universal banks is preferable for financial stability. Over the last year in the US we have see the following moves:

(a) Bear Stearns taken over by JP Morgan.

(b) Merrill Lynch taken over by Bank of America.

(c) Part of Lehman Brothers taken over by Barclays.

(d) Morgan Stanley and Goldman Sachs have become bank holding companies.

61. These changes highlight the fact that the universal banking model has been resilient through the recent market dislocation.

March 2009

Annex A

CHANGES IN OUR BUSINESS

		1988		*1997*		*2008*	
Total Assets (£m)		104,645		232,429	9%	2,052,980	22%
PBT (£m)		1,391		1,697	2%	6,077	12%
Investment Banking Assets (£m)	(a)	4,504	(b)	143,318	(c)	1,700,457	
		4%		62%		83%	
Investment Banking PBT (£m)		33		84		1,897	
		2%		5%		31%	
UK Assets/Total Assets		72.5%		62.8%	(d)	35.0%	

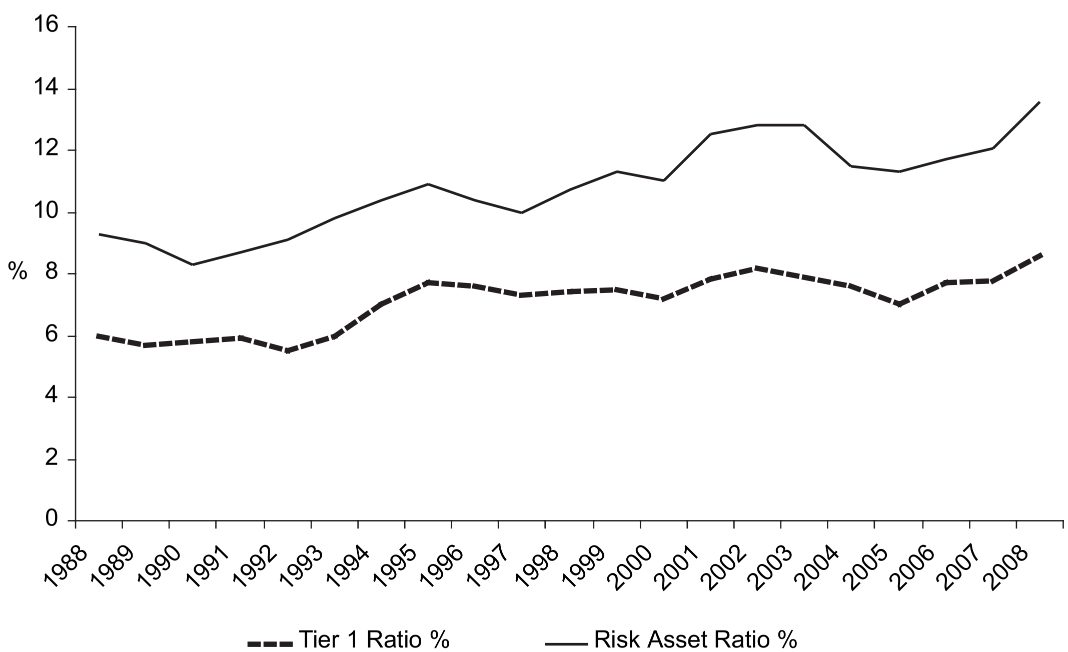
Notes:
(a) 1988—BZW assets only
(b) 1997—BarCap, Old BZW and BGI assets
(c) 2008—BarCap and BGI assets
(d) 2007 percentage as we have not published a number for 2008

Sources:
1988 Barclays PLC Annual Report
1998 Barclays PLC Annual Report
2008 Full Year Results Announcement

Annex B

CAPITAL LEVELS SINCE 1998

	’88	’89	’90	’91	’92	’93	’94	’95	’96	’97	’98	’99	’00	’01	’02	’03	’04	’05	’06	’07	’08	Average
Tier 1 Ratio %	6.0	5.7	5.8	5.9	5.5	6.0	7.0	7.7	7.6	7.3	7.4	7.5	7.2	7.8	8.2	7.9	7.6	7.0	7.7	7.75	8.6	7.10
Risk Asset Ratio %	9.3	9.0	8.3	8.7	9.1	9.8	10.4	10.9	10.4	10.0	10.7	11.3	11.0	12.5	12.8	12.8	11.5	11.3	11.7	12.06	13.55	10.81



Supplementary memorandum from Lloyds Banking Group

In response to the Committee's further request for supplementary evidence, the following information is provided on behalf of the Lloyds Banking Group.

As the Committee will be aware,in January 2009, the Lloyds TSB Group plc acquired HBOS plc and the Group's company name changed to the Lloyds Banking Group plc. For the purposes of comparison, the historic data provided in this response relates to theLloyds TSB Group only. Since the Lloyds TSB Group is a product of the merger between Lloyds Bank plc and the TSB Group plc in 1995. It has not been possible to provide some data for the period 1987 to 1997 as it is not appropriate to compare the Lloyds TSB Group to Lloyds Bank and TSB Group, which traded as separate entities until the merger.

Background Information

1. *How rapidly did your bank grow from 1997? And for the 10 years before that?*

Compared to 1997, Lloyds TSB Group's profit before tax in 2007 was up by 27%. The Lloyds TSB Group was formed from the merger of Lloyds Bank and TSB in 1995 and it has not, therefore, been possible to provide historic data to provide a comparison with 1987.

2. *How did tier one and two capital ratios change over both these periods?*

Lloyds TSB Group	*1987*	*1997*	*2007*
Tier 1 Capital Ratio	Not available	7.9%	8.1%
Tier 2 Capital Ratio	Not available	5.5%	5.8%

3. *What happened to holdings of British government securities over the two periods?*

This information is not available.

4. *What happened to the size of investment banking relative to "high street" banking over the two periods?*

The Lloyds Banking Group's activities are predominantly retail and commercial banking and this has not changed significantly over the two periods.

5. *What share of business was domestic at the beginning and end of each period?*

Lloyds TSB Group	*1987*	*1997*	*2007*
Domestic	Not available	86%	98%
International	Not available	14%	2%

This reduction largely reflected the disposal of overseas businesses over the period.

6. *What was the share of bonuses in total remuneration 20, 10, and one year ago?*

For executives of.Lloyds TSB Group, the proportion of remuneration paid as bonuses over the period in question is as follows:

20 years ago	*10 years ago*	*1 year ago*
Not available	28%	33%

7. *Did you stress-test your balance sheet against a scenario where the wholesale funding markets closed down?*

Lloyds TSB stress tested its balance sheet against a variety of different scenarios impacting the wholesale funding markets. However,like most banks, we did not stress test against a complete close down of the wholesale funding markets. Lloyds TSB also stress tested against several adverse economic scenarios.

CONSUMERS

8. *Bank Rate has fallen sharply. Please provide figures showing the extent to which you have passed through these falls to both savers and borrowers*

The Lloyds Banking Group offers a wide range of borrowing and saving products to many different customers with differing requirements and it would be impracticable to list every product here. However, the table below shows how Lloyds TSB passed on reductions in the Base Rate to its mortgage and Easy Saver customers.

	October Decision	*November Decision*	*December Decision*	*January Decision*	*February Decision*
BBR Reduction	0.5%	1.5%	1.0%	0.5%	0.5%
Bank of England Base Rate	4.5%	3.0%	2.0%	1.5%	1.0%
Lloyds TSB Mortgate SVR Reduction	0.5%	1.5%	1.0%	0.5%	0.5%
Mortgate Standard Variable Rate (SVR)	6.5%	5.0%	4.0%	3.5%	3.0%
Lloyds TSB Savings Reduction	0.5%	1.5%	0.5%	0.0%	0.0%
Lloyds TSB Easy Saver	3.0%	1.5%	1.0%	1.0%	1.0%

9. *What impact do you foresee on your deposit base of interest rates remaining at historic lows, and will this impede your ability to lend?*

Clearly, in a low interest rate environment, there is a reduced incentive for consumers to save. However, increasing levels of unemployment and reduced personal liquidity caused by the recession will also mean that consumers are less able to save and may draw on savings to supplement reduced income.

Reduced interest rates will have a similar impact on all banks and we do not anticipate any impact on the LloydsBanking Group's ability to attract deposits in line with its market share.

The bigger impediment to lending is that a low interest rate environment may reduce the time horizon out to which investors are willing to lend (in the expectation of higher future rates). This will affect tenor rather than volume.

10. *Given that the present crisis proves that large banks can fail and that UK banks benefit from the assurance a deposit protection scheme gives to consumers, should the FSCS now be pre-funded?*

It would take several decades to accumulate a fund of sufficient size to be able to fully compensate depositors of any sizeable failed institution. In addition, pre-funding of the scheme would represent a counter-productive ongoing diversion of scarce capital, which could otherwise be employed to greater immediate consumer benefit, eg to grow lending in line with the Government's.objectives.

11. *How badly were you affected by the Irish decision to guarantee all deposits?*

There has been no material impact on Lloyds TSB Bank as a result of the Irish Government's announcement on 30 September 2008.

12. *How far is harmonisation of deposit limits needed across Europe?*

The European Commission has announced proposals to set financial compensation limits across Europe at €100,OOO from 2010, which will bring harmonisation to EU schemes. Harmonisation will never be precise due to fluctuations in exchange rates and we consider the proposed limit to be unnecessarily high; but harmonisation in principle supports the concept of a "level-playing field" for banks.

