



House of Commons
Committee of Public Accounts

HM Treasury: The Asset Protection Scheme

Thirty-first Report of Session 2010-12

*Report, together with formal minutes, oral and
written evidence*

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Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine "the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit" (Standing Order No 148).

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Ian Swales (*Liberal Democrats, Redcar*)
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The following member was also a member of the committee during the parliament:

Eric Joyce (*Labour, Falkirk*)

Powers

The committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. 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 www.parliament.uk/pac. A list of Reports of the Committee in the present Parliament is at the back of this volume.

Additional written evidence may be published on the internet only.

Committee staff

The current staff of the Committee is Philip Aylett (Clerk), Lori Verwaerde (Senior Committee Assistant), Ian Blair and Michelle Garratty (Committee Assistants) and Alex Paterson (Media Officer).

Contacts

All correspondence should be addressed to the Clerk, Committee of Public Accounts, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5708; the Committee's email address is pubaccom@parliament.uk.

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Summary

In October 2008, the Government put in place measures to support UK banks, including purchases of shares in the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds). The economic downturn continued to intensify, however, further undermining market confidence in the value of banks' assets.

To restore confidence, the Government launched an Asset Protection Scheme (the Scheme) in January 2009 to protect banks against further exceptional losses on their assets. During negotiations to finalise the Scheme, the Treasury remained alert to developments in the market throughout 2009 and made changes to the Scheme to better protect the taxpayer. As part of the Scheme, Lloyds and RBS agreed to meet published targets for lending to households and businesses.

Following the Scheme's announcement, market sentiment towards the banks stabilised, helping to achieve the Treasury's overriding aim to maintain financial stability. The development and implementation of the Scheme is a noteworthy achievement in which the commitment and skills of Treasury staff played a central part. Against this positive overall picture, there are a number of areas where further work could be undertaken.

It is alarming that two of the UK's major banks were simply unable to provide sufficient data to assure the Treasury that their assets were not linked to fraud or other criminal activity. It raises questions on the management controls within the banks and the quality of audit provided to the banks. The lack of certainty on the nature of the assets put the Treasury in a difficult position and the Accounting Officer had to ask for a Direction from Ministers before proceeding with the Scheme. While mortgage lending targets have been met, first year lending targets for businesses were not, despite assurances given by the banks to the Treasury. In part this was because many businesses chose to repay existing borrowers. But subsequent research has indicated that tight credit supply is likely to have been the dominant influence on the level of lending in the economy. With few mechanisms through the Scheme to encourage banks to help credit-worthy businesses in need of finance, the Treasury needs to develop other means of influencing banks' behaviour. Simply changing the lending targets from a net to a gross basis risks reducing the pressure on the supported banks to increase credit.

The prospect of the Treasury having to bail out RBS under the Scheme has receded, but there is a small risk that any future recession may change this. The Treasury now needs to make sure that it retains the knowledge and experience it has built up over the past three years so that it can act to protect the taxpayer if interventions to support UK banks are needed in the future.

On the basis of a report from the Comptroller and Auditor General¹ we took evidence from the Treasury, and separately from RBS and Lloyds, on the maintenance of financial stability and protection of the taxpayer.

