House of Commons

Committee of Public Accounts

Maintaining financial stability across the United Kingdom's banking system

Twelfth Report of Session 2009–10

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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Mr Philip Dunne MP (*Conservative, Ludlow*)

Powers

Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publication

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 http://www.parliament.uk/pac. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Sîan Woodward (Clerk), Emily Gregory (Senior Committee Assistant), Pam Morris and Jane Lauder (Committee Assistants) and Alex Paterson (Media Officer).

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Summary

Banks are vital to the functioning of the economy. In 2007, financial institutions across the world began to encounter difficulties raising the funds needed to keep their operations going, leading to a crisis of confidence in the banking system. In response, governments have intervened to support the financial system.

The complexity of the problems across the financial sector and the speed with which events unfolded presented the Treasury and the other Tripartite Authorities with a formidable challenge.

There have been no disorderly failures of UK banks, and no retail depositor in a bank operating in the UK has lost money. Ultimately success will be linked closely with sentiments and events in world markets. To date a range of indicators, including benchmark interest rates for wholesale funding, bank share prices and the perceived risk of defaults, have stabilised and improved.

But the scale of the support required from the UK taxpayer to maintain financial stability totalling around £850 billion, has been truly staggering. Agreements to purchase shares in and make loans to the banking sector will, by the end of March 2010, result in a net cash outlay of around £117 billion. The Treasury has also provided guarantees of up to £450 billion to support borrowing by banks and has insured, through the Asset Protection Scheme, over £280 billion of assets held by the Royal Bank of Scotland.

Compared to its handling of the Northern Rock crisis in 2007, the Treasury was better resourced to contain the wider crisis that erupted in Autumn 2008, but its small team was seriously stretched. In responding to the crisis it was heavily reliant on the use of external advisers. The terms it agreed with its investment bank advisers included the use of retainers for long periods; and allowed for the potential payment of success fees in situations where no success criteria were specified, a practice wholly inappropriate in the public sector.

Lending to business, vital to the recovery of the economy, is falling short of legally-binding commitments entered into by two of the banks that received the most support: the Royal Bank of Scotland (RBS) and Lloyds Banking Group.

An indemnity given to the Bank of England by the Treasury was not notified to the Committee’s Chairman, in contravention of long-established Parliamentary procedure. As a constitutional safeguard, departments are required to notify Parliament of contingent liabilities and, where confidentiality is necessary, have been able to do so by informing the Chairs of the Committee of Public Accounts and the relevant departmental select committee. This convention was flouted in this instance.

Despite the enormous amounts of taxpayers’ money at stake the National Audit Office has not been able to examine directly the actions of the Financial Services Authority and the Bank of England. We welcome the recent announcement that the National Audit Office will shortly be appointed as auditor of the Financial Services Authority, but this leaves the Bank of England as the only member of the Tripartite Authorities not audited by the

National Audit Office.

The final cost of the schemes to the taxpayer remains uncertain and will not be known for a number of years. The priority now is to get the best value for the taxpayer from the huge sums of public money invested in the banks. The Treasury will have to get its timing right when sales are launched, as well as putting in place well thought through sales processes which take account of lessons learned from past sales.

On the basis of a Report by the Comptroller and Auditor General,[1] we took evidence from the Treasury on: the action it was taking to ensure that the taxpayer and wider economy are protected; its capacity to manage the programme of measures; and accountability to Parliament.

1 C&AG's Report, *HM Treasury: Maintaining financial stability across the United Kingdom's banking system*, HC (2009–10) 91

Conclusions and recommendations

Ensuring that the taxpayer and wider economy are protected

1. **Lending commitments to businesses are not being met and the Treasury appeared unable to tell us why.** We remain unclear whether the decline in lending growth is a result of reduced demand, a fall in the availability of funds for banks to lend, or a combination of these and other factors. The Treasury needs to understand fully the causes of the decline in lending when framing future policy responses and should, with the Bank of England, commission additional analysis to discover why the banks are not meeting the lending targets agreed as a condition of receiving taxpayer support.

2. **The Treasury has only limited sanctions available to it to encourage RBS and Lloyds Banking Group to meet what are described as legally binding lending commitments.** Further lending commitments are likely to be put in place from early 2010 and the Treasury, armed with a better understanding of changes to lending patterns, should use the time available to devise effective and enforceable sanctions if the banks continue to fall short of their commitments.

3. **The taxpayer continues to have hundreds of billions of pounds at stake although the Treasury believes it could make a profit when it sells the taxpayers' interests in the banks.** If a profit is to be made, careful risk management over a number of years and sound judgements on the timing of sales will be crucial. The Treasury and United Kingdom Financial Investments should ensure that the many lessons from our past reports on privatisations and other asset sales are taken on board when the sales processes are designed and executed.

4. **Obtaining good prices for the shareholdings will be important, but true success in disposing of the banks will depend just as much on the enhancement of competition in the banking sector.** The Treasury assured us that fostering competition would be uppermost in its mind when discharging its responsibilities with respect to the banking sector. The Treasury, working with UK Financial Investments, the organisation it set up to manage its shareholding, should establish clear criteria to enable it to assess how well its investment strategy balances its financial and economic objectives.

The Treasury's capacity to manage the programme of measures

5. **Despite additional staff to deal with the financial crisis, the Treasury has been extremely stretched to deal with the full range of its responsibilities, making it very reliant on external advice.** For the future, the Treasury should examine whether its own expertise and capacity is sufficient for the tasks it faces and ensure these skills are properly focused on core areas of responsibility carrying greatest risk.

6. **By agreeing to terms permitting the use of success fees with its investment banking advisers in a situation where no success criteria could be specified, the Treasury risks accepting City bonus practices that are wholly unacceptable in the public sector.** Where it does decide to use external advice, the Treasury should now

press ahead with its proposed framework arrangement for recruiting advisers on terms that will avoid the need to pay expensive retainers for periods of a year or more and remove the use of success fees in situations where no success criteria have been specified.

7. **Complex arrangements have been put in place to manage the Treasury's responsibilities for financial stability.** Much will be expected of two new organisations, United Kingdom Financial Investments and the Asset Protection Agency. While the creation of expert bodies with clear objectives can help protect the taxpayer, the Treasury should ensure that it does not lose sight of its own responsibilities to ensure good value for money. This will be particularly important when the taxpayers' shareholdings are sold and we expect to hold the Treasury to account, alongside UK Financial Investments, for the outcome of any sales.

Accountability to Parliament

8. **Expected losses for the taxpayer have fallen sharply in only nine months but inevitable uncertainties still surround these estimates.** The Treasury should continue to publish regular estimates of the likely net gain or loss arising from the taxpayer's support for the banks in the Budget and the Pre-Budget Report. In addition, greater transparency would be achieved if the key assumptions were also made public, along with the range of outcomes rather than just the single number set out in the recent Pre-Budget Report.

9. **There can be no excuse for flouting Parliamentary procedure. It is unacceptable that the Treasury did not notify us of an £18 billion indemnity covering part of the emergency liquidity assistance provided by the Bank of England to RBS and HBOS. In future, and only in very exceptional circumstances, when highly sensitive matters need to be disclosed, as a minimum we expect departments to provide the Chairman of this Committee with a full oral briefing. The Comptroller and Auditor General must also be present to advise the Chairman on what course of action to take, having had access to the underlying documentation detailing the contingent liability.** An agreed confidential record will be kept of any notification made in this way.

10. **Financial stability in the banking sector has been maintained at a huge price borne in large part by the taxpayer. In such circumstances it is not acceptable that the National Audit Office, the taxpayers' auditor, has not been able to scrutinise directly the actions of the Financial Services Authority and the Bank of England.** Following our report on the nationalisation of Northern Rock, we welcome the announcement that the Financial Services Authority is to appoint the Comptroller and Auditor General to be its auditor. We urge the Treasury to direct, by legislation if necessary, the Bank of England to do the same.

1 Ensuring that the taxpayer and wider economy are protected

1. The support measures were designed to improve confidence in the United Kingdom's banking system, and thereby maintain financial stability. The maintenance of financial stability involves:

- maintaining liquidity to allow banks to meet customer withdrawals of cash, and to repay outstanding borrowings in the wholesale markets when they fall due;
- ensuring that the major banks were solvent, that is, that they had capital to cushion themselves from losses caused by a further deterioration in the financial markets, and
- encouraging banks in receipt of support to continue to lend on a commercial basis to creditworthy borrowers, thereby reducing further deterioration in the economy, which could in turn lead to further liquidity and solvency issues across the banking sector.[2]

2. There is no single measure of success in maintaining financial stability but a range of indicators have since stabilised and improved. Success is linked closely with sentiments and events in both domestic and world markets and drawing a direct link between individual measures and changes in market indicators would not be valid. By November 2009, a range of indicators such as the benchmark interest rates for wholesale funding, bank share prices and the perceived risk of bank defaults had eased. In his report, the Comptroller and Auditor General concluded that the Treasury had met two of the Government's objectives, namely maintaining financial stability and protecting retail depositors. The Treasury's performance in meeting the Government's other objectives of protecting taxpayer' interests and ensuring continuing lending to creditworthy borrowers are considered further in this report.[3]

3. In the March 2009 Budget, the Treasury estimated that the final net cost to the taxpayer of supporting the banks might range from £20 billion to £50 billion, depending on the strength of any recovery in the economy.[4] The most recent estimated net cost, included in the December 2009 Pre-Budget Report, was significantly lower, at some £8 billion.[5]

4. The estimated losses continue to be highly uncertain, although the risks associated with most of the interventions declined significantly during 2009. For example, in its Annual Report for 2008–09, published in July, the Treasury made a provision for expected losses from the Asset Protection Scheme of £25 billion.[6] However, following Lloyds Banking Group's decision not to enter the Scheme in November 2009 and changes to the terms

2 C&AG's Report, para 3.2

3 Q 51; C&AG's Report, paras 12, 13, 3.4 and 3.7–3.14

4 C&AG's Report, para 15

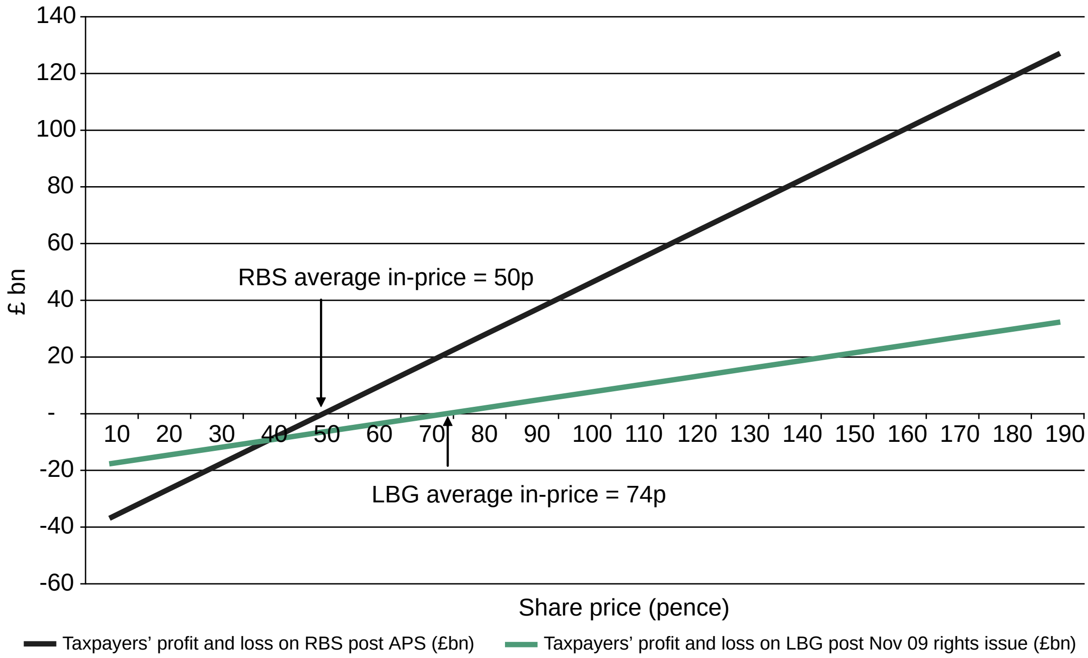
5 HM Treasury, *Pre-Budget Report 2009*, p 199

6 C&AG's report, para 3.32

under which RBS would participate, the Treasury's base case now suggests there may not be any cost to the taxpayer arising under the Scheme.[7] Overall, the Treasury has received sizeable fees for providing guarantees and other forms of support. As the economy recovers, the Treasury expects that a net profit may eventually be made.[8]

5. The main risk for the taxpayer is now the prices obtained when the shareholdings in RBS and Lloyds Banking Group are eventually sold off. For every ten pence increase in the prices obtained for the shares, taxpayers will secure an additional £9 billion from the sale of shares in RBS, and an additional £3 billion from Lloyds Banking Group shares (**Figure 1**).[9]

Figure 1: Potential profit or loss for the taxpayer at different share prices



Source: C&AG's Report, Figure 19

6. It will be some years yet before the taxpayer can disengage from the various support measures and shareholdings. In the Treasury's view, if the assets insured under the Asset Protection Scheme performed well and RBS gained access to alternative sources of capital, it might exit the Scheme early after two to three years. All of the support schemes will eventually be wound down but it is likely that the shareholdings, particularly in RBS, will be the last to end. Timing will depend on the performance of the financial markets, which is difficult to predict, although the Treasury considered that the process could be completed in three to five years.[10]