13. *Once this crisis is over, how different will the financial services landscape be to what consumers could have expected in 2006 and 2007?*

As banks look to minimise their wholesale funding requirements, we are likely to see aggressive competition for bank deposits, leading to more attractive savings rates for consumers which in turn will feed through to higher borrowing rates. Across the market, there is also likely to be a return to borrowing terms akin to historical norms, eg loan-to-income ratios of 3-3.5 times for mortgages. We may also see a stricter burden of proof for affordability, including the possible end of self-certification.

We have already seen consolidation within the banking sector, which has led to a smaller number of large banks and building societies, with well known and trusted brands, able to attract a large stable deposit base.

14. *What are you currently doing to manage consumers' expectations of what will be available in a post-crisis world?*

We have already seen some changes to the terms and availability of products as a result of the financial crisis. For instance, we have seen a.number of lenders reduce loan-to-value ratios. This inevitably means that consumers will have to save more to obtain a mortgage and will generally need to plan better financially in the future.

A key part of the Lloyds Banking Group's strategy going forward is to further support consumers' needs for financial planning and literacy by offering appropriate tools and advice for customers and providing a broader range of saving and protection products to encourage customers to plan for the long term.

Specifically, we are encouraging consumers to save through incentives and innovative saving tools, such as our "Save the Change" product and competitive rates of Interest. We are also offering a range of expert money management tools, including our in-branch Financial Health Check, designed to help customers to manage their money better and plan for the future.

15. *What are you doing to rebuild consumer confidence in the banking system?*

Lloyds TSB has been voted "Britain's Most Trusted Bank" brand[i] since 2001 and since the Autumn, we have run an advertising campaign in the national media drawing on these credentials in order to reassure customers of our financial strength and stability. A number of other major UK banking institutions have run similar campaigns in recent weeks.

The Lloyds Banking Group has also undertaken a number of signature actions demonstrating our commitment to customers, including:

— In January, the Lloyds Banking Group announced that it will be proactively reuniting customers with over £22 million in dormant bank accounts.

— Both Lloyds TSB and Bank of Scotland announced charters' for their SME customers to provide reassurance that we are committed to working with our small business customers through these difficult times.

— Lloyds TSB passed on every reduction in the Bank of England Base Rate. to its mortgage customers.

— We are also proactively approaching customers showing signs of financial difficulty in order to tackle and address any problems early on.

16. *Will you be reducing the level of potentially riskier lending to lower-income individuals?*

As the Committee will be aware, we have made a number of commitments with regard to our future levels of lending, including in relation to the residential mortgage market. However, the Lloyds Banking Group is a prudent bank and therefore our acceptance criteria for lending applications will continue to reflect our current risk appetite together with our own and regulatory standards for responsible lending and fair customer treatment. Our ability to leridwill be affected by the extent to which consumers are impacted by the real economy, eg further increases in the rate of unemployment, and consequent impacts on demand.

The FSA

17. *How would you describe your engagement with the FSA before the current crisis?*

We have always sought to adopt an open and collaborative approach towards our relationship with the FSA. OUf objectives and our aim to build strong, long-lasting customer relationships are well aligned with the FSA's statutory objectives, for instance in ensuring stable markets, and reducing financial crime. It is in,ourinterest to have a competent,independent and strong regulator.

Prior to the current crisis, the FSA's focus of activity was more on conduct of business (COB) aspects of regulation, especially the need to treat customers fairly, than on prudential aspects, for instance, liquidity or the pro-cyclical aspects of the Basel II capital requirements, or governance and risk control.

18. *Did the FSA ever express concerns to you about your business model. or request a slow-down in lending?*

In the FSA's April 2008 Risk Assessment, it recognised Lloyds TSB's achievement in maintaining funding through the market turbulence of late 2007, which reflected the market perception of a lower risk business model. The FSA did comment that that there were a range of known or potential shocks which could put pressure on Lloyds TSS's financial resources, but at no time did it directly request a slow-down in lending.

19. *How has your interaction with the FSAchanged since the crisis.at Northern Rock?*

We remain committed to maintaining a close and collaborative working relationship with the FSA. The overall volume of interaction has increased with daily interactions on wholesale and retail deposit flows and liquidity monitoring with an increased emphasis on scenario planning and stress testing. We have also seen a sharp increase in the volume of data information requests and a greater focus on pro-cyclicality.

20. *One of the features of the FSA's supervisory enhancement programme is that "there will be raised emphasis on assessing the competence of firms'senior management". Have you seen any evidence of that?*

The FSA maintains a high level of direct engagement with a wide range of senior "management across the Group through its "close and continuous" supervisory meeting schedule, which we con'sider helpful. The FSA has made it clear that it will be seeking more tir:ne with Group Executive Directors and senior management across the Group. We remain committed to ensuring that the FSA has appropriate access and we welcome this.

The Future of Banking

21. *Do you consider pro-cyclicality of capital requirements to bea problem?*

The current situation whereby Risk Weighted Assets are more sensitive to changes in the economic cycle under Basel II is potentially exacerbating the effects of the downturn, by causing banks to bolster capital positions and thus restricting the ability to lend. This in turn risks further aggravating the economic downturn.

It is important that international regulators adopt a common approach to addressing this issue, both by stabilising the Risk Weighted Assets and permitting a more dynamic target ratio.

22. *Andrew Crockett former general manager of the Bank for International Settlements has suggested that it would be advantageous for higher capital ratios to be imposed on institutions that were more reliant on short-term funding. Do you agree?*

We do not consider that capital should be seen as an appropriate mitigant for liquidity risk, for which comprehensive stress testing is a key component of effective risk management. However, the Regulator's risk assessment of firms (which in turn leads to determination of minimum regulatory capital requirements under Pillar 2 of Basel II) should reflect the nature of a firm's business model and funding profile, its governance framework and the strength of its Board and management.

23. *The FSA has brought forward proposals on liquidity regulation, including an Individual Liquidity Assessment. and a "liquidity buffer" specific to each firm. Are you confident that their proposals amount to an effective way to assess and limit the liquidity risks which individual institutions face?*

The proposals reflect many of the developments made by larger organisations in recent years, particularly on the qualitative side, and will be an improvement on the existing standards. However, the quantitative framework must be adapted to reflect the quality of the individual firm's management and there are certain areas which will require further discussion, not least of which is the definition of a "liquid asset".

24. *Paul Tucker and Charlie Bean have both suggested that the Bank of England should have some kind of macro-prudential risk instrument to guard against sector-wide risks. What form do you think such an instrument could reasonably take?*

These proposals are seeking to address the pro-cyclicality issue by requiring banks to establish larger capital buffers during the benign part of the economic cycle, so that they are better able to absorb losses during the downturn, when minimum capital requirements may also be relaxed. This is to some extent, being addressed through the FSA's current proposals with regard to benchmark capital ratios. We support the use of scalars or through-the-cycle models. We consider these to be preferable to "dynamic provisioning", which can be difficult to reconcile with currerit International Accounting Standards.

25. *How far do you agree with Jon Moulton that "Supervision and regulation will only work if it is within the capabilities of the people involved to actually discharge those duties"?*

We welcome the recognition, through the FSA Supervisory Enhancement Programme, that FSA supervisory staff skills need to be further developed, particularly the ability to adopt a consultative and risk-based approach, backed by a deep understanding of the business and the business model.

FSA management recruitment and retention strategies must, therefore, be sufficient to attract.and retain highly skilled staff.

26. *Do you think that the FSA can properly regulate you as you are currently configured?*

Yes. We believe the FSA's existing suite of supervisory powers and tools are sufficient for their purposes provided that they are applied appropriately.

27. *What are the strongest reasons• both for and against the separation of traditional. narrow banking activities from riskier trading and investment banking activities by your organisations?*

Whilst restricting a bank's activities to traditional, narrow banking may reduce systemic risk, this can be achieved in other ways, eg through enhanced risk management requirements within banks, enhanced supervisory capabilities and. higher capital requirements for trading and investment banking activities. However, a traditional banking model, more akin to bUilding societies, may enhance depositor trust.

Narrow banks would be less able to serve the full needs of retail and commercial customers, many of whom want their main relationship bank to help them manage and hedge risks in their finances or business through investment banking type capabilities.

It would be very difficult to draw, and maintain, clear boundaries between "narrow" banking and trading/ investment banking, eg at what point does foreign exchange dealing on behalf of customers become trading/ investment banking and how would the swaps necessary to offer customers fixed-rate mortgages or commercial loans be classified?

The collapse of Lehman Brothers has also demonstrated that the demise of pure investment banks can cause system-wide problems.

Reference

[i] Reader's Digest Most Trusted Brand -UK BankIBuilding Society, 2008.

March 2009

Letter from Sir Fred Goodwin to John Mann MP

Thank you for your letter of 2 march 2009, which has only just reached me, in which you question the accuracy of an answer which I provided to the Treasury Select Committee during the hearing on 10 February 2009.

I am grateful to you for setting out in your letter both your question and my reply from the uncorrected transcript of the evidence. Having reviewed my answer, I believe that it is both accurate and relevant to the question you posed, but it may be helpful if I expand upon it.

You asked whether it would be fair that my pension should be linked to the value of the Bank's shares. I replied that my pension was determined in the same manner as other members of the defined benefit scheme. No members of the defined benefit scheme have their pensions linked to the value of the Bank's shares, and indeed it has been the thrust of regulation and best practice over the years to restrict pension fund investment in the shares of the sponsoring company. Pensions payable from defined benefit schemes are related to pensionable service and salary, and not the value of the underlying fund.

Your letter goes on to raise the separate question of how individuals are treated in the event of their early retirement, which was not a question I envisaged by my answer at the hearing. That said, my answer would have been similar. The treatment of my early retirement is consistent with The Bank's usual practice. I understand the practice has been adopted over many years within the defined benefit scheme, extending back, as I understand it, some time before I joined the Bank.