1 C&AG's Report, *HM Treasury: The Asset Protection Scheme*, Session 2010-11, HC 567

Conclusions and recommendations

- 1. In challenging circumstances, the Treasury achieved its overriding aim to maintain financial stability.** By avoiding the huge economic and social consequences of the failure of a major bank, the Asset Protection Scheme (the Scheme) was an important part of a wider package of measures to support the UK's financial system.
- 2. The Treasury conducted extensive investigations of the assets put forward for inclusion in the Scheme, but both banks encountered major difficulties in providing all the data requested.** Two of the UK's major banks could not provide basic information on their assets and sufficient assurance that their assets were not linked to fraud or other criminal activity. As the Treasury did not have a complete picture of the risks the taxpayer would be taking on, it was put in a difficult position and the Accounting Officer had to ask for a Direction from Ministers before proceeding with the Scheme. The Treasury should take steps to ensure the banks address these gross deficiencies in basic data and, when considering the future role of financial services regulators, make sure that arrangements are in place to test whether this has been done.
- 3. The gaps in information on the banks' assets also begs questions about the role played by the auditors of banks ahead of 2008, when the full impact of the financial crisis became apparent.** The Treasury and the Department for Business, Innovation and Skills have been working with organisations in the banking sector to improve the audit framework. They should now expand discussions to include the major professional audit and accountancy bodies. The Treasury should report back to us within a year on specific actions to ensure that professional audit standards and practices are up to the task of providing robust assurance on the internal control and governance of financial institutions, and on the valuation of assets.
- 4. The Treasury lacked effective sanctions against RBS and Lloyds when they failed to meet their lending targets.** In the first year, the mortgage lending targets were met but lending to businesses fell short of the targets by £30 billion. Under the lending commitment the Treasury considered a range of sanctions against RBS and Lloyds, should the second year target be missed, but decided that each sanction had a downside that outweighed the benefits. This is not satisfactory, and the Treasury should consider the precise mechanisms by which it will exert influence, including assessing progress and the application of appropriate sanctions. In giving the lending commitment, the banks wanted to highlight the constraints of demand and risk. Nevertheless there appears to be a reduction in the supply of credit, and we expect the lending commitment to be met, and a determination to achieve it to be shown by the banks.
- 5. There were gaps in the Treasury's analysis of how much RBS should pay for the Scheme.** The Treasury accepted that more could have been done to analyse the range of possible fees. However, the Treasury considered that such an analysis would not

have resulted in a higher fee as that could have risked the viability of the scheme in providing assurance to the financial markets. Given the huge sums at stake, however, it remains unsatisfactory that a comprehensive analysis was not undertaken and we expect to see such analyses in the future where there is a significant exposure to the taxpayer.

6. **Following the announcement of the Scheme in January 2009, the Treasury retained flexibility to make changes and revisited earlier decisions to check whether they still provided value for money.** Just ahead of signing the deal in November 2009, the Treasury reconsidered its options in the light of market changes, but considered that the Scheme remained the best way to ensure financial stability. Lloyds was allowed to leave the Scheme and raise capital in the markets and the terms of RBS's participation were recast. Reviewing decisions in the context of changing circumstances was good practice and the Treasury should ensure its guidance to departments requires this in all cases.
7. **While the prospect of the Treasury making payments to RBS has receded since 2009, there remains a risk that a further and severe economic downturn might result in RBS remaining in the Scheme for the foreseeable future.** Such an outcome would lead to significant and long-term costs for the taxpayer. The Treasury, through the Asset Protection Agency, must make sure that RBS properly prioritises and complies with the requirements of the Scheme to maximise the returns on the insured assets in the interests of the taxpayer, its largest shareholder. The interests of the taxpayer must not in any way be sacrificed for the interests of the bank.
8. **The Treasury took the lead role in developing the Scheme and has accumulated valuable knowledge and experience in doing so.** When Northern Rock got into difficulty in 2007 and had to be nationalised, the Treasury was severely stretched in terms of resources and experience but its capacity and capability have since grown. Current changes in the regulatory landscape mean that much of the day to day management of any future banking crisis will fall to the Bank of England. The involvement of public funds will, however, require the Treasury's prior approval. The Treasury will therefore need to make sure that in reducing its staffing it retains sufficient capability to understand and challenge proposed interventions should its approval be sought in the future.

1 Maintaining financial stability

1. Although a degree of stability had been achieved following the initial purchases of shares in RBS and Lloyds in October 2008, market confidence remained weak. By early January 2009, the Treasury had become increasingly concerned about growing risks to financial stability. Its announcement of the Asset Protection Scheme (the Scheme) later that month, along with further purchases of shares in both banks, had a beneficial impact on the financial markets, helping the Treasury to achieve its overriding aim of maintaining financial stability.²

2. In the period between the Scheme's announcement and its implementation in November 2009, the Treasury conducted intensive work to analyse and understand the assets that might be covered. The Treasury needed assurance on the existence and terms of the assets (for instance, who the debtor was and the banks' rights in the event of a default). Both banks, however, encountered major difficulties providing the Treasury with data on their assets. Over a number of years, RBS had expanded its balance sheet through acquisitions, including the purchase of ABN AMRO in September 2007. The bank attributed the delay in submitting data to this acquisition strategy which had left the bank with over 20 different IT systems in operation across the group. As such, its systems had not been designed to provide data in the form required by the Treasury.³ However it should have held the information for its own purposes and interests.