7. The Treasury accepted that measurement of its ultimate success should extend beyond the return obtained for the shares, with regard paid to future competition in the banking sector. The crisis in the sector had led to further consolidation in the UK market, including

7 Qq 29 and 49

8 Qq 30 and 32–33

9 C&AG's Report, para 3.31

10 Q 50

the merger of Lloyds and HBOS. The Treasury would have to balance its interest as shareholder against its interest in promoting a competitive banking system. The creation of UK Financial Investments as an arms-length body to manage the shareholder interest was partly a means of managing this tension. Under current proposals RBS and Lloyds Banking Group would divest themselves of some of their constituent businesses. There were also proposals to reduce Northern Rock's balance sheet, all of which should result in new entrants to the market.[11]

8. In negotiating the Asset Protection Scheme, the Government agreed lending commitments under which Lloyds Banking Group would lend an additional £14 billion and RBS an additional £25 billion in the year to February 2010. The commitments were legally binding.[12]

9. At the end of September 2009, both RBS and Lloyds Banking Group were on track to meet their mortgage lending targets but lending to businesses, particularly small and medium-sized businesses, is likely to fall short.[13] The Chancellor of the Exchequer had established a lending panel which meets once a month to hold the banks to account. The banks had argued that they were trying to lend, but demand for loans to businesses had fallen away. Larger businesses had raised £25 billion in the bond and equity markets in the previous six months with a lot of this being used to pay off debt (**Figure 2**).[14] But small businesses still reported difficulty getting access to credit from banks.[15] In October, the Bank of England reported that fees charged by the banks on new business or renewed lending remained at high levels compared to before the crisis. Some small businesses suggested the banks were making changes to the conditions governing existing loans and previously agreed overdraft limits.[16]

10. The Treasury could not say why the lending commitments to businesses were not being met. It did not expect the banks to enter into arrangements that were not commercially viable. Higher charges for lending could reflect the fact that lending to small business is more risky during a downturn. Interpreting the lending data was therefore difficult. The Treasury drew upon a range of evidence sources to try to identify the real position, including monthly reports on lending published by the Bank of England and credit condition surveys which sought the views of business. It accepted, however, that it needed to redouble its efforts to understand why the lending targets were not being met.[17]

11. Ultimately, the Treasury has few formal sanctions available if the commitments are not met. It could refuse to extend guarantees for wholesale borrowing under the Credit Guarantee Scheme.[18] The Credit Guarantee Scheme is due to close at the end of February 2010. On closure, a proportion of the existing loans could be rolled forward for up to three

11 Qq 4 and 5

12 C&AG's Report, para 3.19

13 C&AG's Report, paras 3.20 and 3.22

14 Qq 12, 22 and 69

15 Q 40

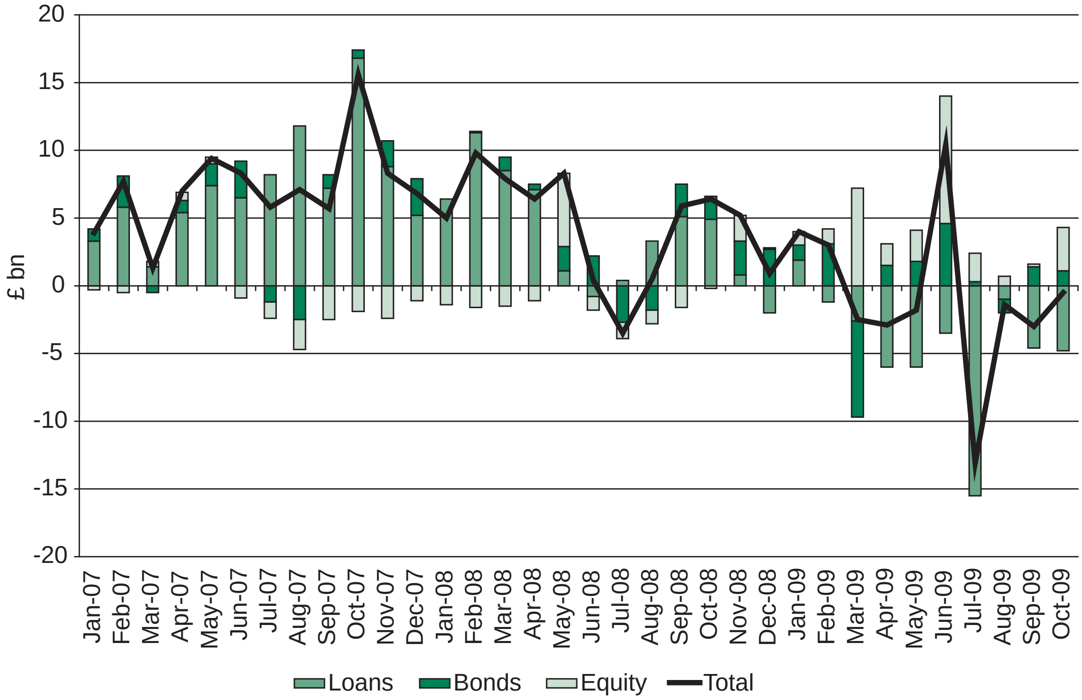
16 Q 59

17 Qq 21, 71 and 72

18 C&AG's Report, para 3.22

years but this was subject to a cap and the Treasury had the power to decide which loans could be rolled forward. In addition, in the case of RBS, the Chief Executive's remuneration is, in part, linked to the achievement of lending commitments. The Treasury expects to put in place further lending commitments from March 2010 but no targets had yet been set.[19] Alongside considering new targets, the Treasury would think about methods of enforcement.

Figure 2: Net funds raised by UK businesses

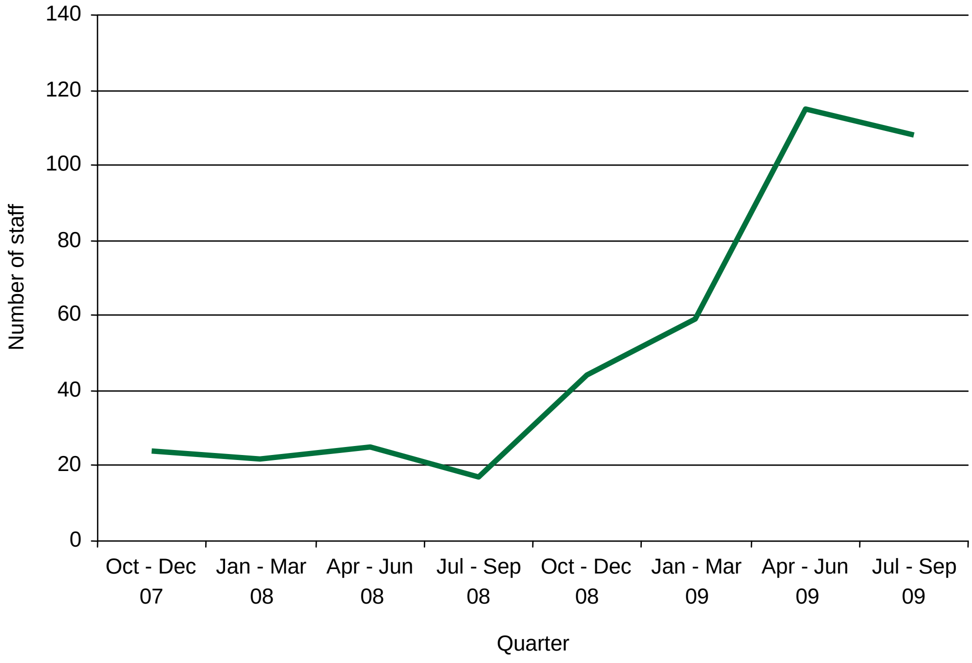


Source: C&AG's Report, Figure 15 (updated to end of October 2009)

2 The Treasury's capacity to manage the programme of measures

12. The banking crisis had placed significant demands upon the Treasury's capacity. Between February 2008, when Northern Rock was nationalised, and May 2009 the number of staff employed on financial stability issues increased significantly (**Figure 3**).[20] Nevertheless, the Treasury had been stretched by the range of issues it had to cope with, on top of the Department's wide range of other responsibilities. Staff had worked very hard in difficult circumstances. Most of the additional staff employed had helped to set up the Asset Protection Scheme. The Treasury considered it could begin to reduce staff numbers in some areas, for example, the establishment of the Asset Protection Agency would mean that fewer resources would be retained within the core Treasury. Nevertheless, it would continue to juggle a range of roles and acknowledged that staffing levels would need to be monitored closely.[21]

Figure 3: the number of staff working in the Treasury's Financial Stability Unit



Source: C&AG's Report, Figure 6

13. The Treasury made extensive use of external advisers, including financial and legal advisers. The Treasury expects to spend £107 million on advisers, although all but £7 million is likely to be charged back to the banks. Two investment banks, Credit Suisse and Deutsche Bank, were appointed, initially on retainers of £200,000 a month for a year. These appointments also included the potential payment of success fees of up to £5.8 million, but

20 C&AG's Report, para 17

21 Q 6

the contracts did not define success, instead leaving payments to the sole discretion of the Treasury.[22]

14. The Treasury considered the sum spent on external advice to be small compared to the sums of taxpayers' money at stake and that the fees paid represented good value for money. The level of fees involved had been lower than the amounts spent by the private sector, for example on capital raising schemes, such as HSBC's 2009 rights issue. It suggested that compared to the figure of £30 million needed to resolve Northern Rock, the remaining £70 million had helped finalise a number of transactions and put in place the suite of support schemes. Some of this work had been particularly complex. The due diligence for the Asset Protection Scheme, for instance, had involved the detailed checking of one million assets.[23]

15. The Treasury believed the payment of retainers to the investment banks was justified in the circumstances but was considering ways of strengthening the procurement of such advice in the future. The investment banks had been appointed at short notice following competition. Given the uncertainties, the precise nature and extent of the work was not known at the start. The Treasury had yet to decide whether to pay the success fees. Where there was less uncertainty, different fee arrangements had been agreed. In the case of Bradford & Bingley, Morgan Stanley provided specific advice on its sale and a fixed fee was agreed for the transaction, rather than a retainer and success fee arrangement. In the case of accountancy advice, it had used an existing government-wide procurement framework and had paid the agreed rates. The Treasury was considering how a framework similar to that used for the accountancy firms could be used to procure investment banking advice in future.[24]

16. The banking crisis has left the Treasury juggling a variety of new roles: as major investor, or owner, of a number of banks; guarantor of borrowings by banks in the wholesale markets; and insurer of the assets owned by RBS. It has established a range of bodies to help it manage some of these responsibilities. It created UK Financial Investments, a company wholly-owned by the Government, to protect and create value for the taxpayer as shareholder, with due regard to financial stability and promotion of competition. In addition, a new Asset Protection Agency will manage its interest in the insured assets of RBS.[25]

17. The Treasury will need to have a clear view of where responsibilities should lie in this new framework and how risk will be managed. It believed that the establishment of UK Financial Investments and the Asset Protection Agency will attract the right skills to those roles and build a critical mass of expertise within those agencies. Its aim is to manage risk where it is most appropriate. It had published information on how it intended to run its relationship with the new bodies and would report regularly to Parliament on performance.[26]

22 C&AG's Report, para 18

23 Q 13

24 Qq 14, 16 and 109

25 C&AG's Report, paras 20 and 21(e)

26 Q 39

3 Accountability to Parliament

18. In October 2008, the Treasury authorised the Bank of England to provide emergency liquidity assistance in the form of loans to HBOS and RBS and indemnified the Bank against potential losses, but did not inform Parliament of the support until November 2009. It is normal practice where a government department proposes to incur a contingent liability for Parliament to be informed beforehand. In circumstances where confidentiality is necessary, long-standing procedures allow departments to inform the Chairs of the Committee of Public Accounts and the relevant departmental select committee in confidence. At its peak, the indemnity covered £18 billion of the emergency support, in addition to over £100 billion of collateral that the Bank of England had received from the two banks. By mid-January 2009, the emergency support had been replaced with other funding, including using debt issued under the Credit Guarantee Scheme.[27]

19. The Chancellor of the Exchequer had decided, given the sensitivity of the situation in October 2008, to disclose the information about the emergency support to as few people as possible to reduce the risk of leaks. The Treasury had been concerned to avoid the situation encountered the previous Autumn when emergency liquidity assistance provided by the Bank of England to Northern Rock had become public knowledge and had led to a run on deposits. It considered that the high level of collateral received by the Bank of England meant that the risk of the indemnity being called was not high. The support was also intended to be a temporary measure ahead of implementation of the Credit Guarantee Scheme.[28]

20. The procedures for departments to notify Parliament of contingent liabilities provide an important constitutional safeguard. The Treasury accepted that the emergency assistance provided directly to HBOS and RBS should have been separately notified. In the Treasury's view, the conventions were still in place and played an important part in Parliamentary accountability. These had been exceptional circumstances involving market information of particular sensitivity. It was aware of Parliament's recent reaction following disclosure of the support and was keen to learn lessons from this episode.[29]

21. Whilst the National Audit Office has been able to examine the action taken by the Treasury to safeguard taxpayers' money during the crisis, it has not been able to examine directly the actions of the Financial Services Authority and the Bank of England.[30] Following our report on the nationalisation of Northern Rock, the National Audit office will shortly be appointed as auditor of the Financial Services Authority.[31] But this leaves the Bank of England as the only Tripartite Authority not audited by the National Audit Office.