You mention that you had spoken to others working within the Bank to whom this does not apply. Without knowing the individuals' circumstances, I cannot comment, but it is worth bearing in mind that not all employees are members of the defined benefit pension scheme.

I hope that this reply reassures you that my answer to the question raised in the hearing was correct, and that my answer to the question raised in your letter has been helpful.

11 March 2009

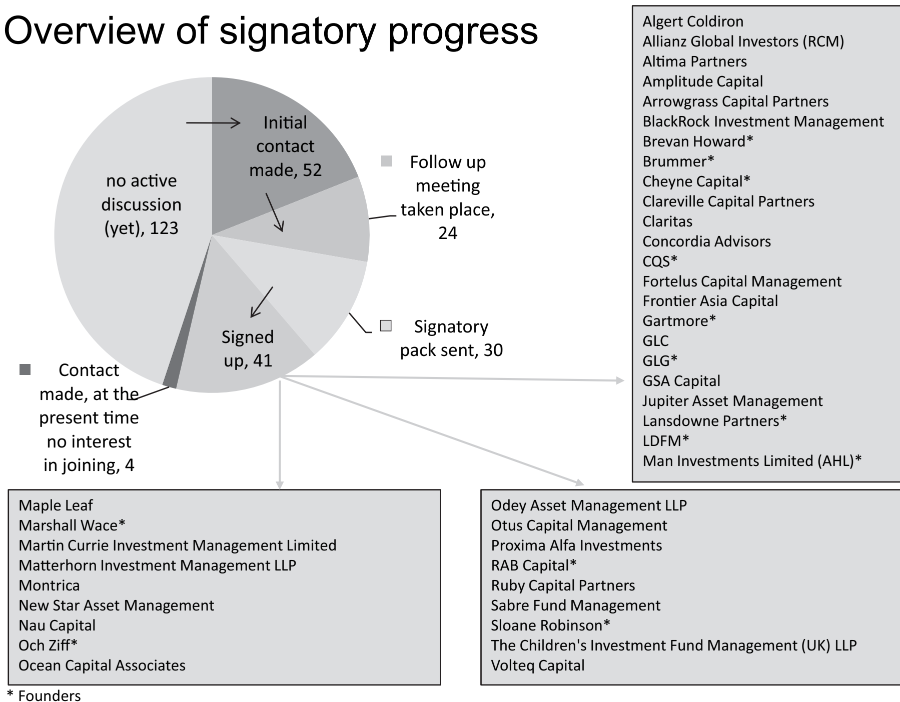
Supplementary memorandum from the Hedge Fund Standards Board

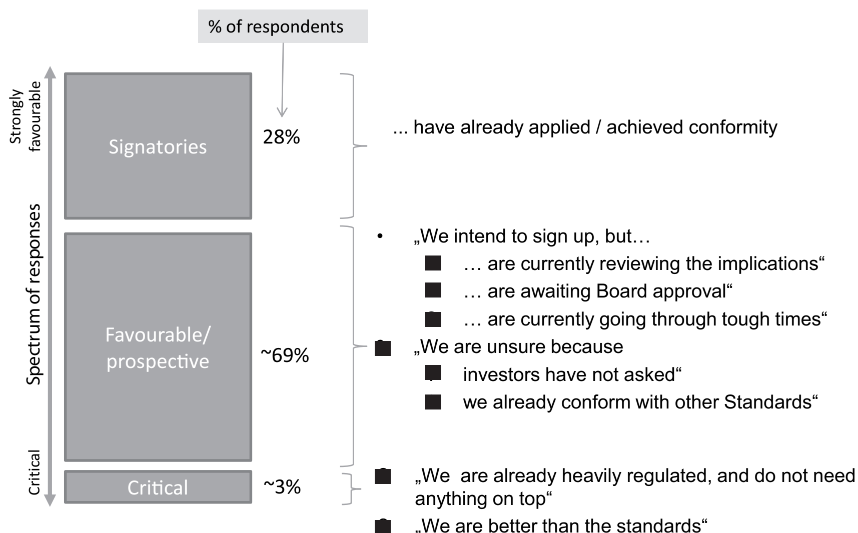
Introduction

At the hearing of the Treasury Select Committee (the "Committee") on Tuesday 27 January 2009, Antonio Borges, Chairman of the Hedge Fund Standards Board Limited ("HFSB"), gave evidence to the Committee in relation to its continuing investigation into the banking crisis.

At the hearing, Mr Borges confirmed that the HFSB has had a number of private discussions with hedge fund managers to gauge their interest in signing-up to the HFSB's best practice standards.

This document provides, as requested by the Committee, an overview of those discussions, together with a qualitative assessment of the responses received. The HFSB hopes that the Committee will find this information helpful.





Letter from Lord Myners to the Chairman of the Committee

I was grateful for the opportunity to appear before the Treasury Committee last week and discuss matters of relevance to the banking inquiry.

A large portion of the session was taken up by discussion of Sir Fred Goodwin's pension following his departure from the Board of RBS and this has received continuing press coverage. Beginning in Saturday's *Times (Lord Myners "knew about massive pension payout for disgraced banker",* 21 March 2009) there has been some commentary on a letter that Sir Tom McKillop has sent—or is perhaps planning to send—to the Committee. Some of this coverage has called into dispute what I said to the Committee with regard to what I knew of the size of Sir Fred Goodwin's pension pot during the Government's negotiations with RBS last October.

Can I point to my answer to question Q2659 in the uncorrected evidence, specifically where I said:

> The following evening (12 October) I was telephoned by a director of RBS, Mr Robert Scott, and during the course of that conversation was told of the then estimated transfer value of Sir Fred Goodwin's pension. At no stage prior to February of this year was I, or anyone else in the Government, as far as I know, made aware that in the process of replacing Sir Fred Goodwin RBS had exercised a discretion which (apparently) allowed him to take his full, undiscounted pension from the age of 50 and thereby nearly doubled the value of his pension.

I clearly did tell the Committee that I knew the value of the pension in October.

As both the Vice-Chairman, Mr Fallon (quoted in The Sunday Times) and Mr Tyrie (quoted in *The Times*) have questioned whether I misled the Committee, I would like to request that I be sent a copy of any submission from Sir Tom McKillop as soon as the Committee receives this.

Last Tuesday's Committee session was not the first occasion when I have made a public statement on this point. For example, in response to a written Parliamentary Question from Lord Taylor of Warwick (5 March, *Official Report: column WA172 and WA173*) I stated:

> "I was informed of an estimate of the capitalised value of the pension late on 12 October 2008. What I did not know—and only recently became aware of—was that the approval of the proposed pension arrangements by the Remuneration Committee of RBS was based on a decision to treat Sir Fred Goodwin as having retired at the request of the company, and that this involved an element of discretion which had the effect of significantly increasing his pension".

I have been consistent and clear about this matter and I am therefore keen to see any statements to the contrary, especially those that the Treasury Committee receives as part of your inquiry. In particular, if allegations are made contradicting what I told the Committee I would like the opportunity to respond to them.

Paul Myners
Financial Services Secretary to the Treasury

23 March 2009

Memorandum from Peter M Brown

The points that you should consider relating to remuneration committees, based on my direct experience, are:

(1) The composition of the committee. I have been a lone voice for years recommending to Peter Montagnon of the ABI, major investment organisations like Hermes and Derek Higgs that remuneration committees, particularly in SME companies, are dangerously amateur groups.

Unlike audit committees which are normally full of qualified accountants or finance directors of other companies, remuneration committees have very few if any remuneration expert members. Non-executives often have executive experience of a single company where they were previously chief executive and simply advocate that company's system whether or not it's appropriate to the company where they sit as a non-executive.

To make remuneration committees more effective, they must have an outside expert member who is not a non-executive director of the company.

This is also important as the remuneration committee is, based on my experience as a quoted company chairman, extremely concerned about major dissension on the board which would be created if remuneration issues are not settled in a way that executives feel is reasonably close to their aspirations.

For this reason, remuneration committees err on the side of generous because they do not want to create a hostile atmosphere at the main board meeting later on the same day.

(2) Remuneration consultants. Whatever they say, remuneration consultants are basically the creatures of the board of the company who appoints them. They normally report to the chairman of the remuneration committee but they are paid by the company and inevitably they are influenced, particularly if they want to be re-appointed, by the aspirations of the executive as well as the non-executive directors.

Again, I've been advised for years that remuneration consultants should, like auditors, be appointed by the shareholders at the AGM and their remuneration should be theoretically fixed by shareholders even if they hand over this responsibility to the board itself. The objectivity of their advice will be influenced by who in the company is their client and authorises their fees.

You asked about the vote on the remuneration report being advisory rather than mandatory. This is because most of the issues have already been settled and implemented so that it would be almost impossible to overturn these existing remuneration policies if shareholders voted against the remuneration report.

If the shareholders want to influence director's remuneration, they have to get into the game much earlier and the only way to do this is to have direct appointing and awarding powers over the consultants appointed to advise the remuneration committee.

(3) The time period for existing options and shares schemes. At the moment virtually all share schemes are encashable between 3 to 10 years from issue. This is an Inland Revenue requirement from the 1970s based upon I'm not quire sure what but it has significantly reduced the power of remuneration committees to set different encashment windows, say five to seven years from issue. Virtually all schemes have automatically followed the Inland Revenue advice of three to 10 and very few remuneration committees are willing to argue against the 99% standard solution of this Revenue imposed seven year window.

One of the great weaknesses in so many long-term incentive schemes is that they can at least in part be encashed too quickly ie after the three years from issue. This is partially driven by the mid-Atlantic employment and remuneration terms of many international companies where they are conscious of the fact that in America, some options can usually be encashed within six months of issue so that they have difficulty switching senior staff between the US and the UK when the encashment windows over options are so different.