3. Because of the poor state of the IT systems at RBS the Treasury could not be sure that the assets were not tainted in terms of their underpinning legality. Given the level of uncertainty the Treasury's Accounting Officer felt that he needed a direction from Ministers to proceed. RBS gave the Treasury an assurance that there was no material or systemic criminal conduct affecting the covered assets. If RBS becomes aware of any such activity, it must report this to the Treasury and the Scheme rules specify that the cover provided may then be terminated. RBS reported that, thus far, there had been no material instances which threatened the taxpayers' position.⁴

4. The difficulties encountered by the Treasury in obtaining the necessary data raise questions about the internal management of the banks, and the audit and regulation of the banks prior to the crisis. RBS acknowledged that a lot of things had not been done well prior to the crisis, including keeping good books and records, and that significant effort had since been made to address this. The Treasury acknowledged that important lessons could be drawn from the situation faced by RBS and that, until recently, its focus had been on managing the range of interventions in the banks to maintain stability. Alongside the Department for Business, Innovation and Skills, which takes the lead on standards relating to accountancy and audit, it had been working with the Bank of England, the Financial Reporting Council and the Financial Services Authority to improve the audit framework. However, it had not engaged, for example, directly with the professional accountancy bodies on the role of auditors in relation to the banks during the crisis. The Treasury

2 Q 91; C&AG's Report, paras 19 and 1.7

3 Qq 10, 11, 18, 19, 187; C&AG's Report, para 2.15

4 Qq 3, 4, 42-44, 72, 187; C&AG's Report, para 2.15

accepted that it needed to be vigorous in pursuing these issues to ensure lessons were learned.⁵

5. Both banks achieved targets for mortgage lending in the first year of operation. The target of £27 billion for net additional lending to businesses was not achieved. Lloyds provided £3 billion of additional lending against a target of £11 billion, missing its target by £8 billion. RBS received repayments that were just over £6 billion greater than its target net lending of £16 billion, missing its target by £22 billion. Together there was therefore a shortfall of £30 billion against targets for lending to businesses. The targets had been agreed with the banks as a condition of participating in the Scheme but RBS and Lloyds suggested that the targets had been agreed only at the last minute and with little thought. Even if this were true it does not diminish the responsibility of the banks to meet the agreements. The Treasury judged that the banks had missed their net lending targets for businesses because many companies had chosen to repay large amounts of existing borrowings. Larger companies had borrowed money through issuing bonds directly to investors, rather than taking loans from the banks. The Treasury considered that the failure to meet the targets had been caused by factors outside the banks' control and therefore no further action was necessary. This judgement is open to question. The Treasury acknowledged, however, that there had been a tension between its aim to see the banks lending more and the banks' desire to strengthen their capital position.⁶

6. For the second year, the Treasury set business lending targets on a gross rather than a net basis to avoid the distortion introduced by increased repayments by businesses. The Treasury considered introducing a range of potential sanctions if the second year targets were not met, but decided that implementing any new sanctions would face insurmountable difficulties. It considered, for example, linking chief executives' remuneration more directly to the achievement of the lending targets but had decided against because of concerns it would encourage lending on non-commercial terms, regardless of whether borrowers were credit worthy.⁷

7. Since the hearing, the Government has announced that the achievement of new lending targets from 2011 will, in part, be a more direct factor in determining the pay of bank chief executives and senior staff.⁸

5 Qq 10-12, 31-37, 41, 187; Ev 31

6 Qq 52-57, 61, 63, 124, 130; C&AG's Report, para 18

7 Qq 50, 66, 92; C&AG's Report, para 3.14

8 Statement to Parliament by Chancellor of the Exchequer, 9 February 2011

2 Protecting the taxpayer

8. The Treasury put considerable effort into assessing the overall pricing structure of the Scheme, but there were gaps in its analysis of the minimum fee to be paid by RBS. Under the final agreement with RBS, the Treasury agreed that: RBS bears the first £60 billion of losses (termed the “first loss”); the Treasury meets 90% of losses incurred thereafter (termed the “second loss”); and RBS will pay annual fees subject to an overall minimum fee on exit of £2.5 billion or, if higher, 10% of the capital relief provided by the Scheme. The National Audit Office concluded that the Treasury analysis underpinning the minimum exit fee had lacked the breadth and depth of analysis it might normally have expected.⁹