22. Since the crisis of 2008, the Tripartite Authorities have been given enhanced powers to deal with financial institutions. The Banking Act 2009 gave the Financial Services

27 C&AG's Report, paras 10 and 11

28 Qq 2 and 74

29 Qq 87–89 and 148

30 C&AG's Report, para 3

31 Committee of Public Accounts, Thirty-first Report of Session 2008–09, *The Nationalisation of Northern Rock,* HC 394

Authority and the Bank of England enhanced roles in resolving banks that get into difficulty. The new Act provided for the Financial Services Authority to determine when the powers in the Act can be exercised and for the Bank of England to decide whether to exercise certain stabilisation powers, including the sale of all, or part of a business to a private sector purchaser, or a transfer to a "bridge bank", pending a final resolution. The Treasury retains the right to take a bank into temporary public ownership where there is a serious risk to the financial system. Ultimately, as this crisis has shown, significant financial risks can end up being borne by the taxpayer.[32]

23. The Chairman of this Committee has recently written to the Chancellor of the Exchequer on the arrangements governing the audit of the Bank of England. The issue of audit responsibility is currently with Ministers.[33]

32 C&AG's Report, para 2.3

33 Q 156

Formal Minutes

Monday 1 February 2010

Members present:

Mr Edward Leigh, in the Chair

Rt Hon David Curry
Rt Hon Keith Hill
Mr Austin Mitchell

Draft Report (*Maintaining financial stability across the United Kingdom's banking system*), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 23 read and agreed to.

Conclusions and recommendations 1 to 10 read and agreed to.

Summary read and agreed to.

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

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

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

[Adjourned till Wednesday 3 February at 3.30 pm

Witnesses

Monday 14 December 2009 *Page*

Sir Nicholas Macpherson, Permanent Secretary and **Mr Tom Scholar,** Second Permanent Secretary, HM Treasury Ev 1

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Oral evidence

Taken before the Committee of Public Accounts

on Monday 14 December 2009

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Keith Hill
Angela Browning	Mr Austin Mitchell
Mr Douglas Carswell	Dr John Pugh
Mr Ian Davidson	Mr Don Touhig
Nigel Griffiths	Mr Alan Williams

Mr Amyas Morse, Comptroller and Auditor General, **Mr Ed Humpherson,** Assistant Auditor General and **Mr Peter Gray,** Director, National Audit Office, gave evidence.

Ms Paula Diggle, Treasury Officer of Accounts, HM Treasury, gave evidence.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

MAINTAINING FINANCIAL STABILITY ACROSS THE UNITED KINGDOM'S BANKING SYSTEM (HC91)

Witnesses: **Sir Nicholas Macpherson**, Permanent Secretary and **Mr Tom Scholar**, Second Permanent Secretary, HM Treasury, gave evidence.

Q1 Chairman: Good afternoon and welcome to the Committee of Public Accounts where today we are considering the Comptroller and Auditor General's Report on *Maintaining financial stability across the United Kingdom's banking system* and we welcome back to our Committee Sir Nick Macpherson who is the Permanent Secretary of the Treasury. Would you like to introduce your colleague?
Sir Nicholas Macpherson: Yes, my colleague is Tom Scholar, Second Permanent Secretary to the Treasury who is responsible for the international and finance side of the Treasury.

Q2 Chairman: The Report tells us that the support provided to the banks was justified and we would not normally, anyway, get into the wider policy implications of action taken by the Treasury but we are just having an initial inquiry here today on how effective that support was and what we can get for it. The figures are absolutely staggering. Do correct me if I am wrong but we have so far actually paid out £131 billion, we have got back £14 billion which leaves a net cost of £117 billion, but if we take into account various guarantees and exposure we may be exposed up to the tune of £850 billion—it is almost like the figures that come out of the US economy of a trillion billion pounds. I am not sure that we have ever used that figure in this Committee before; it just shows where we are. This is an extraordinarily important issue but, first of all, Sir Nick, I want to ask you why it took you 13 months to inform me and my colleague, the Chairman of the Treasury Committee, that you had issued an indemnity to the tune of £62 billion. Just for the sake of the record, if the Government wishes to do something in secret because of commercial sensitivities or national security there are long-standing constitutional safeguards to ensure that the Chairman of this Committee and the Chairman of the Treasury Committee are told in private. This is not sort of *amour-propre* on my part because I have not been told, because I would not have shared this information with anybody apart from the Comptroller and Auditor General, who is the accountant to government and he could have checked that everything was done in the right way. This is a very important constitutional safeguard; why was it not carried out on this occasion, Sir Nicholas?
Sir Nicholas Macpherson: First can I just make a factual point that the extent of the emergency liquidity assistance was £60 billion but the amount which was guaranteed by the Treasury was £18 billion—still a very large sum of money. The Treasury is very mindful of its responsibilities in relation to Parliament and to the Chairman of the Committee of Public Accounts in particular. The events of last October were truly exceptional; we were staring into the abyss in the first two weeks of October and there was a very grave danger that the entire banking system could collapse. We had had a very unfortunate experience the previous year in relation to Northern Rock where—I hasten to add absolutely nothing to do with Parliament—information around emergency liquidity assistance leaked and it can be argued that that precipitated the run on Northern Rock. The decision was therefore taken last October to disclose this information to as few people as possible. It was a decision taken by the Chancellor to minimise the risk of leaks. It is also worth just explaining what the emergency liquidity assistance was there for: it was effectively providing bridging finance to HBOS and the Royal Bank of Scotland before they could take up the guarantees

available under the Credit Guarantee Scheme and the Special Liquidity Scheme. Both those schemes we had been very clear about in terms of the support the Treasury would give them and, indeed, on October 8 the Chancellor announced to Parliament the extent of those guarantees. In effect the guarantees under emergency liquidity assistance were subsumed within these further guarantees, so through this period Parliament was always aware of the maximum total risk. What you were not aware of was that some of this was being provided through emergency liquidity assistance rather than the Credit Guarantee Scheme. Over the course of the year a number of things have happened, leading to the announcements last month in relation to Lloyds and, at that point, the Governor of the Bank of England took the view that it was reasonable to disclose.

Q3 Chairman: You did not take the decision to disclose it because the NAO Report which we are now going to discuss this afternoon was about to be published and it was going to come out anyway. 13 months too late you decided to publish this because you knew it was about to come out.
Sir Nicholas Macpherson: National Audit Office reports always concentrate people's minds but the fact is that the announcements in November, which included an announcement about the general amount of support Lloyds was getting, indicated that the market had stabilised and there would be no threat to stability in revealing this sum of money. I should also say that since then you have quite rightly written to the Chancellor of the Exchequer and the Chancellor of the Exchequer has written back and indicated that we are keen to learn the lessons.

Q4 Chairman: We will leave that conversation as well. I do not want to go on and on about this, there is so much to discuss this afternoon. We have made our point, the Chancellor has talked about various protocols, we just want to ensure that this does not happen again because we are not just anybody, this is Parliament and this is what Parliament does, it votes the money, and somebody in Parliament should know what is going on. We will just leave it like that. Figure 5, if you look at that, on page 19, you can see that the six largest banks in the UK mortgage market increased their market share to 78%, so as far as the general public are concerned do you think that at the end of this we are going to get better priced banking for the consumer, despite the increasing market share of the largest providers?
Sir Nicholas Macpherson: We certainly have an interest in greater competition in the banking sector and that depends on having banks which are reasonably strong and therefore able to compete. As a result of the events of last year and the decision by HBOS and Lloyds to merge we obviously have got one fewer bank because HBOS is no longer independent, but against that the decisions taken to increase competition will result in significant reductions in both RBS's and Lloyds' balance sheets. There are also proposals to reduce Northern Rock's balance sheet, all of which should result in new entrants in the market. We want to see a competitive banking system and we will continue to monitor and indeed promote that.

Q5 Chairman: Is there now not a conflict inside the Treasury between your duty to protect yourself as shareholders and your desire to help the consumer?
Sir Nicholas Macpherson: What you have identified is the classic tension within the Treasury between being an economics ministry and a finance ministry. We try and internalise that tension and indeed some of our institutional arrangements—for example creating UK Financial Investments to in effect represent our shareholder interest at arm's length—enable us to make that work. It would be nice to make a profit on our shareholdings but we would be very careful about seeking to make a profit at the expense of reducing competition; competition is really important for the effective operation of the economy and I completely endorse this Report's findings that in measuring success we should take a broad view which goes beyond the finance ministry return.

Q6 Chairman: I read somewhere in this Report that before Northern Rock you only had 17 people in the Treasury working on financial stability; you are now a huge shareholder in these banks, you are managing these enormous sums in terms of guarantees, you are running the economy, you are doing your traditional role of telling the Department of Work and Pensions how much it can spend on office furniture: can you cope? Have you got the resources? Also you are dealing with the whole of tax credits and all the difficulties we have had over that. Where is the Treasury going to? You are managing the Treasury.
Sir Nicholas Macpherson: We have got the resources in place. As you know we have had to increase staffing levels over the last 18 months, primarily to deal with the banking crisis but also some of the other issues falling out from the global downturn. I am confident we have got the resources and indeed, actually, in some areas we can now begin to pull back a bit. For example, we have just set up the Asset Protection Agency; that will result in fewer resources allocated to financial stability but you are right to identify this as an issue and it is something we need to keep a close eye on. But the Treasury has been firing on all cylinders over the last year and people have worked incredibly hard, often over many weekends. I am actually quite proud of the workforce of the Treasury and they have done a pretty good job under very difficult circumstances, but we will continue to monitor staffing levels.

Q7 Chairman: There have been reports about this today indeed. How do you feel about the EU being responsible for British banking being competitive? Are you happy with the EU being responsible?
Sir Nicholas Macpherson: We are in a single market; when we joined that single market through the 1986 Single European Act the terms of debate on competition changed. The Commission has played a constructive role but it is also important that our own competition authorities are alert to the banking

system, and indeed the Office of Fair Trading has been playing quite an active role in relation to the banks.

Q8 Chairman: The answer is yes, you are happy.
Sir Nicholas Macpherson: Look, I am an official, Mr Leigh.

Q9 Mr Bacon: A happy official is an oxymoron.
Sir Nicholas Macpherson: I accept the regime.

Q10 Chairman: All right, we will leave that, we will pass on. What the public are obviously very concerned about is the lending commitments that were made by RBS and Lloyds to business; we have got struggling businesses in a recession. Shall we look at paragraph 3.20, Sir Nick?
Sir Nicholas Macpherson: Yes.

Q11 Chairman: The last sentence tells us: "Performance so far in 2009 suggests that RBS's commitment to lend an additional £16 billion to business by February 2010 will not be achieved." If we read the previous paragraph, 3.19, we see that "In negotiating the Asset Protection Scheme, the Government agreed legally binding lending commitments with Lloyds Banking Group and RBS." Do you feel you have been led up the garden path by these banks?
Sir Nicholas Macpherson: Just one positive: they are meeting their mortgage lending commitments. Their lending to the corporate sector is more disappointing.

Q12 Chairman: Disappointing? They are breaking a legally binding commitment. Are you going to sue them? What is going to happen? Are you going to drag them in? Is the Chancellor going to ensure that they meet their commitments? We have bailed them out, the taxpayer; now have we not, the taxpayer, also got a right to demand that they meet their commitments?
Sir Nicholas Macpherson: We do have a right to demand that although we want them to lend to profitable propositions. Anybody can lend money if you are prepared to throw it down the drain, so we want sensible lending. The figures have been distorted by the fact that business has been raising a great deal of money from the bond market and from the equity market—some £25 billion has been raised from those sources in the last six months—and quite a lot of that money has been used to pay down debt at the banks. It is therefore quite a complex set of issues. Ultimately, as you say, they are commitments, they are legally binding ones. What you have identified is what can we do if they fail to meet them and obviously we need to understand why they have not met them. On the face of it RBS are doing quite a lot in terms of trying to lend money to the corporate sector and one sanction we have got is to withdraw support through the Credit Guarantee Scheme. We have set that out and it is fair to say in the case of RBS our lending commitments do affect some of the remuneration incentives which RBS staff have.