(4) Banks: In terms of banks which are big and complex organisations, I have limited direct experience although we did do a lot of work for financial services companies included in the FTSE 250 index.

I would suggest that independent subsidiaries, divisions or trading units within a major bank should have their board or top executive remuneration checked over by the remuneration committee if any executives earn 2/3 of a main board executive director's package.

In many cases, the highest paid executives in the bank will not be on the main board, they will be the chief executives or senior dealers of the derivatives and other trading units that share the classic profit split; 50% to the bank; 50% to the trading team.

In this area, the major remuneration scandals have taken place below the main board and I think it would be reasonable for the government to insist that all financial service companies have to submit their wholly or jointly-owned subsidiary trading units directors' packages for approval by the remuneration committee.

This is another reason for having an independent, knowledgeable member outside of the committee as the amount of time involved in checking such remuneration strategy and implementation will be well beyond the capacity of non-executive committee members.

(5) Finally, equities as the option only currency. I have very serious reservations. In most companies, the only alternative to a cash bonus is to offer options or ordinary shares as directors' incentives. These are highly volatile securities and as 80% of option holders in the UK have now discovered can go well below the issue price so they are operating as disincentive schemes.

I believe very strongly and have said so openly for two or three years that there should be an alternative option currency ie a Convertible Dated Preference Share which could be issued to executives in place of an equity option. It would carry a very low rate of interest and would be redeemable on a set date if it hasn't been converted into equity. It is effectively a delayed cash bonus with an equity kicker attached if the company is successful. Unlike an equity option, it would not automatically be encashed on a take-over bid or a change of control which is one of the great weaknesses of the current system which encourages companies to go for takeovers because it will allow encashment of all the equity options held by the executive team.

March 2009

CORRESPONDENCE BETWEEN THE GUERNSEY FINANCIAL SERVICES COMMISSION AND THE FINANCIAL SERVICES AUTHORITY

1. Letter from the Director General, Guernsey Financial Services Commission, to the Chief Executive, Financial Services Authority, dated 6 January 2009

LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION) (LGL)

We have corresponded on previous occasions on the subject of inter-regulator cooperation. For example on 29 November 2007 you responded to my letter of 20 November, in the context of Northern Rock Guernsey, confirming that the FSA was committed to keeping the Commission informed of relevant developments. In your letter of 25 April 2008, addressed to our Chairman Peter Harwood, you referred to work that was being done generally to enhance supervisory collaboration, and confirmed that the Memorandum of Understanding between the FSA and the Commission (which was signed in July 2003) allows the exchange of confidential information. The Memorandum of Understanding explicitly recognises that cooperation in respect of such exchanges of information will enable both the FSA and the Commission to more effectively perform their respective functions.

In this context, I am now writing to explain our considerable concern over the effectiveness of the present level of collaboration, particularly in respect of matters relating to LGL. Please treat this letter both as an expression of our concerns generally and also as a formal request for consultation in respect of the issues raised below under clause 16 of the Memorandum of Understanding. For your information, the Commission will be making a submission on the morning of 12 January to the UK Treasury Committee inquiry into the banking crisis; that submission will include detailed reference to LGL and the Commission's concerns about the effectiveness of cooperation and information exchange between the FSA and the Commission.

I had hoped to be able to write to you with our concerns and then to have enough time to discuss those concerns with you at your convenience. In the event, however, work on the report on the Commission's role in the LGL affair (see below) was completed only yesterday, and we are due to make our submission to the Treasury Committee next Monday morning. The opportunity for us to meet and discuss matters is therefore, unfortunately, limited.

As I am sure you are aware, on 6 October 2008 the Board of Directors of LGL took the decision that it was in the best interests of depositors to put the bank into administration because of the refusal of Heritable Bank Limited (Heritable) to repay funds deposited with it by LGL.

The Commission's involvement with LGL started in September 2006 when it was asked to approve the acquisition by the Landsbanki Group of the Guernsey subsidiary of the Cheshire Building Society.

The Commission approached the authorisation and subsequent supervision of LGL confident in our ability to rely on cooperation with the FSA in order to be able to act effectively to protect depositors. Regrettably, information we now have raises a very serious concern over the way in which the expected cooperation has operated in practice.

In April 2008 the FSA became fully aware (in the context of LGL) of our close interest in matters relating to Heritable, including our concerns in relation to Heritable's links with its parent Landsbanki Islands hf (Llhf). In particular, a letter dated 21 April 2008 from Dr Jeremy Quick to Mr Stephen Funnell explained those concerns and sought FSA confirmation that Heritable was "a UK-orientated, self-standing firm, with only limited Icelandic risk". The letter also asked questions of the FSA aimed at ensuring, by way of assurances from the FSA, that Heritable's exposure to Llhf, including in respect of dependence on funding lines, would be limited. Specific mention was made of our concern that LGL might become dependant on liquidity from Heritable. Mr Funnell responded, in a letter dated 25 April 2008, confirming the FSA's commitment to maintaining dialogue and stating that Heritable met the FSA's capital and liquidity guidelines. The letter also confirmed that Heritable was "a UK-orientated, self-standing firm, with only limited Icelandic risk". Mr Funnell continued, by stating that any Icelandic risk was "predominantly reputational ie by virtue of its parentage". Mr Funnell also mentioned that funding flows were in both directions, although at that time the movement of funds was from Llhf to Heritable and this situation was not expected to change.

On 11 July 2008, Mr Stuart Bailey of the Commission wrote to Mr Funnell asking for the FSA's confirmation that Heritable was "ring-fenced from Icelandic risk". On 16 July Mr John Brennan of the FSA responded in writing stating "I can confirm that our assessment of Heritable's exposure to Icelandic risk has not changed materially from Stephen's letter of 25 April 2008 to Jeremy Quick".

More generally the Commission took additional comfort from the greater attention paid by the FSA to liquidity given the market conditions in 2007–08. A core element of that assurance was the FSA's treatment of the liquidity of UK banks. As the Integrated Prudential Source Book (Volume 2 4/2) states "UK banks are expected to be able to stand alone, and therefore should normally monitor and arrange their own liquidity separately from the liquidity of other institutions in the group". At no time did the FSA tell the Commission that it had either informally or formally waived this requirement for Heritable.

The information provided to us by the FSA in April and July 2008 was a key determinant in our permitting funds to be placed with Heritable, as explicitly stated in Dr Quick's letter of 21 April 2008.

LGL was placed into administration in the early hours of Tuesday 7 October 2008, less than a day before Heritable itself was placed into administration. The reason for LGL's administration was the refusal of Heritable to repay funds, deposited with it previously by LGL, on 6 October and the prospect that they would not be released on 7 October.

Before raising our concerns with you, the Commission decided to examine our own handling of the matter. On 30 October 2008 I advised Jon Pain and David Strachan that an inquiry was to be carried out by Mr Michael Foot of Promontory Financial Group. A copy of Promontory's full report is enclosed for your information. Please note that this is provided to the FSA under paragraph 5 of the Memorandum of Understanding between the FSA and the Commission, and on the basis that it is confidential to the FSA and its legal advisers and that neither the report nor any part of it can be disclosed to any other third party without our consent. You will appreciate that paragraphs 14 and 15 of the MoU apply. We would be grateful for your assurance that the FSA will do all it can to resist pres sure to disclose the report and that the Commission will be consulted at the earliest possible point in any dispute over publication.

Please note that a separate version of the report—in which confidential information has been removed—has been prepared by Promontory and put in the public domain by virtue of its publication on the Commission's website earlier today. I have provided a copy of this redacted report to Jon Pain and David Strachan, and a copy of it will also accompany our submission to the Treasury Committee.

You will see that the report concluded that the Commission comfortably met international banking regulatory standards, did not act in bad faith, did not act unreasonably, and that there was no evidence of regulatory failure.

In paragraphs 7 to 25 of the full report, it examines the cross-border responsibilities of regulators. Apart from the assurances provided by the FSA as Heritable's home regulator, the Commission also took comfort in the host to host relationship with the FSA, given that the FSA also regulated a UK branch of Llhf (Icesave). During conversations with the FSA the Commission was given to understand that the FSA was maintaining a close watch over the group's management of its liquidity, not least as Icesave provided significant funding for Llhf. This appeared to involve the FSA in close contacts with the Icelandic authorities in respect of the wider affairs of the Landsbanki Group, enabling the FSA to have much greater access to information and greater power and influence over the affairs of the Landsbanki Group than the Commission. However, this did not lead to the FSA informing the Commission promptly about the October liquidity crisis; nor to clarify for the Commission that Heritable was dependent on group liquidity and therefore vulnerable to Icelandic risk.

You will see that paragraphs 67 and 69 of the Foot report refer to the comfort derived by the Commission from assurances given by the FSA in relation to the Heritable loan portfolio. Paragraphs 72—77 also address the matter of relations between the Commission and the FSA and our concerns, both in respect of Northern Rock Guernsey and LGL.

As the Icelandic crisis deepened, following the nationalisation of Glitnir banki hf on 29 September 2008, the Commission's communications with the FSA became much more frequent and our dependence on the FSA's provision of information and support became critical.

The Commission understands that the FSA intervened at Heritable on Friday 3 October and again on Monday 6 October to prevent any payments being made by Heritable to LGL. By this time, LGL directors had made it clear orally to Heritable that they wanted all the LGL deposits with Heritable (which were repayable on demand) repaid. However, formal requests for repayment were made for only part of the funds to be repaid, apparently after the directors had been advised, again orally, that full payment would not be possible.