9. The Treasury accepted that it could have performed more analysis to underpin its decision on the fee. The fee had been the last thing to be agreed with RBS after the effect of other parts of the Scheme on the bank’s capital, such as the level of losses to be borne by RBS, had been considered. The Treasury judged that, even with more extensive analysis, it would have set the minimum fee at £2.5 billion. The critical driver for its decision had been to charge the maximum fee possible consistent with securing financial stability and maintaining an incentive on RBS to exit the Scheme as quickly as possible.¹⁰

10. Before finalising the Scheme, the Treasury considered whether an alternative of a larger capital injection might be better value for money. Although there might have been a saving of £4 billion under a stressed economic scenario if the Scheme had been replaced by a larger capital injection, the Treasury rejected this option. The Treasury was concerned that, without the Scheme, further injections of capital by the taxpayer into RBS would put the bank at even greater risk of being perceived as nationalised. It also saw advantage in having the Scheme in place in case it was needed by other banks. As market conditions improved during 2009, the alternative of a contingent capital injection became a possibility but this had occurred fairly late in the development of the Scheme and would have taken time to implement. The Treasury was concerned that any further delay to finalisation of the Scheme might have been misinterpreted by the financial markets as an indication that problems at RBS were worse than expected.¹¹

11. If the first loss is exceeded, RBS will have less financial incentive to stem further losses and the taxpayers’ position would be particularly vulnerable if losses were to exceed about £73 billion. By September 2010 losses stood at £37 billion, against an expected total of £57 billion, over the life of the Scheme.¹² So far, losses have remained below the first loss of £60 billion, beyond which the Treasury would be liable to make payments to RBS. The Treasury thought that losses of £73 billion would only be reached in extreme circumstances.¹³

9 C&AG’s Report, para 10, 16

10 Qq 74-77, 83; C&AG’s Report, para 15, recommendation (a)

11 Qq 5-7; C&AG’s Report, para 6 and Appendix 3, paras 21-22

12 Subsequent to the hearing, the Asset Protection Agency published a lower figure for the expected loss of £51 billion (Interim Report for the period 1 July 2010 to 31 December 2010, February 2011)

13 Q 93; C&AG’s Report, paras 12 and 13

12. Analysis conducted by the Asset Protection Agency, set up by the Treasury to oversee the Scheme, suggests these extreme circumstances would have to involve, for instance, default rates on loans and other assets held by banks similar to those seen in the Great Depression. If such a downturn did occur, the Treasury envisaged the need for much larger interventions across all banks rather than just the need to consider issues surrounding RBS staying in the Scheme. The Treasury's assumption was that RBS, based on current performance, would consider it financially worthwhile to exit the Scheme in 2012. RBS has confirmed that it is hoping to exit the Scheme in 2012-13, subject to regulatory approval.¹⁴

13. Over the past three years, the Treasury has accumulated much knowledge and practical experience of dealing with banks in difficulty. From 2007, when Northern Rock had to be supported, the Treasury had to handle interventions in private sector businesses of a type and scale that it had never faced before. At its peak, the Treasury had around 100 people working on the development of the Scheme. Although staff numbers had reduced considerably following implementation of the Scheme and the establishment of the Asset Protection Agency, the Treasury had retained expertise to oversee the legislation needed to make changes in the regulatory system. As the Bank of England will now take the lead in resolving banks in difficulty, the Treasury recognised it needed to retain the experience and ability to ask difficult questions of the regulator and protect the taxpayer.¹⁵

14 Qq 93-95, The Royal Bank of Scotland Group Annual Review and Summary Financial Statement 2010, page 41

15 Qq 1, 99, 100; C&AG's Report, recommendation (c)

Formal Minutes

Monday 4 April 2011

Rt Hon Margaret Hodge, in the Chair

| | |
|---------------------|------------------|
| Mr Richard Bacon | Jo Johnson |
| Mr Stephen Barclay | Mrs Anne McGuire |
| Dr. Stella Creasy | Austin Mitchell |
| Jackie Doyle price | Nick Smith |
| Matthew Hancock | Ian Swales |
| Chris Heaton-Harris | |

Draft Report (*HM Treasury: The Asset Protection Scheme*) proposed by the Chair, brought up and read.