Q13 Chairman: I do not want to make a lot about this because maybe others will want to comment on bonuses, but one thing I want to ask you is while there has been all this publicity about bonuses it is staggering what you are paying for consultants—this will be my last question and I will let others come in. One firm of solicitors, Slaughter & May, has netted £30 million from us. How can one firm of solicitors do that—that is half the entire budget for the National Audit Office. £10 million you paid to Credit Suisse; you are paying £200,000 a month (or were) to Deutsche Bank and £110,000 a month will come out in success fees. There has been all this criticism of bonuses that the banks have paid their own staff, but you are paying success fees, a total of a massive £100 million in consultancy fees. You have been telling me how efficient you are at running the Treasury, why do you spend £100 million of our money in feeding consultants?
Sir Nicholas Macpherson: The £100 million is a very, very small sum in relation to the huge sums of money you mentioned at the beginning, and it is actually striking that if you look at any large corporate—say when HSBC had its rights issue recently—they will spend far more on advisers' fees than we have spent. I actually think that the amount we have spent on advisers is good value for money for the taxpayer. It is striking that you had me before this Committee about a year ago and you quite rightly identified that we spent £30 million odd in relation to Northern Rock. If you look at what we have managed to achieve for the remaining £70 million it is a huge amount. These are hugely complex transactions; the Asset Protection Scheme alone is based on one million assets; we have got to do due diligence on that sort of thing, you would be criticising me if we had not, and with the best will in the world I cannot run the Treasury as if it is both an investment bank, a firm of City solicitors and an accountancy firm on the basis that once in a generation—not even once in a generation, once in 100 years—transactions like this will come along. We have charged all but £7 million of those fees back to the banks and indeed we have already got £80 million of it paid back by the banks, so I am afraid I will not apologise for the amount of money we have spent on advisers' fees.
Chairman: Fine; thank you very much. Angela Browning.

Q14 Angela Browning: Thank you, Chairman. I would like to pick up where you have just left off on this question of external advisers because you have just said, Sir Nicholas, that you will not apologise, but I would like to plumb a little deeper into what have been the lessons learned in the way in which you have commissioned work from external advisers and what you might do differently in the future. If we could begin by looking at pages 24 and 25, in Part 2, which give an overall outline of the case that Mr Leigh mentioned, Slaughter & May, and then we see the amount of money paid under figure 7 to various accountancy firms, I understand that when a crisis hits you are not going to be geared up to have that expertise in the numbers you want on tap in the Treasury but I do share the Chairman's concern about these open-handed contracts where they are just paid ongoing retainers. Can you just tell us what have been the lessons learned from this exercise?

Sir Nicholas Macpherson: We have learned quite a few lessons and this Committee and the National Audit Office helped us learn those lessons along the way. In particular I mentioned Northern Rock; it is striking that the amount of transactions we have got for the money has improved vastly over time. You have identified two areas for example where we did use retainers. That was the right thing to do if you are, as we were then, staring into quite an uncertain future where you want to have the advice on tap but you do not want to set out—you cannot because of uncertainty—precisely what you are going to want from the advisers, but in a whole lot of other areas it has been possible to articulate that very clearly. We have also used better project management techniques in terms of managing these contracts, we have also used framework deals where we can, and actually another lesson in terms of the Asset Protection Scheme was bringing in people on secondment to whom we were paying pretty much the same amount of wage as we pay to a Treasury official to do some of the work on the due diligence around the Asset Protection Agency. I do think we have learned. Tom Scholar has managed a lot of these contracts and may want to just very briefly expand on that.

Mr Scholar: Thank you. Just to give you a couple of examples, in the case of Morgan Stanley that was specific advice on a specific transaction which was the resolution of Bradford & Bingley and in that case we agreed a specific fee relating to that rather than any kind of retainer or success fee. In the case of the accountancy firms listed in figure 7 we took those from an agreed government procurement framework and paid them the agreed rates, so where possible we have always followed that kind of procedure. As my colleague says, in the case of the two investment banks where we knew we were embarking into possibly a long period of advice against a backdrop of great uncertainty, in those two cases we did adopt the other approach. Having said that, we are clear now that we have come to the end of that period; we have come to the end of a number of major projects on which Deutsche Bank, Credit Suisse and indeed Citi were working, so what we are now going to do is to look to see how we can replicate for investment banking advice the same frameworks that we already had for accountancy and that we have now put in place for legal advice.

Q15 Angela Browning: When you have a major crisis and you have to issue contracts of this nature, I assume you are not able to have the time to go through the normal procedures you would have. I am not asking you to mention any particular company but how did you go about making sure that the people you were commissioning had that particular expertise and that you were getting good value for money, or did good value for money go out of the door in the crisis?

Mr Scholar: No; good value for money was absolutely essential and guiding our decisions at all times. Just to give an example on that, the table sets out a total cost of £107 million; around £30 million of that was for Northern Rock, most of the rest of that was for the Asset Protection Scheme. This was a transaction of potentially £600 billion; it would be quite normal in a commercial transaction for a fee of something around the order of 10 basis points—in this case that would be £600 million—to be paid, and we were clearly paying only a very small fraction of that. There is a good reason for that which is that a number of the advisers concerned were keen to work for the Government, even at what they understood would be much, much lower rates, but that did give us a certain degree of negotiating leverage which we certainly exercised. How did we choose who to employ? In the case of the investment banks we contacted half a dozen. We had previously worked with two others, we did not want to go back to them again because we thought it important to have a range of advice, so we contacted the leading players that we were satisfied did not have any conflict of interest in relation to the particular banks that we knew we would be dealing with in the autumn of 2008. We contacted them, we invited them in, they submitted bids and we selected on the basis both of competence and quality of advice and the bids that we had.

Chairman: We are going to have to have shorter answers; poor Mrs Browning has only had about three questions so could you try and make it a bit more zippy.

Q16 Angela Browning: The success of a good contract, at its heart, is really the specifications that are drawn up initially. If you do not get that right you can waste a lot of money and not hit targets and so on. How did you, in this crisis, manage to draw up the specification for the contracts which these companies eventually were given? Where did you draw on that expertise for drawing up the contracts and writing up the spec, or did they actually write their own specs?

Mr Scholar: No. In the case of Morgan Stanley, the example I gave, the success criterion was very simple: it was the successful resolution of the Bradford & Bingley in a short timeframe. In the case of Credit Suisse and Deutsche Bank who we employed in the autumn of 2008, we did not know at that point the circumstances that we would be dealing with. We therefore stipulated that the success fee would be at our sole discretion. We have not to date paid the success fees because we have only just come to the conclusion of all the work so we are now going to evaluate the work that they did for us and what it delivered for the taxpayer and we will make an assessment based on that, but it is at the Treasury's sole discretion.

Q17 Angela Browning: What is the biggest lesson you have learned from the way in which external advisers have been involved in helping with this crisis?

Mr Scholar: I would say two lessons. First of all we need to have a high degree of internal expertise in order to be sensible and intelligent customers and, secondly, it is very important to build ongoing relationships with a number of potential advisers and that is why we put in place the panels that we referred to earlier.

Q18 Angela Browning: Are they going to be an ongoing part of the way the Treasury runs from now on?
Mr Scholar: Yes, very much so.
Chairman: Thank you very much, Mrs Browning. Keith Hill.
Keith Hill: Thank you, Chairman. I am bound to say that it seems to me that £100 million for saving two major banks is not an extortionate amount of money if you compare the evidence we have from yesterday's *Sunday Times* that PricewaterhouseCoopers seem to have made fees of £154 million out of the collapse of Lehman Brothers Europe, part of a "charmed circle" according to the *Sunday Times* who have made £3 billion over the last two years out of insolvencies. Indeed, this provoked the observation that ". . . 'this is an enormous extortion racket carried on behind a very opaque scheme quietly. These firms are making themselves very rich', Austin Mitchell, a Labour member of the Commons Public Accounts Committee".
Mr Davidson: So it must be true.
Mr Mitchell: It must be true.

Q19 Keith Hill: It does seem to me therefore that £100 million is not, frankly, an excessive amount when set against the sums of money involved. However, I do want to follow up on the issue of the failure of these banks to meet their lending commitments. You mentioned, Sir Nick, that one of the few sanctions that you might have available on these banks was through refusing an extension of access to the Credit Guarantee Scheme, is that right?
Sir Nicholas Macpherson: Yes.

Q20 Keith Hill: But am I also right in thinking that this scheme is due to close to new lending by the end of December of this year?
Sir Nicholas Macpherson: That is correct; it is being rolled forward for another couple of months into February and the scheme may be closed to new loans but loans which mature thereafter can be rolled forward subject to a three-year limit, is that right?
Mr Scholar: That is right; a certain proportion of the existing loans under the scheme can be rolled forward, but that is subject to a cap and the Treasury will decide which of those loans to extend. That is where this sanction would bite.

Q21 Keith Hill: Could I ask you also about an observation made in paragraph 3.22 of the NAO Report which is about higher interest margins being charged on bank loans. The problem is not so much larger scale corporations raising money from the money markets but, rather, the limited access that small business in particular has and its traditional reliance on the banking sector. Let me quote the NAO Report: "Higher interest margins and fees on bank loans may also have acted to reduce demand." It goes on to quote from the Bank of England's *Trends in Lending* report of October, "The Bank's regional agents report that fees charged on new business or renewed lending facilities remained at high levels, compared to before the crisis." Let me ask you, do you recognise these higher fees as a deterrent to particularly small businesses taking advantage of bank lending?
Sir Nicholas Macpherson: Inevitably they will act as some deterrent but I do not think these higher charges are necessarily capricious; they reflect the fact that lending to small business is more risky during an economic downturn. Having said that, the point is that as interest rates are at very low levels you would expect margins at banks to increase because historically banks tend to get a lot of their profit from the difference between what they are paying to depositors versus what they are lending out at, and as interest rates get down to zero all that becomes a bit problematic. This is something we are monitoring closely. We have an extensive dialogue with the major banks and we want to keep the pressure up; on the other hand we do not want them to lend at a loss, they have got to be quite hard-headed in their decisions. To come back to my earlier point, competition is important and we need to continue to promote that.

Q22 Keith Hill: But what pressure are you keeping up?
Sir Nicholas Macpherson: There are a number of forums within which we meet the banks. The Chancellor has a lending panel which meets pretty much once a month to hold the banks to account. This is difficult because the banks argue that they are trying all they can to lend, RBS has got special help lines, it is running seminars, it has a special small business charter informing its lending practices, but they would argue that the demand is not there. I know you hear from your constituents and we hear from members of the public that companies feel it is still pretty tough out there, so we are seeking to keep the pressure up.

Q23 Keith Hill: But it is just exhortation really that you can exercise; this is maybe the reality of the situation, it is persuasion and appeal.
Sir Nicholas Macpherson: It is a bit more than exhortation. One of the success criteria in Stephen Hester of the Royal Bank of Scotland's bonus is meeting the lending agreement, so there are real implications there.

Q24 Keith Hill: Are you thinking about setting lending targets for the next financial year?
Sir Nicholas Macpherson: We have not got to the end of this one yet. The year goes from March to the end of February 2010; we will obviously take stock at that point but I would fully expect there to be lending targets for the next financial year, yes.

Q25 Keith Hill: How are these likely to differ if at all from the present targets and are you thinking about methods of enforcement?
Sir Nicholas Macpherson: We are clearly going to have to think about that. As you know from targets in other areas you want targets to be stretching but also achievable, and we will have to look at how the economy is doing at that point and what is a realistic level of growth. Clearly the Treasury is forecasting that a recovery is going to be underway by the year end and, historically, bank lending tends to pick up with economic growth, so I would expect pretty demanding targets consistent with a growing economy.

Q26 Keith Hill: Since all banks have benefited in some respects from the taxpayers' bailout may I ask if you have ever considered imposing lending commitments on other banks?
Sir Nicholas Macpherson: We have, because banks which access the Credit Guarantee Scheme have to have lending agreements—for example, Nationwide have entered into a lending agreement as part of their access to the CGS. Similarly, Barclays entered into an agreement and Northern Rock obviously are already part of the system. Tom, again you are closer to the action.
Mr Scholar: We have done all those things and, indeed, one or two other banks, I am thinking in particular of HSBC, have made their own commitment even though they have not had any direct form of government support.

Q27 Keith Hill: How are they doing?
Mr Scholar: I do not have all the figures in front of me but I believe that those, particularly in respect of mortgage commitments, which is where they have principally been made, are on track.

Q28 Keith Hill: It is the same pattern.
Sir Nicholas Macpherson: It is. The basic pattern is that the business sector is paying down a huge amount of debt. Unlike in previous recessions the profitability of the business sector as a whole has held up reasonably well, and what is happening is that people are just choosing to reduce their debt. That is one of the problems in interpreting the data.

Q29 Mr Touhig: The 2009 Budget, Sir Nicholas, led us to believe that the net cost of government intervention was going to be between £20 and £50 billion; the PBR now suggests that it could be £8 billion. These are pretty wildly varying forecasts; why are they so widely varying?
Sir Nicholas Macpherson: They have changed a great deal because at Budget time the risks around our banking interventions looked a lot higher. That was partly to do with the design of the Asset Protection Scheme. At that time RBS was going to incur a smaller first loss than the one we finally negotiated; in addition Lloyds, in the end, did not need to make use of the Asset Protection Scheme, it is managing to raise a reasonable amount of capital from the private sector and so it now looks as though on the central case we will not lose money on the basis of the Asset Protection Scheme so, in effect, the main area where we are at risk is in the share price of RBS and Lloyds. That tends to move around. At the time of the PBR it was consistent; had we sought to sell all our shares at that point we would have made an £8 billion loss but there have been periods in the last few months where we would actually have made a profit. Obviously if you sold all the shares the share price would almost certainly fall so you would not have actually been able to make that profit.