It is also of concern to the Commission that the FSA may have prevented the directors of Heritable from making repayments to LGL while, at the same time, allowing payments to be made to other creditors.

The FSA did not tell the Commission of its actions, nor explain to us any of the concerns which must have underlain them and which presumably led to the FSA placing Heritable into administration on Tuesday 7 October. The FSA will be aware that doubts have been expressed over whether this action was necessary.

Indeed, during a telephone conversation on 6 October 2008 between representatives of the FSA, the Commission and a director common to both LGL and Heritable, the FSA stated that Heritable did not have significant Icelandic exposure so there was no reason to think it was insolvent. During the day of 6 October, the dependence of Heritable on Uhf for liquidity first became apparent to the Commission and it also became clear that the FSA had allowed Heritable to become substantially dependant on Uhf for its liquidity without advising the Commission of this fact and despite assurances to us that Heritable had limited Icelandic risk.

It is particularly disappointing that at no stage did the FSA provide adequate information to the Commission to enable it to act effectively to protect LGL's depositors. The FSA did not, in the proper spirit of the Basel standards, the MoD between us, the assurances provided to us, and the confirmation provided to us, open and maintain a dialogue with the Commission that would have enabled a strategy to be agreed which could have protected the interests of the depositors in LGL as well as the interests of the depositors

in Heritable. Instead, the unilateral actions of the UK authorities in placing Heritable into administration and removing all retail depositors from Heritable jeopardised the interests of the LGL depositors (some 33% of which by value are based in the UK) whilst protecting the retail depositors of Heritable. The FSA acted in this way in full knowledge of the Commission's concerns. The FSA must have been aware that its actions would effectively destroy the commercial viability of Heritable and LGL and their reputations. In addition the FSA must have been aware that its actions would make it virtually impossible to achieve a normal work-out of the loan portfolios, therefore making it much less likely that LGL's depositors would be repaid in full.

The Commission would like to receive the FSA's comments on the following matters:

1. Did the FSA take actions on or before Friday 3 October and Monday 6 October to prevent Heritable repaying any or all of the deposits placed with it by LGL?
2. If it did take such actions, on what grounds were those actions taken?
3. Why did the FSA not advise the Commission of its concerns and its planned actions in accordance with the normal standards of supervisory cooperation, the MoD, and the assurances and confirmation to this effect that had been given to us?
4. Why did the FSA not open a dialogue with the Commission to seek a resolution to its concerns that could have sought to protect depositors in both Heritable and LGL?
5. Why did the FSA not advise the Commission that Heritable was substantially dependant on Llhf for its liquidity despite its assurances to the contrary?
6. Did the actions taken by the FSA and other UK authorities in relation to Heritable and its retail depositors amount to an unfair preference over LGL?

I look forward to hearing from you. Please let me know if you would like further information. I would be happy to come to London for a meeting to discuss these matters this week, if that would be helpful.

2. Letter from the Chief Executive, Financial Services Authority, to the Director General, Guernsey Financial Services Commission, dated 15 January 2009

LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION) (LGL)

Thank you for your letter of 6 January. We have carefully considered the points you make and respond to your questions as follows.

1. *"Did the FSA take actions on or before Friday 3 October and Monday 6 October to prevent Heritable repaying any or all of the deposits placed with it by LGL"?*

As you would expect, we engaged in increasingly intensive supervision of the UK branch of Landsbanki and Heritable in order to protect consumers and market confidence as concerns about the Icelandic banking system developed. This process included the imposition of a requirement on Heritable on 3 October that prevented it transferring assets to other group companies without our consent. The effect of this requirement was that Heritable would have required our consent, on three days' notice. to rep ay any of the deposits made by LGL.

On 5 October, the firm gave notice to us of its intention to pay funds to LGL, when due, with effect from 8 October.

We had not responded to this when we were called by Jeremy Quick of the GFSC at around noon on 6 October. He informed us that he had asked the LGL board, which was due to meet shortly, to call for the amounts on deposit with Heritable and that he would expect to see these repaid that day or the following day. In an email sent to the FSA at 12.43 he stated that "I would ask you to ensure that Heritable re lease the funds once they are requested to do so by Landsbanki Guernsey".

We understand there were discussions between LGL and Heritable about the possibility of repaying the deposits and that. as well as referring to the requirements we had imposed on the firm to obtain our consent, Heritable indicated to LGL that it did not have the funds to repay the LGL deposits in full at that time. As you indicate in your letter, there was then a discussion about partial repayment of the deposits. However, later in the day, we were informed by Heritable that LGL was no longer asking for the repayment of the deposits, as they believed that alternate funding was available.

We did not at any time advise Heritable that we would refuse to consent to it repaying the LGL deposits.

2. *"If it did take such actions, on what grounds were those actions taken"?*

The requirement to obtain our consent to intra-group transfers was to enable us to consider whether any such transfers were appropriate, before they were made, so as to protect the interests of consumers. It was not specifically aimed at LGL, rather it covered the group generally. As I have explained above, we did not make any decision on whether or not to approve any payments from Heritable to LGL.

3. *"Why did the FSA not advise the Commission of its concerns and its planned actions in accordance with the normal standards of supervisory cooperation, the MoD, and the assurances and confirmation to this effect that had been given to us"?*

Guernsey is outside of the EEA and, as the Promontory report recognises, the normal standards of supervisory cooperation in such cases are set out by the Basel Committee. Principle 25 of the revised Core Principles for Effective Banking Supervision and the supporting essential criteria in the Core Principles Methodology make it clear that information should normally always involve the home supervisor, that is, the information flows between the home supervisor and any host supervisors, rather than between hosts supervisors direct. In the case of the Landsbanki group, both the FSA and the GFSC were host supervisors and the FME was the home supervisor.

This position is not modified by the MoU between the GFSC and FSA, which generally deals with the provision of information in response to specific requests. While it recognises that information may be provided on a voluntary basis, it does not express any expectation that this will happen.

Of course, notwithstanding the fact that we were a host supervisor, we sought to operate in as helpful and cooperative manner as we could.

4. *"Why did the FSA not open a dialogue with the Commission to seek a resolution to its concerns that could have sought to protect depositors in both Heritable and LGL"?*

LGL was placed into administration in Guernsey on the night of 6 October on the application of its directors, before the FSA applied to the Court in Scotland for Heritable to be placed into administration. Therefore, the crucial events in Guernsey preceded our actions.

LGL, was only one of a number of unsecured creditors of Heritable. Our decision to apply for an administration order in relation to Heritable on the morning of 7 October was designed to ensure an equal treatment of all depositors and other unsecured creditors. The chief executive of Heritable indicated his support for this application.

The arrangements that were put in place in the UK to transfer certain deposits with Heritable to ING Direct depended on the application of the UK Financial Services Compensation Scheme, the provision of significant funding by the UK Government and the use of UK legislation.

5. *"Why did the FSA not advise the Commission that Heritable was substantially dependant on Llhf for its liquidity despite its assurances to the contrary"?*

I cannot accept your implication that the FSA misled the GFSC as to the level of dependence of Heritable on the provision of liquidity by Landsbanki.

Indeed, as you note, Stephen Funnell's letter of 25 April 2008 made it clear that at that time funding was being provided by Landsbanki to Heritable. It stated that: ". . . we have historically seen funding flows in both directions. At present, however, any movements are from Landsbanki to [Heritable], and we do not expect this to change.". This letter also made it clear that while we were not aware of any material exposures to Iceland in the course of Heritable's normal lending activities, Heritable was exposed to reputational Icelandic risk by virtue of its parentage. As events unfolded, this reputational risk crystallised. The collapse of confidence in the Icelandic banking system caused Heritable to lose wholesale funding. This, in turn, increased its dependence on its parent for funding.

You refer to our general guidance on liquidity. This makes it clear that a firm can rely on committed facilities from group companies where appropriate (see paragraph 21(d) of Section 7 of Chapter LM of our Interim Prudential Sourcebook for Banks). At no time did we indicate to you that we had restricted the firm's ability to rely on intra-group funding lines.

6. *"Did the actions taken by the FSA and other UK authorities in relation to Heritable and its retail depositors amount to an unfair preference over LGL"?*

No.

The requirement to obtain our consent to intra-group transfers was an entirely appropriate response to the circumstances we faced on 3 October. As noted above, we did not advise Heritable that we would refuse to consent to it repaying the LGL deposits. While we understand there were practical limitation s on Heritable" s ability to repay all of the deposits at that time, it was seeking further funds from Landsbanki. When it became clear that such funds would not be made available, we applied to the Court to place Heritable into administration.

As noted above, the FSA's actions in applying for an administration order in relation to Heritable ensured the equal treatment of unsecured creditors.

The transfer of certain retail deposits from Heritable to ING Direct by a transfer order under UK legislation was funded entirely by the UK Financial Serv ices Compensation Scheme and the UK Government. They now stand in the shoes of those depositors as creditors in the administration of Heritable on an equal basis with all other unsecured creditors.

The information in this letter is provided in accordance with the confidentiality provisions in the MoU. Please do not to disclose it to any party outside of the GFSC without our consent in writing.

I trust that the clarifications provided in this letter will reassure you as to our actions and enable us to move forward in a productive spirit of cooperation, which will assist in the discharge of our respective obligations. Our ability to work closely and cooperate with the GFSC is particularly important given the activities of UK firms in Guernsey and we would be happy to consider any proposals for strengthening our cooperation arrangements.

3. Letter from the Director General, Guernsey Financial Services Commission, to the Chief Executive, Financial Services Authority, dated 23 January 2009

Landsbanki Guernsey Limited (In Administration)

Thank you for your letter of 15 January 2009.