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

Paragraphs 1 to 13 read and agreed to.

Conclusions and recommendations 1 to 8 read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Thirty-first Report of the Committee to the House.

Ordered, That the Chair 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.

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Monday 9 May at 4.00 pm]

Witnesses

Wednesday 2 February 2011

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Sir Nicholas Macpherson KCB, Permanent Secretary, and **Tom Scholar**, 2nd Permanent Secretary, HM Treasury

Ev 1

Wednesday 16 March 2011

Stephen Hester, Chief Executive, **Nathan Bostock**, Head of Restructuring & Risk, Royal Bank of Scotland, **Eric Daniels**, Former Group Chief Executive, and **Tim Tookey**, Group Finance Director, Lloyds Banking Group

Ev 15

List of printed written evidence

1 HM Treasury

Ev 31:33

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2010–11

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| Second Report | Delivering Multi-Role Tanker Aircraft Capability | HC 425 |
| Third Report | Tackling inequalities in life expectancy in areas with the worst health and deprivation | HC 470 |
| Fourth Report | Progress with VFM savings and lessons for cost reduction programmes | HC 440 |
| Fifth Report | Increasing Passenger Rail Capacity | HC 471 |
| Sixth Report | Cafcass's response to increased demand for its services | HC 439 |
| Seventh Report | Funding the development of renewable energy technologies | HC 538 |
| Eighth Report | Customer First Programme: Delivery of Student Finance | HC 424 |
| Ninth Report | Financing PFI projects in the credit crisis and the Treasury's response | HC 553 |
| Tenth Report | Managing the defence budget and estate | HC 503 |
| Eleventh Report | Community Care Grant | HC 573 |
| Twelfth Report | Central government's use of consultants and interims | HC 610 |
| Thirteenth Report | Department for International Development's bilateral support to primary education | HC 594 |
| Fourteenth Report | PFI in Housing and Hospitals | HC 631 |
| Fifteenth Report | Educating the next generation of scientists | HC 632 |
| Sixteenth Report | Ministry of Justice Financial Management | HC 574 |
| Seventeenth Report | The Academies Programme | HC 552 |
| Eighteenth Report | HM Revenue and Customs' 2009-10 Accounts | HC 502 |
| Nineteenth Report | M25 Private Finance Contract | HC 651 |
| Twentieth Report | Ofcom: the effectiveness of converged regulation | HC 688 |
| Twenty-First Report | The youth justice system in England and Wales: reducing offending by young people | HC 721 |
| Twenty-second Report | Excess Votes 2009-10 | HC 801 |

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|-----------------------|-----------------------------------------------------------|--------|
| Twenty-third Report | The Major Projects Report 2010 | HC 687 |
| Twenty-fourth Report | Delivering the Cancer Reform Strategy | HC 667 |
| Twenty-fifth Report | Reducing errors in the benefit system | HC 668 |
| Twenty-sixth Report | Management of NHS hospital productivity | HC 741 |
| Twenty-seventh Report | HM Revenue and Customs: Managing civil tax investigations | HC 765 |
| Twenty-eighth Report | Accountability for Public Money | HC 740 |
| Twenty-ninth Report | The BBC's management of its Digital Media Initiative | HC 808 |
| Thirtieth Report | Management of the Typhoon project | HC 860 |
| Thirty-first Report | HM Treasury: The Asset Protection Scheme | HC 785 |

Oral evidence

Taken before the Committee of Public Accounts on Wednesday 2 February 2011

Members present:

Rt Hon Margaret Hodge (Chair)

Mr Richard Bacon
Stephen Barclay
Jackie Doyle-Price
Matthew Hancock
Chris Heaton-Harris

Joseph Johnson
Mrs Anne McGuire
Austin Mitchell
Nick Smith

Amyas Morse, Comptroller and Auditor General, **Gabrielle Cohen**, Assistant Auditor General, **Peter Gray**, Director, and **Paula Diggle**, Treasury Officer of Accounts, National Audit Office, were in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