Q30 Mr Touhig: I appreciate that. Even at the beginning £50 billion is two and a half times greater than £20 billion, that is a huge figure. Are you relying heavily on economists to give you this advice?
Sir Nicholas Macpherson: One of the things the Treasury has tried to promote throughout this exercise is transparency. We thought it was better to provide an estimate than no estimate but back in March there was still huge uncertainty. We had to intervene again in late January and through February with various announcements and at that time there was far less certainty that the banking system would stabilise. Since then, actually, it has been quite encouraging in terms of certainly Lloyds' performance so there is far more certainty, it looks far less likely that we will lose any money on interventions like the Special Liquidity Scheme, and indeed we are getting paid quite healthy fees for providing these guarantees and forms of support. If the economy recovers—and I expect that it will—the estimates of the costs will come down and I expect that in the fullness of time we might make a profit.

Q31 Mr Touhig: According to a former Chancellor the Treasury economic forecasts have always had a dark side. Denis Healey once said that being an economist is like a man who knows 99 ways how to make love but does not know any women. He also said that if he had not listened to economists he would have been a Prime Minister forming his fifth administration, so perhaps we sometimes do get a bit concerned about the wildly varying figures that the Treasury comes up with.
Sir Nicholas Macpherson: There is huge uncertainty about these things. It is better to try to provide an estimate than just refuse to give you an estimate but we will continue to reassess this cost, we will publish it in each Pre-Budget Report and each Budget and I would hope over time that it will come down further.

Q32 Mr Touhig: You touched on share prices et cetera a moment ago and the Report tells us on page 38 that one of the factors in terms of the overall cost to the taxpayer will be the shareholdings in RBS and Lloyds Bank and what they will be sold for. Given that we are not out of the slump yet, do you anticipate, are you planning, are there expectations that the markets will rise and that you will actually make a profit on this at the end of the day?

Sir Nicholas Macpherson: Yes.

Q33 Mr Touhig: That is your expectation?
Sir Nicholas Macpherson: It is.

Q34 Mr Touhig: Is that your complete goal out of this?
Sir Nicholas Macpherson: It goes back to my earlier points to the Chairman. We are not just in this to make a quick turn for the taxpayer. It would be nice to make a quick turn for the taxpayer because the taxpayer deserves one, but there are wider measures of success and critical to this is getting the economy moving, the banks lending, competitive interest rates, competition more generally. I would not want the success of this intervention to be judged solely on profit to the taxpayer, even though that is an important consideration.

Q35 Mr Touhig: You said in answer to the Chairman when he was questioning you that anyone can lend money providing they throw it down the drain. British banks have got plenty of experience of that, have they not? Do you think they have learned any real lessons from the crisis that they put us through?
Sir Nicholas Macpherson: I would certainly hope that they have and quite a few of them have lost their jobs.

Q36 Mr Touhig: Some thought they should lose their heads.
Sir Nicholas Macpherson: I would not want to comment on that.

Q37 Mr Touhig: A nice idea though, is it not?
Sir Nicholas Macpherson: I do detect greater humility amongst leading bankers and I am quite certain history will not repeat itself in precisely the same way, it very rarely does, but the time to really get worried about this is not now whilst the crisis is still fresh in all our minds, it is going to be five, six, seven, eight years down the track when people begin to rewrite history and can claim that black is white, that none of us really understand it and that they have found the Holy Grail or some other cliché.

Q38 Mr Touhig: Without wanting you to stray into policy matters you and Mr Scholar are both experienced people within the Treasury; have you not been surprised that British banks, in selling products they did not understand, thought they could wipe out something called risk? When I crossed the road from the Abbey to the Commons today I took a risk crossing the road; the idea is that you can take away risk and yet British banks have operated on that basis for some time. Does it not surprise both you gentlemen?
Sir Nicholas Macpherson: I have been quite surprised. We are now insuring a large amount of the Royal Bank of Scotland's assets; it took us a very, very long time to get to the bottom of those assets, pretty much a year, and what was striking along the way was that at the beginning you could forgive us for not understanding them because we had not acquired them, but it was clear to say, Tom, that RBS did not fully understand their balance sheet.
Mr Scholar: Absolutely. The distinction between those banks that survived and those banks that failed is the ones that understood risk and managed it properly were able to survive and the ones that did not could not, so what has to be done now is to ensure that through better transparency, better regulation and better corporate governance the lessons are properly learnt.

Q39 Mr Touhig: From your point of view in the Treasury—the Chairman touched on it too—at page 8, paragraph 20 of the Report the Comptroller and Auditor General points out that: "The Treasury now has to juggle a variety of new roles: as major investor, or owner, of a number of banks, guarantor of borrowings by banks in the wholesale markets; and insurer of assets owned by RBS." These can all be conflicting interests; how are you going to operate and what vision do you actually have of the Treasury now with those new roles that you have got?
Sir Nicholas Macpherson: It is very important to have the right governance and to be very clear about how that governance is going to work. It was sensible to set up an arm's length body to manage the shareholding, it is sensible to set up another arm's length agency to deal with asset protection; you need the right skills in those roles and you need to bring together a critical mass of expertise within those agencies. Getting the remit of your arm's length bodies absolutely right, ensuring that there is a sensible framework document and so on, is critical. Equally it is important that you can ultimately internalise some of the trade-offs between the economics ministry role and the finance ministry role within the Treasury. We are acutely conscious of our obligations in terms of accountability and I fully expect this Committee to keep a very close eye on what we are up to in the coming years and hold us to account.

Q40 Mr Touhig: My colleague Keith Hill touched on the question of lending and you said earlier that banks had increased their lending on mortgages and so on, but is it understood in the Treasury how angry many of our SMEs are—in Wales 97% of our businesses are SMEs and they still cannot get access to credit from banks—how angry they still feel?
Sir Nicholas Macpherson: I am acutely aware of the anger out there, partly through people's representatives like yourselves but also through direct contact when I manage to get out of the Treasury.

Q41 Mr Bacon: You answered Mr Touhig's point quite fairly about the difficulty in identifying how much money you will get back when because it obviously is dependent on so many different things. It is also true that the individual risks for different segments of the money that you could get back are different; the chances of getting money back for the Bank of England if it bought some of your gilts are pretty high and the same for everyone else who bought gilts, but it is plainly not so for elements of the Asset Protection Scheme. What risk framework do you yourselves apply or are you developing at the Treasury to help you to analyse all these different risks?

Sir Nicholas Macpherson: I will just answer at the global Treasury level and then Tom can home in on the particular issues around asset protection. This economic crisis we have been through has raised a number of issues around risk; for a start why did people not spot this crisis happening. We have been reviewing our approach at board level within the Treasury in terms of monitoring and identifying risks. One of our senior officials, Michael Ellam, who is a managing director, is going to chair a committee which is going to be solely looking at risk.

Q42 Mr Bacon: It has not been set up yet.

Sir Nicholas Macpherson: No, it is up and running and we are extremely focused on this issue. The other point was about actually once you get into specific areas what is your risk framework. Clearly asset protection is all about that; Tom may want to expand on it.

Q43 Mr Bacon: It is not just the Asset Protection Scheme; you have got all these things referred to in the summary on page 5. You cannot just take all those in aggregate and say that is the total risk, can you?

Sir Nicholas Macpherson: No, no. I suppose my point is that it is important to manage risk where it is most appropriate. I could centralise all Treasury risks in which case I would never be able to do anything other than go through the extraordinary lists of risks facing us. At board level you want to be conscious of the 10 to 15 really big things which might come and hit you, some of which will be external but some could be internal. One of the things which keep me awake at night is what if the money which comes into the Treasury every day, which is billions, gets diverted to Rio de Janeiro.

Q44 Mr Bacon: Is there anything we should know?

Sir Nicholas Macpherson: Not at the moment, but as and when it is diverted I would fully expect to have to come up with a very good explanation. It goes back to the Revenue and the lost disks; one has got to be really focused on these things as an accounting officer but you have equally got to delegate risk management and this is the point where I hope Tom can come back in relation to the specifics.

Mr Scholar: To give one example, the Bank of England's Special Liquidity Scheme, the Bank requires high-quality collateral and more collateral than the value of the Treasury bills that they are handing out. They are monitoring very closely the performance of that collateral and, in turn, we are in very regular dialogue with them, so that is one way we can protect our risk on that particular scheme. In relation to the Asset Protection Scheme, which is potentially a big exposure, we have set up an agency precisely for the purpose of overseeing the Royal Bank of Scotland. We set out last week to Parliament how we intend to run our relationship with that agency and we will be reporting regularly to Parliament on performance.

Q45 Mr Bacon: Going back to the global problem—and by all means please do answer this as well—you have got this range of exposure from £117 billion down to £50 billion or £20 billion or even a possible profit, as Sir Nick was saying earlier. Do you have a model that enables you, using a set of assumptions, to make some predictions about where you think you will be in one, two, five years out in terms of that number, in terms of the level of exposure?

Mr Scholar: We have not got some sort of overarching model by which you can calculate those sorts of estimates.

Q46 Mr Bacon: Even if they are only estimates, and plainly they would be, in four years time are we going to be £80 billion in a hole or £10 billion in a hole is quite an interesting thing for you to know.

Sir Nicholas Macpherson: The experience since the Budget of this year when the estimate came down from 20 to 50 to 10 is instructive. We have got a pretty good idea now of what the variables are, but it really goes back to Mr Touhig's point that you could develop some all-singing, all-dancing model on this but what came out of it I suspect would not actually tell you a huge amount because it is totally dependent on the assumptions you feed into it. As I was saying earlier, the risks on most of the interventions have declined hugely. I would be very surprised, partly because of the collateral which has been put up, if the Bank of England made losses on the Special Liquidity Scheme. Similarly, the emergency liquidity assistance which we were talking about earlier, that has all been paid back so we are not going to make any loss there and indeed the taxpayer got a small, £18 million, fee back for that. The risks are being reduced. The ultimate uncertainty is the share price and modelling share prices—I am sure there are lots of investment banks who would come along peddling brilliant models which would cost a lot to predict share prices, but I think you would probably agree that people who claim that they can predict share prices . . .

Q47 Mr Bacon: It was my first ever job and I did not do it very well. Could I just ask Mr Scholar, on the £280 billion of RBS assets what are you doing to absolutely bear down on them, minimise the losses from those?

Mr Scholar: That is now the job, since last week, of the agency that we have set up. The agency is being staffed by people with commercial expertise in dealing with troubled assets and they are in constant dialogue with senior figures at RBS including the chief executive to monitor the performance of those assets over time. That is their sole role and their sole focus and they have in extreme circumstances various rights around stepping in to make sure that the assets are properly managed if they are not satisfied as to RBS's stewardship.

Sir Nicholas Macpherson: Just to expand on that, in agreeing which assets were in and which were out we explicitly refused certain assets for inclusion where we thought those assets looked excessively dodgy—for various different reasons.

Q48 Mr Bacon: Too toxic even for you.
Sir Nicholas Macpherson: Yes.

Q49 Mr Bacon: What assumptions have you made about what a change in GDP—say for example a 1% change in GDP growth—would do to your overall level of exposure?
Mr Scholar: Because of the nature of the assets, some of which are extremely complex and are derivatives of various sorts, it is not easy or indeed possible to make a simple correlation between what GDP is and what the performance of those assets is because it all depends on the particular corporates or other borrowers concerned. In our central assessment, our base case assessment, which is roughly speaking the forecast set out in the Pre-Budget Report, in that case we would not expect there to be any cost to the taxpayer of the Asset Protection Scheme; indeed, we would expect there to be a small benefit to the taxpayer because of the fees. We have also modelled it using the FSA stress test—and they published details of that last summer—and we would not expect any call on the taxpayer to come until well into that stress test, but it is not a simple correlation between GDP and the cost.

Q50 Mr Bacon: How long is this all going to take to come out in the wash? I know we only finished paying for the Second World War three years ago; what should we expect before you can sit before us and say "Here is the result"? How long roughly—five years either way?
Mr Scholar: Everything will depend on the performance of the markets over the period ahead which is, of course, very difficult to predict. It is quite possible to imagine a scenario in which, taking the Asset Protection Scheme, things go well, assets perform well, the Royal Bank of Scotland has alternative sources of capital available to it and it could exit from the scheme early after, say, two or three years, and we have structured the pricing to encourage RBS to do that precisely to reduce the risk to the taxpayer. Exiting from all of the interventions, my best guess would be that the shareholding in those two banks, particularly RBS, will be the last thing for the Government to be able to sell down. I would not want to predict that, it is very difficult, but I think we are looking at something of the order of three to five years.
Mr Bacon: About that amount of time. Thank you.

Q51 Nigel Griffiths: The conclusion, paragraph 19, basically says the support provided to the banks was justified. "If the support measures had not been put in place, the scale of the economic and social costs if one or more major UK banks had collapsed is difficult to envision." I am not sure it is because obviously Lehman Brothers went bust and became the biggest bankruptcy in history, and one day later we had the biggest failure of a private company when AIG Insurance went broke and then the largest bank failure in history in America followed that with the Washington Mutual when £60 billion was taken out in the course of 10 days, and of course the biggest mortgage brokers Fannie Mae and Freddie Mac became the biggest nationalisation in history. I tend to concur with the success of the measures, paragraph 12, "There have been no disorderly failures of UK banks, and no retail depositor in a bank operating in the UK has lost money." Would you summarise that as the success really of the intervention by the Treasury and others?
Sir Nicholas Macpherson: The Report is very fair. The interventions of last autumn were successful in those terms. We have been talking about whether we will get a return from it, how it will all impact on the economy, but in terms of the interventions at that time I think our interventions were successful. It is very striking that other countries tended to follow the approach we adopted, so without in any way being complacent we can be quite proud of what we achieved at that time.