I do not propose in this letter to address your responses to the questions contained in my 6 January 2009 letter. They will be addressed in due course, as appropriate. This letter deals solely with the issue of confidentiality.

I note the reference in your letter to the confidentiality provisions under the Memorandum of Understanding between the Commission and FSA. I would like to stress that the Commission wishes, if at all possible, to resolve the issues raised in my 6 January letter in private.

However, as I indicated in my letter of 6 January 2009 would be the case, the Commission has now served written submissions on the Treasury Select Committee ("TSC") on 12 January 2009.

The Commission's submissions are on the TSC's website. I am scheduled to attend before the TSC to answer their questions on 3 February 2009. It is very possible that the TSC's questions will address some of the areas covered in my letter of 6 January 2009 and your response of 15 January. At present I do not have any indication of the subject matter of any questions and I will not know until very shortly before the hearing, if I have any advance warning at all.

The Commission has been considering with our legal advisors the obligations which arise in connection with giving evidence before a Select Committee, and our view is that I am required on threat of being in contempt of Parliament to answer fully and honestly any questions put to me. Not only do we believe that this is a legal duty applying to all witnesses appearing before such a tribunal but it is also the approach that we would be compelled to adopt having regard to the statutory functions of the Commission.

Notwithstanding this, I can assure you that, in the spirit of the MoD, every reasonable effort will be made to respect the confidentiality of our correspondence. However, you will appreciate that I cannot guarantee that it will be possible to avoid disclosure of otherwise confidential information if relevant questions are raised by the TSC. The purpose of this letter, therefore, is to put the FSA on notice that I may be required by law to make public certain otherwise confidential material. It should also be noted that the issues under investigation before the Select Committee go beyond Landsbanki Guernsey Limited, and my answers may therefore be required to reach into areas beyond the specific content of our recent correspondence and may also involve the Commission in being required to disclose otherwise confidential material.

The purpose of the TSC's enquiry is, of course, quite broad and every effort, therefore, will be made to confine our evidence to general matters and not to specific details of our otherwise private correspondence or other otherwise confidential communications. Please do not hesitate to let me know if the FSA considers that we would not be compelled to disclose otherwise confidential information to the TSC if asked particular questions and the reasons for taking such a view. We would be willing to pass on those reasons to the TSC. Of course, you may wish to approach the TSC directly if you have specific concerns.

4. Letter from the Chief Executive, Financial Services Authority, to the Director General, Guernsey Financial Services Commission, dated 29 January 2009

Landsbanki Guernsey Limited (in Administration)

Thank you for your letter of 23 January.

I appreciate you taking the trouble to write to me, setting out your concerns about confidentiality, in advance of your appearance before the TSC to give evidence on 3 February. I quite understand how you have reached the view that, notwithstanding the confidentiality which usually attaches to exchanges between regulators, it is more important that you should answer fully and honestly any questions put to you by the TSC. That is the position we have adopted in our own dealings with the TSC, and we would expect to do so again in our own evidence to the Committee next month.

I note that you intend to respond more fully to my letter of 15 January in due course, which response we look forward to receiving.

5. Letter from the Director General, Guernsey Financial Services Commission, to the Chief Executive, Financial Services Authority, dated 23 February 2009

Landsbanki Guernsey Limited (in Administration) ("LGL")

I refer to my letter of 23 January 2009 and to your letter of 15 January 2009. 1am sure that you will be aware that I have now given evidence to the Treasury Select Committee and, to a certain degree, that evidence is relevant to issues that have been identified in our private correspondence. Whilst my obligations to the Treasury Select Committee required that I answer any questions put to me honestly and openly, it remains my wish to seek to resolve these matters by way of private correspondence.

Unfortunately, your reply does little to reassure either me or the Commission over the effectiveness and understanding of the present co-operation arrangements with the FSA, particularly at times of economic stress.

Whilst I understand that your letter has focused on providing specific answers to the questions raised in my letter of 6 January, the context within which those questions were raised (as expressly identified in paragraph 2) was to open a dialogue with you over the effectiveness of the present level of co-operation between the FSA and the Commission. Unfortunately, your letter served only to confirm that, as matters stand at present, there would appear to be a significant difference of opinion as to the scope and purpose of the present co-operation arrangements.

Your letter to Peter Harwood of 25 April 2008 emphasised that an integral part of your Supervisory Enhancement Programme was to strengthen liaison with international regulators "to improve crisis management for global groups". You also confirmed that the FSA would "need to look at how we more specifically link our domestic agenda with ideas being advanced in the international arena".

So far as LGL was concerned, you will know from the evidence that I provided to the Treasury Select Committee that my principal concern is that the FSA considered that it was entitled to act solely in pursuit of a domestic agenda at a time when what was needed was a co-ordinated interpretation of the steps required for effective "crisis management for global groups". There is no suggestion anywhere within your letter that the FSA acknowledges any legitimate criticism of its conduct in relation to LGL. The Commission does not accept that such a stance reflects a proper analysis of events.

I think that my point is illustrated by reference to a comment made in your letter under Question 4. My understanding of your comments in paragraph 2 is that your action in relation to Heritable Bank (which had a direct bearing on the administration of LGL) was to "ensure an equal treatment of all depositors and other unsecured creditors". With respect, this observation is only true if it refers to a wholly UK domestic agenda. LGL is a significant creditor of Heritable Bank and was clearly disadvantaged by the action taken by the FSA. In reality (having regard to the nature of the LGL business), this harm was caused not to a Guernsey company, but ultimately to the individual depositors of that company, of which approximately one third by value were UK residents.

Our interpretation of the arrangements reflected in the Memorandum of Understanding, and as interpreted in the letter to Peter Harwood of 25 April, was that the FSA was looking to approach the crisis management for international banking groups such as Landsbanki, from the perspective of international collaboration rather than domestic protection—a view reinforced by the direct assurances given to the Commission by the FSA. This clearly did not happen with LGL and we believe that the FSA's practice is some way out of line with the views being expressed within the international regulatory context and indeed by your own more recent thinking as expressed in the FSA's Business Plan for 2009–11 which states that consideration needs to be given to whether there is scope for better coordination and cooperation between regulators in normal time s and during periods of crisis.

Turning to your specific answers, and adopting the numbering in your letter, the Commission comments as follows:

1. You refer to your requirements imposed on 3 October that prevented Heritable from transferring assets to other group companies without your consent ("the Consent Requirement"). We remain at a loss to understand why this requirement was not communicated to the Commission and would welcome an explanation.

It appears from paragraph 2 that, at the time the request for payment was received by Heritable, it may in fact have been in possession of sufficient funds to make the payment as it was contractually obliged to do. Please confirm that this is correct. Given that the Consent Requirement would clearly cause Heritable to breach the terms of its contractual arrangements with LGL, it would help to understand the statutory power under which the restrictions were imposed.

We note that you say that you were informed on 6 October (before you had come to any decision about Heritable's request for permission to pay funds to LGL) that LGL was no longer asking for repayment of its Heritable deposits, "as they believed that alternate funding was available". This is not a fair reflection of events. LGL had no choice but to seek alternative funding as it had been told (but without proper explanation) that the Heritable deposits were effectively blocked.

It is irrelevant (although apparently correct) that the FSA did not advise Heritable that it would refuse consent to repayment of the LGL deposits. The Consent Requirement was in operation and the FSA was in control of intra-group transfers and in fact the FSA put Heritable into Administration before the expiry of the FSA's 3 day time period for consideration of requests for payment. I fail to understand why the fact of the Consent Requirement was not communicated to the Commission. Instead, we were left to make decisions based on an entirely insufficient understanding of the true position.

The FSA Consent Requirement appears to have been designed to protect the assets of Heritable from transfer out of the FSA's control, to the detriment of retail depositors in LGL. This is not consistent with the spirit of the MoU between our respective organisations and contrary to your wish to strengthen liaison with international regulators within the context of crisis management of global groups.

2. See above.

3. Your answer to this question ignores the spirit of the MoU and the sentiment of your letter of 25 April 2008. You say that information flows between host supervisors should always involve the home supervisor, in this case, the FME. While it is correct that both the FSA and the Commission were host supervisors, you stated that the Consent Requirement was imposed "to enable us to consider whether any such transfers were appropriate". This amounts to a statement that the FSA was taking control of the day to day business of Heritable and acting with the character of a home supervisor for that business, rather than merely acting as host supervisor.

You also state "notwithstanding the fact that we were a host supervisor, we sought to operate in as helpful and co-operative a manner as we could". Please explain why this co-operation did not extend to advising the Commission of the change in relationship between Heritable and its parent and of a significant regulatory action by the FSA.

4. You state that your decision to apply for the administration of Heritable was designed to "ensure an equal treatment of all depositors and other unsecured creditors". In the event, however, your actions were designed to protect only UK depositors at the expense of Guernsey depositors. At the very least, it would have been helpful and co-operative if the FSA had given the Commission advance warning of its intention to put Heritable into administration, given its knowledge of LGL's large placement with Heritable.

5. You refer to Stephen Funnell's letter of 25 April 2008 and its reference to "reputational risk". You state that this reputational risk crystallised, causing Heritable to lose wholesale funding. The basis for this statement is unclear. It does not accord with our understanding of Heritable's funding structure. Heritable was, as far as we understand the matter, reliant on retail deposits and not wholesale deposits. The only inter-bank deposits they had came from group sources namely LGL and LIHf. Please confirm whether this is correct.

It was fully understood by the FSA that the purpose of the redistribution of LGL's assets in April 2008 was to reduce the exposure to the perceived risks associated with the Icelandic banking sector. Is it your case that, at the time that it went into administration, Heritable was a UK oriented, self-standing firm with only limited (and predominantly reputational) Icelandic risk as the FSA had previously confirmed to the Commission?