Q52 Nigel Griffiths: It says in paragraph 1.11 that "While preserving the UK's financial stability required support for banks that would otherwise fail, such support could be construed as rewarding inappropriate risk taking." How did you construe such support?
Sir Nicholas Macpherson: The critical thing when intervening with a failing bank is that you do not want to reward failure, so the first thing is that if the Government is intervening shareholders should be taken to the cleaners. That is precisely what happened with Bradford & Bingley. Obviously in the case of Lloyds and RBS it was rather more complex, although in both cases I do not get any sense that shareholders are leaping for joy; they are currently sitting on rather big losses and people who are shareholders in HBOS took quite a big hit. To come back to this moral hazard point, it is important not to reward failure, but I would argue actually that for the most part failure has not been rewarded. The senior management of RBS and HBOS are no longer in place.

Q53 Nigel Griffiths: I notice that in paragraph 17 the number of staff that you had in the Treasury increased some six-fold before the crisis of October 2008, so the NAO appears to endorse that action that was taken between the collapse of Northern Rock in particular and then. When I look at the consultants—and that has been picked over by other members of the Committee—figure 7, I am right in thinking £107 million was spent on consultants but did you say to the Chairman earlier that £80 million of that has already been paid back by the banks?
Sir Nicholas Macpherson: Yes, and eventually £100 million will be. The only additional spending will be £7 million and that was to do with system-wide advice. You always need some professional advice in these circumstances and the trick is to try and have

enough in-house capacity so you are not spending money for advice which is not professional advice. That is what we have tried to achieve.

Q54 Nigel Griffiths: 2.16 says that "a department needs to inform the Chairs of the Committee of Public Accounts and the relevant departmental select committee . . ." I am presuming the Treasury Committee here, is that right?
Sir Nicholas Macpherson: Yes.

Q55 Nigel Griffiths: I notice the Chairman added the National Audit Office; is there anyone else we need to add to this list?
Sir Nicholas Macpherson: Those would be the right ones.

Q56 Nigel Griffiths: Why did you not do it?
Sir Nicholas Macpherson: Because of very considerable concern about the intervention leaking. As I said earlier there are lessons to be learned for the future.

Q57 Nigel Griffiths: What I am concerned to know is did the Governor of the Bank of England specifically endorse that approach?
Sir Nicholas Macpherson: He did.

Q58 Nigel Griffiths: Right, so it had his imprimatur and backing?
Sir Nicholas Macpherson: Yes.

Q59 Nigel Griffiths: On small businesses certainly I am aware of not just concerns about the lack of lending to small businesses, although I take your point about small businesses and others going elsewhere for funding, but what I am particularly aware of is the bank changing the rules for small businesses which already have loans. Are you aware of those criticisms that the charges are higher, that previously agreed overdraft limits, even after the financial crisis, are being really breached?
Sir Nicholas Macpherson: Can I very briefly correct my last answer because I misunderstood the question. We did not consult the Governor of the Bank of England about whether to disclose to Parliament. The Governor was very concerned about disclosure in general; it was the Treasury's and the Chancellor's decision not to, in this instance, tell the respective Chairmen of the select committees. To come back to the other point, Tom is now going to give you the answer.
Mr Scholar: We are very well aware of the concerns that have been expressed and they have been discussed through the lending panel and other places. As part of our discussion with RBS and Lloyds on the Asset Protection Scheme, in parallel with those discussions we were talking to them about what more they could do on small business lending and, as you will have seen, in November both of them came out with a small business customer charter which gave various commitments around availability of credit, pricing of credit, for example committing not to change arrangement fees on loans or overdraft facilities of more than 1.5% a year. They put a range of commitments there and those came very directly out of discussions not just for lending but also over the Asset Protection Scheme.

Q60 Nigel Griffiths: That was last month was it?
Mr Scholar: That is right, in November.

Q61 Nigel Griffiths: Are you going to be reporting to the Treasury Committee the success or otherwise of that particular new set of guidelines?
Mr Scholar: We will include a report on that at the time of the report on the lending commitments in general and that will be after the end of February, which is when the full year comes up.
Nigel Griffiths: Thank you very much.

Q62 Dr Pugh: In the notes that I have got it says that the Treasury estimated in April 2009 that there may be a loss of between £20 billion and £50 billion; is that still your estimate?
Sir Nicholas Macpherson: No, our estimate is now much lower, it is around £10 billion.

Q63 Dr Pugh: That is in line with the Chancellor's pre-Budget announcement.
Sir Nicholas Macpherson: Yes.

Q64 Dr Pugh: I thought I was going to catch you out then! Okay. Can you help me again with something the Chancellor said in his pre-Budget statement, he said "Following intervention by the Government total bank loans to businesses today are above where they were when the crisis hit in 2007." You are aware in this Report there is a graph showing loans to businesses throughout that period, except non-financial businesses. Can you help me with this graph? Does the figure after July and going into August and September show a radical change in the picture of that graph or does it remain much the same? That is the graph on page 34.
Sir Nicholas Macpherson: I would have thought it would remain broadly the same.

Q65 Dr Pugh: Broadly the same?
Sir Nicholas Macpherson: Yes.

Q66 Dr Pugh: How do you explain the Chancellor's statement that total bank loans to business today are above where they were when the crisis hit in 2007?
Sir Nicholas Macpherson: I would be happy to send a letter to the Committee on that.[1]

Q67 Dr Pugh: That would be helpful. It does strike me that part of the explanation might be that the graph is about non-financial businesses and the Chancellor does not qualify when he mentions businesses he just talks generally about businesses, but the increase in loans as spoken about by the Chancellor at the pre-Budget statement may actually be indicative of more going on between banks.
Sir Nicholas Macpherson: It could be but, as I say, I would need to check back.

[1] Ev 18

Q68 Dr Pugh: Could you send us a note on that? That would be very, very helpful.
Sir Nicholas Macpherson: Certainly.

Q69 Dr Pugh: You used the expression that businesses are "choosing to reduce debt" and the Chancellor says some businesses who reacted to the uncertainty may be repaying existing loans. I kind of think that there are two sides to this answer. Some people certainly would wish to repay debt, some people have debt demanded of them by the banks. Are you able to differentiate between the two scenarios in any quantitative way?
Sir Nicholas Macpherson: Probably not. As you say, there is quite a lot going on here. What we do know is that business has raised £25 billion in the last six months through corporate bond issuance, equities and so on and we have the strong impression that quite a lot of that £25 billion has been used to pay down debt.

Q70 Dr Pugh: But you cannot tell for sure whether it is choosing to reduce debt or banks actually calling debts in or tightening the lines of credit.
Sir Nicholas Macpherson: No, any more than you can tell whether fundamentally the current flatness of lending is a demand problem as opposed to a supply problem. It is very difficult to get an answer.

Q71 Dr Pugh: You have done no work in this area?
Sir Nicholas Macpherson: We do a lot of work on it and a lot of analysis is done.

Q72 Dr Pugh: Why do you not know then?
Sir Nicholas Macpherson: The Bank of England publishes a monthly lending report and it provides a lot of analysis of this area. What you cannot get though is the definitive answer.

Q73 Dr Pugh: Could you provide us with any data that you have that teases out the difference between businesses voluntarily choosing to reduce debt—which is your expression—and actually loans being called in and credit lines tightening?
Sir Nicholas Macpherson: If there is any information I can give you on the subject I shall give it to you.[2] Just coming back to your earlier point, one guess in interpreting the Chancellor's statement is that this could have been a statement on the overall stock of corporate lending being at the same level, but I will give you chapter and verse on that.

Q74 Dr Pugh: Any clarification would be gratefully received. Again, I hate to harp on about the Chancellor, the Chancellor made a response on an urgent business question about the £60 billion that had been lent to the banks, even before this all blew up. We were much intrigued by what he said about the cost. Presumably that £60 billion—or it might have been £18 billion—was taken up . . .
Sir Nicholas Macpherson: No, it was over a very brief period. There was £60 billion of which £18 billion was guaranteed by the Treasury but the £60 billion was lent on the basis of collateral of £100 billion so the Bank's view certainly was that this was not high risk.

Q75 Dr Pugh: The Chancellor said expressly a charge was made, did he not?
Sir Nicholas Macpherson: A charge was made—a fee of 170 basis points—and £18 million was paid back to the Treasury.

Q76 Dr Pugh: He was unable to tell us whether a market rate of interest was charged; are you able to tell us?
Sir Nicholas Macpherson: It is in the nature of emergency liquidity assistance that you generally lend at what is known in the trade as a penal rate. I do not know whether penal in this case is a terribly helpful term but you certainly are forced to pay substantially in excess of market rates.

Q77 Dr Pugh: The Report says in 2.35 that "UKFI has the objective of protecting and creating value for the taxpayer" and they are an arm's length company, is that correct?
Sir Nicholas Macpherson: Yes.

Q78 Dr Pugh: Do the people working for this arm's length company get paid bonuses the better they do it?
Sir Nicholas Macpherson: Bonuses are extremely small, it is fair to say, by private sector standards and the chief executive, whom we recently recruited, I think has explicitly agreed not to have a bonus in his contract. He is paid—

Q79 Dr Pugh: How are the bonuses calculated?
Sir Nicholas Macpherson: Where bonuses are paid they will be based on clear criteria.

Q80 Dr Pugh: Would the UKFI be caught by the Chancellor's bank bonus scheme?
Sir Nicholas Macpherson: I do not think UKFI for these purposes is a bank but more generally, in certainly the Civil Service, we have been adopting a pretty aggressive approach in terms of trying to get bonus payments down, and in my own case I voluntarily waived a bonus for last year.

Q81 Dr Pugh: Just to ask a last question, bonuses have already been paid to some people in UKFI, have they?
Sir Nicholas Macpherson: I would be quite surprised because it has not been up and running for that long.

Q82 Dr Pugh: You think not. Could you send us a note on that?
Sir Nicholas Macpherson: We can.[3]

Q83 Chairman: How large was the bonus you voluntarily waived?
Sir Nicholas Macpherson: I do not know because I never got to the point where the permanent secretaries' pay committee offered me one to waive.

[2] Ev 18

[3] Ev 17

Q84 Chairman: I am trying to give you more credit here, Sir Nicholas.
Sir Nicholas Macpherson: You are very kind, Chairman. The previous year I got either £12,000 or £15,000.

Q85 Chairman: Worth every penny.
Sir Nicholas Macpherson: You are very kind.

Q86 Mr Mitchell: You said rather hesitantly in answer to the two sets of questions that you did not go through the normal procedure of notifying the guarantee to either the Chairman of our Committee or the Chairman of the Treasury Committee, as would have been usual practice. Which of the two did you not trust?
Sir Nicholas Macpherson: I trust both of them equally. They are both men of huge integrity.

Q87 Mr Mitchell: You did not trust them enough to give them this information according to your usual practice.
Sir Nicholas Macpherson: The usual practice is to write a letter. It is in the nature of writing letters that inevitably more people see those letters. Normally in public institutions more people see them than the person who writes the letters.

Q88 Mr Mitchell: Parliamentarians are not to be trusted because they cannot keep letters to themselves?
Sir Nicholas Macpherson: This was about minimising risk. Your Chairman acknowledged earlier we are having discussions about what we might learn for the future. I totally recognise the legitimate concerns, both of your Chairman and this Committee, as did the Chancellor. This was very exceptional.

Q89 Mr Mitchell: You could have given them the letters personally, could you not?
Sir Nicholas Macpherson: You could have done.

Q90 Mr Mitchell: In a darkened room from which they cannot exit until they have eaten the letter.
Sir Nicholas Macpherson: These are the sorts of things we need to think through for the future.

Q91 Mr Mitchell: At any stage in this was any consideration given to letting any of the institutions go bust?
Sir Nicholas Macpherson: Yes.

Q92 Mr Mitchell: Was that post-Lehman or pre-Lehman?
Sir Nicholas Macpherson: Pre-Lehman. Going back to risk management and the lessons of Northern Rock, from the collapse of Northern Rock onwards we were putting in place some serious risk management. We were looking across the banks. We were looking at the size of their balance sheets. We were thinking through what would happen if they were to collapse.

Q93 Mr Mitchell: The Governor of the Bank had been prating on for yonks about the moral hazard, had he not? Surely that cannot just apply to manufacturing firms?
Sir Nicholas Macpherson: The Governor did indeed have some serious views on moral hazard. Banks are different in the sense that, if a bank is run badly, you want the shareholders to lose money. You do not want the depositors to lose all their money because you are dealing with quite a—

Q94 Mr Mitchell: It was the spectacle of queues of shareholders/investors outside the Bradford and Bingley that really decided it?
Sir Nicholas Macpherson: No, not the shareholders. It is the depositors.

Q95 Mr Mitchell: They used to be shareholders.
Sir Nicholas Macpherson: Yes, they did indeed used to be shareholders. The prospect of HBOS with a balance sheet of £1 trillion or so collapsing and for the government to sit idly by as people queued outside every Halifax and Bank of Scotland—

Q96 Mr Mitchell: Fear cast out moral hazard. I was brought up on Sir Ivor Jennings and I always think of the Treasury as the finest minds in a Rolls Royce machine, kind of like economic versions of James Bond, probably dressed appropriately. Why, in this contingency, did it not have people who could tell it what to do? Why did it have to turn to big accountancy houses, where presumably there are enough chaps of great ability—first rate minds—sitting chatting round the water cooler with nothing much to do who could be drafted in to save the Treasury? Why has the balance of power shifted from the Treasury?
Sir Nicholas Macpherson: I do not believe it has done. I do not want you to go away from this session thinking that we subcontracted the strategy to accountants or investment bankers. I think that would have been very dangerous. We own the strategy but inevitably, as you populate the detail of that strategy, you need accountants who can go through extremely long balance sheets. I think we did have the in-house expertise. I do not want to get into the business of naming too many names but Tom Scholar on my left and John Kingman played a very important role in this process.

Q97 Mr Mitchell: You could have managed it on your own.
Sir Nicholas Macpherson: We did manage it on our own to a large degree.

Q98 Mr Mitchell: With £107 million quids' worth of advice.
Sir Nicholas Macpherson: When you are having to draw up legally watertight—

Q99 Mr Mitchell: I am not talking about the lawyers. I am talking about the accountancy houses.
Sir Nicholas Macpherson: The accountants were going through the balance sheet of RBS. We could have done that ourselves but actually we needed

quantity and we needed accounting expertise. The Treasury has accounting expertise but not on the scale necessary to do that job.

Q100 Mr Mitchell: It says at paragraph 2.3 that you had in fact been forewarned. It says that the authorities had been aware since 2005 that the existing legislative framework would not be sufficient in a crisis. What made you aware of that in 2005 and why was nothing done about it?
Sir Nicholas Macpherson: I think I have been through that on a previous appearance before this Committee. The so-called standing committee of the tripartite authorities did identify this as an issue in 2005. At that time nobody realised that a crisis was round the corner. We had started doing work but it involved getting a legislative slot. It involved working through the details of a failure regime. That did not seem urgent in the spring of 2007. When the crisis did strike, the Treasury was very quick to bring in legislation in early 2008.

Q101 Mr Mitchell: It was very quick to bring in consultants too.
Sir Nicholas Macpherson: It was that legislation which enabled us to sort Bradford and Bingley out over the course of a weekend.

Q102 Mr Mitchell: I see Paula Diggle nodding enthusiastically at what you are saying.
Ms Diggle: I remember all these events vividly.

Q103 Mr Mitchell: Let me ask about not only the big accountancy houses but about the bankers. You only brought in foreign bankers to deal with this: Credit Suisse, Deutsche Bank and Citi. Why no British banks?
Mr Scholar: As I said earlier, we selected the banks from a number of bids that we received on the basis of the best professional advice and the best value to the taxpayer.
Sir Nicholas Macpherson: There was also a conflict of interest issue here. You could not very well employ RBS to provide investment bank advice on sorting out RBS.
Mr Mitchell: No, you could not, but there are other banks.
Chairman: Not many.

Q104 Nigel Griffiths: HBOS?
Sir Nicholas Macpherson: One of the effects of the big bang is that there are not many investment banks which are British.
Nigel Griffiths: Get Santander in.

Q105 Mr Mitchell: Santander survived the crisis better than any British bank. You describe £107 million as a fairly small sum but you have no definition of success for the payment of the contracts. Why did you not have a definition of success?
Sir Nicholas Macpherson: This issue of definition of success I think only relates to two specific contracts and involves something like a maximum of £6 million—we may well not choose to pay out that amount—out of the £107 million. It is a very small, specific example which we regarded as necessary given the high degree of uncertainty at the time.

Q106 Mr Mitchell: You will not be getting any consultants in to advise you what constitutes success?
Mr Scholar: No. We are just embarking now on assessing it because all of the interventions have just completed.
Sir Nicholas Macpherson: As a matter of good practice you do not want to use consultants—

Q107 Mr Mitchell: Why are you not using the power you now have as the major stakeholder to enforce better practices on the banks in respect of, say, fees? One thing that I will mention because it is in Grimsby is it is clear that there are going to be closures as a result of these mergers. HBOS and Lloyds wants to close a branch in a major deprived area. Why is not the Treasury using its power and the Government using its power, given this stake in the banks, to enforce a proper procedure on closures so they do not hit deprived areas?
Mr Scholar: You ask two questions there.

Q108 Mr Mitchell: Fees caused the problem. The Americans have tight legislation saying that if they close a bank in a deprived area it has to give compensation to the area.
Mr Scholar: In the case of fees, UKFI did insist, in the case of the Lloyds rights issue which has just completed, on much lower fees than would normally have been paid. If you compare the fees paid by Lloyds with the fees paid by HSBC earlier in the year, you will see that Lloyds have paid much less even though the transaction was much higher. They certainly have insisted on that in that case. On the question of redundancies and branch rationalisation, these things are managed by UKFI who, as we set out earlier, are an arm's length body which look to manage the shareholdings on a commercial basis. That said, they are constantly in dialogue with the management of these banks and are very insistent on reminding the management that they have certain responsibilities as banks which have taken a large degree of public support.

Q109 Mr Davidson: Mr Scholar, in response to a point raised by Mrs Browning about consultants you mentioned that they were being paid agreed rates in a number of cases. Can you provide us in writing the agreed rates that were being paid?
Mr Scholar: I can certainly do that. The cases I was referring to were the accountancy firms.

Q110 Mr Davidson: Could I turn to the question about lending? I am also on the Scottish Affairs Select Committee and we have had the Law Society of Scotland and the Federation of Small Businesses and others telling us about how hard pressed they are by the banks refusing to lend. I understand your point about anybody can lend to schemes that do not work. How are you assessing where the truth lies? We found it impossible to identify who was

telling us the full story. I got the impression in response to one of my colleagues that you were really just relying on what the Bank was telling you.
Sir Nicholas Macpherson: No. There are a number of potential data sources. For example, there are credit condition surveys which actually ask firms rather than the banks: how easy is it to raise money at the moment? There is survey data. Then there is the Bank data itself. The Bank of England has a longstanding—

Q111 Mr Davidson: Is the evidence you are getting corroborating the points that lawyers in Scotland and the Federation of Small Businesses were telling us? That is, that the clients feel that the banks are being much tougher than they were?
Sir Nicholas Macpherson: I think the clients definitely feel that, although I think things have got a bit better in recent months.

Q112 Mr Davidson: When lawyers are complaining about high fees, it does make you think that there is something untoward, does it not? Who better to know about high fees?
Sir Nicholas Macpherson: Yes. They are people who one would want to listen to. There is a whole range of sources of evidence. My point simply was that it does not give you a simple answer because some of the tightening up is legitimate because of the change in—

Q113 Mr Davidson: I understand that. I am just not entirely clear where the truth lies and I am not entirely clear that you are doing enough to identify what the position is.
Sir Nicholas Macpherson: We are very focused on this. We need to redouble our efforts to try and reach a better understanding.

Q114 Mr Davidson: Can I just turn to the Asset Protection Scheme? It seemed to me that basically you have taken on all the rubbish and that the losses of the banks have been socialised and the gains will be privatised. I see that from the last estimate it was potentially £280 billion of losses. Has that figure come down at all?
Sir Nicholas Macpherson: We are now insuring £280 billion. What has come down is that RBS will bear a bigger first loss. The first £62 billion of that £280 billion will be borne by the Royal Bank of Scotland.

Q115 Mr Davidson: The public purse is only at risk for £220 billion?
Sir Nicholas Macpherson: Yes and then obviously RBS will pick up 10% of that.

Q116 Mr Davidson: That is another £28 billion off that.
Sir Nicholas Macpherson: Yes. It is about £200 billion. RBS are also having to pay us fees for this insurance. As I said at the beginning, our central estimate is that we will not lose money as a result of the asset protection scheme.

Q117 Mr Davidson: You also said at one point that you detect a greater humility amongst many bankers. Can you just clarify how exactly you have identified that growth in humility? All the discussion we have had about bonuses did not seem to me to indicate a greater degree of humility.
Sir Nicholas Macpherson: Bankers obviously like earning bonuses. This bonus season is not over and, as you know, the government has announced a tax on those bonuses. I think the more thoughtful bankers are more conscious of—

Q118 Mr Davidson: The ones who are claiming the big bonuses are less thoughtful bankers? Is that what you are saying?
Sir Nicholas Macpherson: We are in tough times. I think it is incumbent on everybody to think what is an appropriate bonus.

Q119 Mr Davidson: Indeed, but where is the evidence of humility then?
Sir Nicholas Macpherson: Maybe I am being excessively charitable at this time of year.

Q120 Mr Davidson: I think that is my whole point. Is it not the case that you are being excessively charitable to the banks in these circumstances? You did actually say: "RBS did not understand the balance sheet." If that was the case, why did you leave any of the board still there? Why did you not just clear them all out?
Sir Nicholas Macpherson: I think the board is pretty much cleared out now.

Q121 Mr Davidson: No, it is not entirely cleared out, is it?
Mr Scholar: The senior management is. Most of the board is and that is something which the new chairman working with UKFI has been very keen to do, to replace the board.

Q122 Mr Davidson: Some of the board are still there and some of the senior management. It depends how far down you go who you describe as senior management. Quite a lot of people who ought to have been expected to have understood the balance sheet are still there. Is this not another example of you being unduly charitable?
Mr Scholar: There has been a huge amount of change there.

Q123 Mr Davidson: Can I clarify "huge"? How many of the board members have gone?
Mr Scholar: I think the great majority of them. I do not recall.

Q124 Mr Davidson: There is still a number there. How many of the senior management have gone?
Mr Scholar: My understanding is that all of the top management has gone.

Q125 Mr Davidson: How many is that?
Mr Scholar: Of the executives that were previously on the board, I think none of them.

Q126 Mr Davidson: How many is that?
Mr Scholar: I do not recall the precise number.

Q127 Mr Davidson: Single figures?
Mr Scholar: I do not recall the precise number, but I do not—

Q128 Mr Davidson: Is that a do not know or a will not tell?
Mr Scholar: It is a do not know.

Q129 Mr Davidson: We are talking maybe about numbers who are in single figures having gone from the top of the bank but surely a much larger number of people ought to have been expected to have understood the balance sheet.
Mr Scholar: I think the culture of Royal Bank of Scotland under its previous management was very much set from the top. I think that the decisions were being taken—

Q130 Mr Davidson: The rest were obeying orders, basically?
Mr Scholar: I think decisions were taken at that level and—

Q131 Mr Davidson: The rest were obeying orders simply and should not be blamed for anything at all?
Mr Scholar: They work for their management and I think their management—

Q132 Mr Davidson: In terms of changes in the way in which the Royal Bank of Scotland operates in future, given that the Treasury has an enormous impact upon them, can we expect to see them undertaking less work in relation to tax avoidance schemes being read out in the Channel Islands, the Isle of Man and places like that, and taking corrupt money from Nigeria and similar affairs?
Mr Scholar: As I am sure you know, the government has introduced a code of conduct for tax compliance and we are very determined that RBS should be right in the lead of its obligations on this, just as on all other issues of public interest.

Q133 Mr Davidson: They will not be marketing any longer tax avoidance schemes in the Channel Islands, in the Isle of Man and other jurisdictions?
Mr Scholar: I should make an apology here. The relationship with RBS is now handled by UKFI.

Q134 Mr Davidson: You give them no guidance in these matters?
Mr Scholar: We have set out a framework document. We have presented that to Parliament. We will report on it regularly.

Q135 Mr Davidson: There is a conflict of interest here, is there not? Clearly, the share price of RBS in particular will be improved by allowing them to continue marketing tax avoidance schemes; yet, as economic managers, you would presumably want them to withdraw from that area. How do you handle that dilemma?
Mr Scholar: At the same time as a bank enjoying public support, RBS comes under public scrutiny. They understand that and we have told them that. They understand that it is just not sustainable for them to carry out activities that are not deemed acceptable by the public in general.

Q136 Mr Davidson: How is that going to be measured then?
Mr Scholar: We report annually on UKFI's performance and they in turn report on their relationship with the Bank.

Q137 Mr Davidson: Can I just clarify a final point? The strength of the UK has managed to support RBS and HBOS and see them through this crisis. Do you believe that a Scottish economy on its own could have maintained the position of RBS and HBOS without collapsing their economy?
Sir Nicholas Macpherson: I think it is a difficult one but you only have to look at Ireland and Iceland to realise that, if you are a small country with a big banking sector, things can get quite nasty. There are benefits in being a bigger country, having deeper capital markets. If you look at this international crisis, it tends to be the peripheral countries which have had more problems. I do not know what the counter factual would be if Scotland had been a separate sovereign state but I do think the Irish experience is instructive.