6. Please confirm whether any payments were made to other creditors between 3 October and 6 October 2008. If it is the case that the FSA permitted payments to other creditors of Heritable, then our concern about preferences remains live.

You will no doubt wish to consider these points with your team. I would be happy to discuss any of these points with you either before or after your formal written response is provided. Going forward I still firmly believe that we need to build a workable consensus for effective global cooperation between regulators because, if that is not possible, the Commission will have no alternative but to approach the regulation of other banks operating in Guernsey, which have material links to the UK, on a stand-alone basis. This is not an approach which would be in the interests of the banks or our two economies.

6. Letter from the Chief Executive, Financial Services Authority, to the Director General, Guernsey Financial Services Commission, dated 29 January 2009

RE: LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION) ("LGL")

Thank you for your letter dated 23 February. I have noted your wish to seek to resolve matters by way of private correspondence and agree this is the best way forward. I am of course fully aware that certain matters may have to be discussed publicly in forums such as the Treasury Select Committee to which I also gave evidence recently.

I am sorry if you think that my letter dated 15 January failed to engage fully with your concerns over the effectiveness of the present co-operation arrangements between the GFSC and the FSA. We remain committed to developing and strengthening our links with international regulators which have an impact on UK firms and markets, in which category of course I include the GFSC. I think we have reached the point where, in order to focus on future co-operation rather than past events, it would be more sensible to deal with the key themes emerging from your letter, rather than engaging in a point by point response.

Home/Host Supervision and a "Domestic Agenda"

We are both familiar with the principles behind home/host supervision. For present purposes, it is relevant to focus on the situation where the bank's presence in the host state is a locally incorporated subsidiary, as it is subject to the laws of the host state, including the requirement that it be authorised and supervised by the host supervisor and that it is subject to the host state's insolvency regime. While, consistently with EC Directives and the Basel Core Principles, there has to be effective co-operation between home and host supervisors, the host supervisor will also have its own domestic law responsibilities in relation to the subsidiary. Nevertheless, it is clear that information flows should be through the home supervisor, which clearly needs to see the whole picture, rather than between two or more host supervisors.

In the case of the Landsbanki group, I think it is important to recognise that what the FSA and the GFSC were supervising were sister subsidiary companies. We were both host supervisors, with the FME being the home supervisor. Because Heritable was a UK incorporated subsidiary, we had to comply with the UK's legal framework in carrying out our supervisory functions, as that is an unavoidable result of local incorporation and authorisation. While I can assure you it that the FSA regards international cooperation as necessary for effective crisis management, to ensure that regulatory decisions are based on accurate information and all those involved know to whom they are required to communicate what information, there is likely to be a time in any crisis when regulators have to make decisions to protect creditors within the jurisdiction for which they are responsible, even if those decisions have consequences for creditors outside the jurisdiction. In the case of Heritable this point came on 7 October, when Heritable indicated that the required funding would not be forthcoming from Iceland and we made the decision to apply for an Administration Order. You of course took similar action slightly earlier in Guernsey.

Insolvency and the Protection of Creditors

Once it becomes apparent that a subsidiary supervised by a host supervisor no longer has any reasonable prospect of obtaining adequate funding, and has therefore lost its continuing ability to pay its creditors, I do not see that there is any alternative to putting the subsidiary into administration. In the absence of such action, the inevitable consequence would be that some creditors would receive 100% of what they are owed, while other creditors would (in the resulting, delayed insolvency) have a reduced recovery caused by a smaller pool of assets in the estate. I would stress that at the point of Heritable going into administration, and subsequently, all creditors (be they LGL depositors or Heritable depositors) have been treated equally. The only reason that Heritable depositors have been treated differently from other creditors is because the Treasury and the Financial Services Compensation Scheme placed amounts equivalent to their deposits into ING Direct, then stood in their shoes as creditors of Heritable on an equal basis with all other unsecured creditors. These were policy decisions which it would be open to the relevant authorities in other jurisdictions to take.

The FSA's Supervisory Response

Up to the point of putting Heritable into administration all the actions we took were intended to ensure the bank remained a viable business. Ultimately, as indicated above, that proved not to be possible.

You ask a number of questions about the "consent requirement" we imposed on Heritable. The requirement was imposed under section 45 of the Financial Services and Markets Act 2000. The power is exercisable where a bank is or is likely to have inadequate resources or in order to protect existing or potential depositors. It is a long-standing power, having been used by the Bank of England when the Banking Act 1987 was still in force. During the dates that the requirement was in force, it was open to Heritable to ask for our consent to payments being made. They made a request on 5 October on three days' notice to repay, inter alia, the LGL deposits, but the administration intervened. In any event, we were told by Heritable, after they submitted the request, that the funds to make full repayment were unavailable to them and this was something they had communicated to LGL. While we understand that there were subsequent discussions on 6 October between LGL and Heritable, as there were between the FSA, GFSC and Heritable, we did not receive a request on 6 October for approval of a payment from Heritable to LGL. We did give Heritable discretion to make some payments—between £2 and £3 million of BACS/CHAPS payments—on 6 October which were already in the system in the normal course of collection.

THE MEMORANDUM OF UNDERSTANDING

It is also clear from your letter that a continuing point of concern is the FSA's failure to inform the GFSC of the imposition of the Consent Requirement. In my letter of 15 January I set out why we were not obliged to do this, and indeed, our policy is not to disclose (at least in the short term) the existence of a requirement to any third party. This is to avoid the risk that our actions will become public, which could cause further difficulties for the bank concerned. Taking into account that Heritable was a UK subsidiary authorised by the FSA, I would not see our actions as having made the FSA the home supervisor: we were making the decisions required of us under UK law.

If the GFSC thinks that matters in the Memorandum of Understanding need amendment or clarification I would be more than happy for the FSA to address this with the GFSC as a matter of urgency. The FSA will be fully involved in any future discussions about changes to the current home/host supervisory regime. As you know, some possible shortcomings have been identified in the de Larosi€re Group's latest report and our Chairman, Lord Turner has made recommendations in this area in his report on banking supervision published this week. I would hope that any changes which are adopted will serve to increase understanding and cooperation between the FSA and GFSC should any future crisis occur.

HERITABLE'S FUNDING

You have asked some questions about Heritable's funding, most of Heritable's funding was from retail deposits (c£538 million), but wholesale deposits (c£420mn.) were also significant. The latter were mostly made up of deposits from various UK building societies and local authorities (in many cases these latter two sources of funding were required to withdraw their funding after the group was downgraded by the rating agencies in late September). I have reviewed the exchange of letters between Jeremy Quick and Stephen Funnell in April 2008. It appears from these letters Mr Funnell did not regard Dr Quick's request as being about wholesale funding, so Mr Funnell did not provide any information in this regard. It remains the FSA's view that while, at the point of administration, Heritable was a UK-oriented firm, with only limited direct exposure to Icelandic risk, it could not be isolated entirely from the problems of its parent or the wider Icelandic economy.

In conclusion, I would repeat that we want to work with the Commission to strengthen our relationship. I would be pleased to ask colleagues responsible for managing the relationship with the Commission to visit Guernsey in the near future, to discuss changes to the MoU and other practical measures we can take to achieve that end.

7. Letter from Neil Roden, Group Human Resources Director, RBS, to the Chairman of the Committee, dated 30 March 2009

RESPONSE TO TSC QUESTIONS ON LUMP SUM

Following the questions you posed to Lord Myners on 17 March, UKFI have asked RBS to provide you with some more information on the lump sum taken by Sir Fred Goodwin in exchange for part of his pension.

The ability to take a lump sum at the time of retirement in place of part of a pension is a very common provision in UK pension schemes, and in particular is part of the rules of the main RBS pension fund. This right applied to Sir Fred's pension from his funded un-registered pension scheme (his FURBS) as well as from the main RBS pension fund. A lump sum payable from a tax-registered pension fund is tax-free (within certain limits) but this does not apply to one from a FURBS. RBS agreed in 2007 that if Sir Fred exchanged part of his pension from the FURBS for a lump sum then (for a lump sum up to a certain amount) the FURBS would meet the tax due on this lump sum.

Sir Fred chose to exchange £186,979 a year of his pension for a lump sum of £2,781,317 of which £94,740 was paid from the main RBS pension fund. Sir Fred subsequently indicated that he was willing in principle to repay the lump sum, provided he incurred no tax liability. However, HMRC have clearly stated that tax will be payable on this lump sum even if it is repaid, and as a result the FURBS is liable to pay the tax on the part of the lump sum that was paid from the FURBS. In the light of this, Philip Hampton has asked Sir Fred to consider if he is prepared to waive part of his entitlement and Sir Fred is considering this.

We can confirm that no further contribution is required to the FURBS as a result of Sir Fred taking this lump sum and the tax that is due to be paid on it.

If you have any further questions, then please let me know.

8. Letter from Sir Tom McKillop to the Chairman of the Committee, dated 30 March 2009

Many thanks to you and your Committee colleagues for inviting me to make a written submission.

As I hope was clear from my letter to you dated 17 March, I was concerned that the evidence of Mr Moreno, Mr Kingman and Lord Myners might benefit from clarification, particularly in relation to the pension arrangements between Sir Fred Goodwin and the Royal Bank of Scotland.

As I wrote on 17 March, I have remained silent since my resignation from RBS because of my profound regret at events there and a desire not to create controversy that might harm the bank or the public interest. I remain acutely aware of the unhappiness that has been caused to investors and employees at the Royal Bank of Scotland. I am also keenly aware and appreciative of the Government support for the RBS.