Q138 Mr Carswell: You claim to have taken action to maintain financial stability. Have you not really just insulated feckless bankers from the consequences of their financial stupidity? It was they who built a business model based on lending long and borrowing short. It is they who conjured up new financial instruments, many of which turned out to be froth. Are you not merely protecting greedy people from the consequences of their own greed?
Sir Nicholas Macpherson: I would hope not. Banking by its nature is all about lending long and borrowing short. I would hope that some good things will come out of this crisis. I think there are lessons for all the institutions involved in it. Quite a few bankers have lost their jobs. We have talked about the bonus issue. Certainly in terms of the banks we own, we are very keen and indeed ensuring that the banks are subject to new remuneration codes. We do need to learn lessons from this.

Q139 Mr Carswell: It is often asserted that allowing the banks to fail would be unthinkable. The lazy commentariat constantly tell us this. This Report seems to echo that view. Could we not have somehow protected retail savers but allowed bankers to go to the wall?
Sir Nicholas Macpherson: That is in effect what we did with Bradford and Bingley. Over the course of a weekend, we sold all the deposits to Santander and more recently the Bank of England has pulled off a similar trick with Dunfermline Building Society. I

should be careful what I say because all of these transactions are subject to an independent valuer determining what the value to the shareholder is. I do not want to prejudge that process. That is for the valuer. I think it is fair to say that on any basis shareholders have lost a lot of money through this crisis.

Q140 Mr Carswell: Could we not have taken a B&B/ Dunfermline approach throughout? Would that not have been better?
Sir Nicholas Macpherson: The worry with the bigger banks is would anybody have been able to take on the assets. You were dealing with big banks. Probably, if you had gone down the same route as we had with B&B, we would almost certainly have ended up nationalising the banks in question. I have no great problem in principle about nationalising banks but I do think there is value in maintaining some sort of private shareholding if you can, because that way at least you can remain subject to market disciplines.

Q141 Mr Carswell: Sorry; I am particularly slow. Why would it result in nationalisation if you said you were to guarantee the retail depositors' deposits and let the rest go?
Sir Nicholas Macpherson: Because the process of the new resolution regime is that implicit in the process is, if you cannot sell the deposits to somebody else, effectively they end up in the hands of the Bank of England and they will end up owning that bank. On that basis, you are heading for nationalisation. It does depend on there being a ready market for what you are taking over.

Q142 Mr Carswell: This is to do with the issue about the availability of loans. Before the government stepped in obviously banks had to answer more outwardly to customers rather than inwardly to government. That helped ensure that they provided credit and loan services at a price that people were willing to pay. Might it be that one of the reasons why there is not enough lending is the fact that the banks are now answering upwards to you rather than to would be consumers? There is less incentive for them to perhaps provide the product that they would have previously had to provide.
Sir Nicholas Macpherson: That is an interesting point of view but if that were the case you would expect there to be a particular problem with lending by Lloyds and RBS and you would think that HSBC would be making hay while the sun shone. What I was saying earlier is that it appears to be the case that across the banking sector lending has not grown as much as some of us would have hoped. It seems to be a generalised problem.

Q143 Mr Carswell: I hope you do not mind me asking the next few questions because they sound a bit nippy. You said earlier you would not apologise for how much you spent on external advisers' fees and on page 24 they list some £107 million in 2007 in fees paid. Have you or your team accepted hospitality from any of the said advisers in receipt of any of the said fees? Do you receive hospitality from them?
Sir Nicholas Macpherson: If you are in the business of negotiating these deals, we would on the whole discourage receipt of hospitality. I did not negotiate any of these deals but I think I can recognise I have received hospitality from one or two of them over the last year but it has to be said I have received pretty little hospitality. I do not get out much.

Q144 Mr Carswell: Have members of your team gone off to work for any of these advisers? Is there a sort of revolving door between the government and them?
Sir Nicholas Macpherson: No. For all I know, one or two people may have gone off to work for these firms, but we have pretty tight rules about this. There are business appointment rules, especially at senior levels, where you would be expected to serve quite a long quarantine period if you had been working with one of these organisations and then they were to offer you a job. We did second people in from some financial institutions, partly because it was cheaper than employing them as advisers. I think that is good practice. They obviously will have returned to their parent firms, but we run a pretty tight ship when it comes to people moving off and joining one of these firms.

Q145 Mr Williams: It is a tidying up operation. We all understand what the consequences would have been if the information had become public and the nervousness of the markets worldwide at that time, so you can take that for granted. Can I ask the C&AG, looking at it from the parliamentary accountability point of view, how important is it that we try to retain what we thought was a convention or are we better recognising it never was one and is not worth keeping?
Mr Morse: Can I just make sure I have the question clear? The convention of?

Q146 Mr Williams: Notifying the two chairs.
Mr Morse: I think it is important we retain it. It is a constitutional protection.

Q147 Mr Williams: In that case, we were told it was taken at a very high level. Were the law officers consulted, since it is an important constitutional issue?
Sir Nicholas Macpherson: No.

Q148 Mr Williams: That is interesting. Where are we now? Is the convention in your eyes alive or is it now dead?
Sir Nicholas Macpherson: As far as I am concerned, the convention is very much alive. This was one exception.

Q149 Mr Williams: How can you be sure there will not be a similar exception? I am not saying it should not have happened. I am just trying to clarify—

Sir Nicholas Macpherson: I know that the Chancellor of the Exchequer is acutely aware of the reaction within Parliament.

Q150 Mr Williams: We were not asking for the performance of the whole of Parliament. We were only asking that the two individual chairmen be notified.
Sir Nicholas Macpherson: We are keen to learn lessons from this. There will be times when things are extraordinarily market sensitive and I think we just need to consider whether, in very exceptional circumstances for example, there might be an oral briefing rather than writing a letter and then maybe making some sort of provision to ensure that, if the decision is taken to continue non-disclosure, there is an opportunity or a requirement for further oral briefings.

Q151 Mr Williams: You referred to the dangers of a letter. There was no danger in this being known to many people in the two institutions involved, no danger at all. A letter there was not vulnerable or capable of being leaked.
Sir Nicholas Macpherson: This was all about minimising risk. In the case of Northern Rock, it all came out very quickly. I think it is actually very reassuring that this did not leak because, in the modern age, things almost always seem to. You get Mr Peston on the news or whoever. I think it is a measure of success that this was not disclosed or did not get into the public domain until the Governor of the Bank of England thought it was time to reveal it. All that said, I am keen to learn the lessons of this. The Chancellor and indeed the official Treasury are acutely aware of the importance of parliamentary accountability. None of this was remotely personal. We all hold your Chairman in very high regard and I am keen that we learn the lessons and establish some ground rules if there is ever going to be a truly exceptional case like this again.

Q152 Mr Williams: What ground rules do you need? Either they are going to be informed or they are not. That is a ground rule, is it not?
Sir Nicholas Macpherson: Indeed. The issue may be around how we tell the Chairman but I do not think we are disputing that—

Q153 Mr Williams: What do you mean how you tell him? Either you tell him or you do not tell him.
Sir Nicholas Macpherson: Exactly. The issue is: do you write a letter to him or do you come round and give him an oral briefing.

Q154 Mr Williams: That seems sensible, does it not?
Sir Nicholas Macpherson: I have already had a meeting with your Chairman on this subject and I am pretty confident that we can find a way through on it which respects your undoubted legitimate interests.

Q155 Chairman: When I am briefed on the accounts of the Security Services, I am given an oral briefing.
Sir Nicholas Macpherson: I am hopeful that we can solve this problem.

Q156 Chairman: The Bank of England: obviously ultimately we, the Treasury, have to bear the risk. Do you think this strengthens the case for the National Audit Office being able to audit the Bank of England given that very large indemnities are being given back by you and honoured by us?
Sir Nicholas Macpherson: Last year when I appeared before this Committee you asked about the Financial Services Authority. Since then the Financial Services Authority have requested the NAO to audit them from the next financial year, so we have reached a situation where two of the three authorities involved in banking interventions are audited by the National Audit Office. Inevitably, the Bank of England guards its independence jealously and no doubt values its unique relationship with the Treasury Select Committee. I know you have recently written to the Chancellor on this subject. This is a policy issue. I do not feel it would be appropriate as a mere official to comment any further.
Chairman: Thank you very much. That concludes our hearing.

Supplementary memorandum from HM Treasury

I am writing to provide the information requested by Committee members at the PAC hearing on maintaining financial stability across the United Kingdom's banking system of 14 December.

Question 81 (Dr Pugh): *asked for details of UKFI's bonus arrangements and whether any bonuses have yet been paid.*

Specific remuneration arrangements within UKFI are a matter for the UKFI Board. As stated in UKFI's Framework Agreement with HM Treasury, we expect all such remuneration arrangements, including any incentivisation packages, to be developed and recommended by the Board's Remuneration Committee for directors and senior management, and to be in line with the FSA's code. HM Treasury has authorisation over the terms on which each director is appointed, remunerated and incentivised.

HM Treasury's interest is primarily in ensuring that remuneration levels:

— are sufficient to attract and motivate high calibre individuals to drive the delivery of the activities and objectives described or set out in the Framework Document;

— are tied closely to performance, as measured by compliance with the Investment Mandate (and implementation of the Company's investment strategy), adherence to the UKFI Business Plan and delivery of the objectives in the Framework Document;

— are aligned with the objectives set out in the Framework Document; and

— deliver value for money.

In addition, HM Treasury does not condone rewards for failure, and would expect the Board to support the removal of any director or member of senior management responsible for a failure to adhere to the UKFI Business Plan, comply with the Investment Mandate or for any other serious failure.

I am informed by UKFI that no bonuses have yet been paid to UKFI staff, that any bonuses will be paid as a proportion of salary (not multiples), and that even if maximum payouts were made they would only be in aggregate up to 20% of total staff costs. UKFI has some civil servants on secondment who are eligible, like all civil servants, for modest bonuses. Employees from the private sector are earning substantially less than they have earned and could earn elsewhere. In addition, UKFI's Chief Executive has agreed not to receive any bonus.

Question 73 (Dr Pugh): *asked whether the £25 billion raised by businesses from equity markets and corporate issuance, has been used to repay debt through choice or because banks have called in loans. You asked that the Treasury present the Committee with the work undertaken on that matter.*

Data on repayments includes both the roll-off of existing debt and repayments by customers. Information we have from the Bank of England Trends in Lending report covering the whole banking sector (not just the lending commitment banks) indicates that the total level of repayments has been £16bn greater than the total level of new lending for quarters 2 and 3 of 2009. Information from the lending commitment banks shows a pattern in line with this market.

Survey evidence from BCC and Deloitte suggests that apart from perceptions around access to finance, businesses have stated tough economic conditions and a lack of customer demand as key challenges to growth and investment decisions. In line with this, independent survey evidence by BIS reflect steps by SMEs and Mid Caps to cut costs and manage debt by reducing dependency on bank finance and seeking alternative sources of funding.

Also, the Bank of England's Agents have described banks as being unwilling to foreclose in the face of breached loan covenants, in response to low collateral values, suggesting that repayment levels may be less driven by banks demanding repayment and more so by businesses' restructuring decisions.

Question 66 (Dr Pugh): *that I clarify a statement made by the Chancellor on the Pre-Budget Report, in the context of Figure 14 from the NAO Report (page 34). I believe he was referring to this exchange*

> *Official Record 15 Dec 2009 : Column 782*
>
> Mr Michael Fallon (Sevenoaks) (Con): Is not the reality that businesses in our constituencies still cannot access the credit that they need, and that all this newly printed money is being siphoned off into purchasing gilts to finance the extra borrowing that is a direct result of the Chancellor's failure to come up with a proper fiscal plan to reduce the deficit?
>
> *15 Dec 2009 : Column 783*
>
> Mr Darling: No. I believe that the quantitative easing measures taken by the Monetary Policy Committee of the Bank of England are helping the process of recovery. The hon. Gentleman has a point, however, about bank lending. As I have said before, the stock of lending is broadly similar to what it was before the crisis. In addition, the banks in which we have major shareholdings—RBS and Lloyds—have lent an additional £50 billion. At the same time, however, there has been a repayment of lending by other businesses, which is why the net figure looks so low. As I said last week, it is necessary that the deficit be reduced, and we will halve it over a four-year period once recovery has been established-but it is important to ensure that we get that recovery established.

Analysis of past financial crises by the Bank of England in their July 2009 Financial Stability Report shows that in the aftermath of a credit crisis real credit growth turns positive several quarters after the resumption of output growth. However, whilst monthly flows of net lending to private non-financial corporations have been volatile over the past two years, the total stock of lending to private non-financial corporations has remained broadly stable. For example, the total stock of lending to private non-financial corporations was £494 billion in November 2009 as compared to £492 billion in November 2007.

Sir Nick Macpherson
Permanent Secretary

13 January 2010

Following my previous letter, this note addresses the request for information regarding bonus arrangements for Asset Protection Agency staff.

No bonuses have yet been paid in respect of Asset Protection Agency staff, and there will be very few staff eligible for payments covering the period to March 2010. Eligibility and payment of any performance bonuses are fully in accordance with approved practice for civil servants, and will be disclosed in the APA annual report in due course.

Sir Nick Macpherson
Permanent Secretary

15 January 2010

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