I have never sought to avoid accountability for my actions as chairman of RBS. I have apologised publicly both at the shareholder meeting and before your own Committee. Having said that, I must emphasise that there was no "elaborate ruse" by myself and Mr Scott to give Sir Fred any more than he was contractually entitled to and that we and, I believe, all the directors acted in what we judged to be the best interests of the shareholders, including the Government.

In that context the following points need to be made:

1. Sir Fred Goodwin was recruited by RBS and appointed to the Board in 1998 and the principles of his contract of service (including his pension entitlement) were agreed prior to the arrival of any director who was on the RBS board in October 2008.

2. These principles included him being treated, notwithstanding the pension cap, as if he was a member of the RBS pension fund for his full salary.

3. As part of these principles agreed by RBS in 1998, Sir Fred's benefits were calculated assuming a notional employment starting age of 20.

4. He also became subject to the RBS Fund rules which provided that employees leaving RBS early at the request of their employer received a pension as though they had attained age 60. The wording in the Annual Report is:

> "RBS Fund rules allow all members who retire early at the request of their employer to receive a pension based on accrued service with no discount applied for early retirement."

5. The requirement to treat Sir Fred as if he was a member of the RBS pension fund meant that any lump sum taken at the time of the pension payment being settled would (like a lump sum paid to any other RBS pension fund member) be received tax free in respect of pension accrued up to April 2006. In February 2007, in light of the implementation of "A Day" (the simplification of the pensions tax regime which had occurred in April 2006), RBS confirmed the application of this principle taking into account the Pension Act changes.

6. Ahead of October 2008, the Board concluded that no bonuses would be paid to senior executives for 2008.

7. In the days ahead of the weekend of 10–12 October 2008, RBS executives took part in confidential talks with HM Government about rapidly deteriorating asset quality, liquidity and share price. Details of these talks were leaked, principally to the BBC, exacerbating a difficult situation.

8. On Friday 10 October 2008, the non-executives (excluding myself) met and decided that Sir Fred would have to stand down. It was discussed and agreed at that meeting that it was necessary that Sir Fred's departure be managed carefully. Public confidence in RBS at that time was very low. Continuity and stability were very important.

9. The Nominations Committee, with the benefit of soundings from board members, determined that Stephen Hester, who had recently joined as a non-executive director, was the most appropriate successor. He was then the Chief Executive Officer of British Land plc and it would be necessary to obtain agreement that British Land plc would release him sooner than his notice period at that company. The timing was not clear but we thought it was more likely to be months rather than weeks before Mr Hester could fully take up the role. This reinforced our belief that Sir Fred's departure needed to be carefully phased to ensure stability.

10. This was recognised in the Nominations Committee minute of the 10 October 2008 meeting:

> "The Committee discussed the process for selecting and appointing a new Group Chief Executive but recognised that this should take account of the need to ensure management stability and a smooth handover."

11. All of this meant that there would need to be a consensual departure of Sir Fred. He would be leaving at the request of the company with his full contractual entitlement to a pension and other items, as laid out in the Annual Report. As a result we secured continuity, stability and the continued cooperation of Sir Fred. That, in my judgement, was in the best interests of the shareholders of RBS.

12. On Friday 10 October, Sir Fred was advised of the Board decision. He accepted the decision and agreed to discuss his departure on a consensual basis.

13. On the evening of Saturday, 11 October 2008, Sir Fred, Bob Scott (the senior independent director) and I attended a meeting at the Treasury with Lord Myners, other Treasury officials and their advisors, including representatives from the Financial Services Authority and the Bank of England. The meeting was to discuss the terms of the proposed Government investment in RBS.

14. At the conclusion of this meeting, Lord Myners asked Mr Scott and I to join him for a private meeting. At this meeting, he explained that the Government expected Sir Fred to stand down as part of the recapitalisation process. I explained to Lord Myners that the Board had already reached that conclusion and had communicated this to Sir Fred. Lord Myners was told at that meeting that Sir Fred's pension benefit would be the sensitive issue and that it would be "enormous".

15. Lord Myners stated on the Saturday evening that the Government was concerned to ensure that there was "no reward for failure." We explained that the Board of RBS had already determined that there should be no bonuses for 2008.

16. The size and complexity of the Government recapitalisation made it all the more important that Sir Fred was willing and available to help negotiate and finalise the Government package, to launch that on Monday 13 October 2008 and to help in the preparation of the prospectus, as well as dealing with the ongoing integration of ABN Amro and all the other duties of the CEO until Mr Hester was able to take those tasks over.

17. Mr Scott spoke to Lord Myners in the afternoon of Sunday 12 October 2008 and went through with Lord Myners the Remuneration Committee paper which set out the terms of the arrangement with Sir Fred. Mr Scott is certain that he discussed each element of the proposed terms of departure set out in the remuneration paper, including the pension. As well as referring to the undiscounted effect, and the consequence of early retirement and deemed service for the amount of the pension, Mr Scott also gave Lord Myners (in the conversation on 12 October 2008) a range of £15 million to £20 million as being Mr Scott's best estimate of what the pension liability might be.

18. It is not correct, as Lord Myners has suggested, that Mr Scott indicated that disclosure of Sir Fred's pension "could be spread over a couple of years to deflect adverse comment". The point made by Mr Scott was that accounting rules and the timing of arrangements with Sir Fred would determine in which financial year disclosure should properly be made. Mr Scott was aware that the pension arrangement would need to be properly disclosed and did not at any time suggest otherwise.

19. In a discussion on Sunday 12 October 2008 with Mr Scott, Lord Myners made it plain that he considered it appropriate to ask Sir Fred to give up part of his contractual entitlement (the payment in lieu of notice). Sir Fred agreed to give this up in discussion with Mr Scott, after, I believe Sir Fred and Lord Myners had discussed this matter directly.

20. At no stage did Lord Myners or any other representative of the Government ask the RBS directors to attempt to alter any of the contractual terms relating to Sir Fred's pension. Nor did Lord Myners attempt to discuss the matter with Sir Fred, as he did with the payment in lieu of notice.

21. Subsequently, on 2 November, Lord Myners contacted Mr Scott and said that the Government wished Sir Fred to waive certain share related benefits to which Sir Fred was contractually entitled. Sir Fred agreed in discussions with Mr Scott to forego these entitlements, on the basis that all other elements of his package would be honoured and would remain unchanged. Mr Scott passed this information on to Lord Myners, with particular reference to the pension arrangements being part of that remaining package.

22. In summary, there was no question of any discretion to be exercised in relation to Sir Fred's pension and no discretion was exercised in this regard by any RBS director. RBS considered itself contractually bound to pay the pension benefits which had crystallised by virtue of its request to Sir Fred to leave the company—but not to pay any more than the proper contractual obligation. Mr Scott and I had been informed by Lord Myners on the Saturday evening that RBS should mitigate liabilities but not abrogate contractual requirements. We had put in place mitigation measures (for example in relation to the payment in lieu, before it was given up) but had not sought to deny Sir Fred's contractual entitlements.

23. By contrast, the Government (through the actions of Lord Myners) made it clear that they were willing to seek to encourage Sir Fred to forego contractual entitlements, and they did so in relation to the payment in lieu of notice and stock related benefits (successfully) but did not make any attempt to do so in relation to the pension.

24. It was clear to the Government (and indeed the public at large) that Sir Fred was departing on a consensual basis. The press release issued on 13 October 2008 expressly recognised that an agreement had been reached with Sir Fred. The release stated that Sir Fred would continue "for a short period" as chief executive to allow for a "smooth handover" with Stephen Hester. The contents of this and subsequent press releases were agreed with the Treasury after considerable scrutiny by them.

25. A subsequent press release agreed by the Treasury and issued on 17 October reinforced the agreed nature of Sir Fred's departure. It announced that Mr Hester would take over as group chief executive on 21 November 2008, and spoke of the desirability of Sir Fred remaining at the RBS Group until 31 January to ensure an orderly departure. At no stage did Lord Myners or another Government representative suggest that Sir Fred should be dismissed.

26. It has been suggested that Watson Wyatt advised RBS at some stage over the weekend that the manner in which RBS dealt with Sir Fred's departure would have "adverse consequences" and that "shareholders would not approve". Neither Mr Scott nor I have any knowledge of any such advice, from Watson Wyatt or anyone else. Watson Wyatt could not in fact be contacted for most of the weekend.

The Committee will appreciate that I have not sought to avoid my fair share of accountability for the circumstances in which RBS finds itself—as I made clear during my appearance before the Committee. I make the points above because I believe the circumstances relating to Sir Fred's pension have not been accurately represented to the Committee. In addition, I and other RBS directors have been the subject of allegations which are unfair and unjustified. In particular:

(a) there was no "elaborate ruse" (as it has been alleged) to pay Sir Fred any amount other than was contractually required in the circumstances—with particular reference to the best interests of RBS shareholders at a very difficult time. The arrangements were put before RBS's Remuneration Committee and the non-executives meeting as the Chairman's Committee;

(b) full disclosure was made to the Government of the position, as was necessary at the time. There was no concealment of any relevant matter. Mr Scott and I were keen to disclose the terms upon which Sir Fred was to depart (and indeed the terms on which his replacement would assume office). This was particularly the case in relation to the pension which was obviously a large and sensitive item. All requests from the Government were responded to constructively; and

(c) the suggestion that I or other directors in some way failed in our duty is inconsistent with others (Lord Myners and other Government representatives) approaching the matter in exactly the same way on the basis of the same relevant information—which is itself entirely consistent with the context and particularly the need for RBS to maintain Sir Fred's cooperation in the best interests of RBS shareholders.

Please note that Mr Scott has reviewed a copy of this statement and confirms that its contents are correct from his point of view.

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