The Asset Protection Scheme (HC 567)

Examination of Witnesses

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

Q1 Chair: Welcome again. I think this will become a regular occurrence. And welcome to Tom Scholar. As you know, this is the first of three hearings on these issues that we are to hold over the coming weeks. I want to start off with a very general question. You took these decisions in a tough environment. In January 2009 you took the decision to set up an Asset Protection Scheme, which went live at the end of that year. If you look back on it, what have you learned? Would you do the same thing again in the same circumstances? Is there anything that you would think of doing differently from what you did at that time?

Sir Nicholas Macpherson: I think we have learned quite a lot. Many of the interventions that took place in 2008 and 2009 were done for the first time; in terms of both scale and nature, this was cutting-edge activity. Clearly, the interventions have succeeded in the number one priority, which was to create financial stability. With the benefit of hindsight, interventions like the Asset Protection Agency compare quite well with alternative interventions pursued by countries such as Ireland, but inevitably from Northern Rock onwards it has been a learning experience. I think the National Audit Office and this Committee have played a constructive role in drawing attention to areas in which we could do better. For example, with Northern Rock, we clocked up quite large professional fees, but I think it is fair to say that by the time we got to later interventions, we had accumulated in-house expertise and perhaps we got rather better at procuring professional advice. It is striking that that is an area in which we have improved.

Q2 Chair: But looking very narrowly at the Asset Protection Scheme, do you think that was the right route to go down at that point?

Sir Nicholas Macpherson: Yes, very much so, and I think this report bears that out. There were other

options. We could have nationalised RBS; we could have set up an Irish-style NAMA-type scheme where effectively we took over the assets. I think the success of the Asset Protection Scheme rests on the fact that we did not have to go into the markets and raise lots of money effectively to buy these assets, but it did put a floor under RBS at that time. I would not say that RBS is totally out of the woods; it has some way to go.

Chair: We will come back to that.

Sir Nicholas Macpherson: But its share price suggests that this is an organisation with a future. I remain confident, as I told the Committee the last time I appeared before it, that when the dust settles in several years' time, the taxpayer will make a profit out of all these interventions. I recognise that there has been a huge cost in terms of the effect on the economy, but we all have an interest in the taxpayer making a return.

Q3 Chair: We will come to that. If it was the best of the options that faced you in relation to creating financial stability and confidence, why did you issue a letter of direction?

Sir Nicholas Macpherson: The letter of direction was at the more technical end of the spectrum when it comes to directions. There were special issues that came out of *Managing Public Money*.¹ If we were to underwrite assets, I felt we needed a better understanding of those assets. Inevitably, not least because of the state of RBS's systems, we could not know whether some of those assets might be tainted in terms of their underpinning legality. There are directions which are about really big value-for-money issues, some of which we discussed the other week, but I think this was a technical one. I felt that I needed it, given the guidance in *Managing Public Money*.

¹ DN: official HMT publication—mark in italics

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Alistair Darling was very happy to give me one, and as directions go, it was quite an agreeable exchange of letters.

Q4 Chair: Was it a letter of direction which simply put into the public domain that it was a risk but you thought it was a good idea, or was it one where you and the officials felt—this is why I questioned you a little earlier about whether you thought it was the best option—it was a very risky way in which to secure greater stability of the banking system and RBS in particular?

Sir Nicholas Macpherson: No. I thought it was the right approach. It was a technical issue that I felt we had to cover off, not least for the benefit of this Committee.

Q5 Joseph Johnson: Before we go into the details of the Asset Protection Scheme itself, could we go back to the moment when you faced the choice of which solution to go for: the bad bank; the injection of more capital, which effectively would have meant nationalisation, particularly of RBS; or the Asset Protection Scheme? Appendix 3 of the Report seems to suggest that injecting more capital might have been better, on a simple value-for-money basis. If I read the Report correctly, the NAO suggests in paragraph 21 that you might have saved between £200 million and £4 billion had you decided to go down the route of more contingent capital to RBS. In light of that, why do you say so confidently that APS was a better route, from a value-for-money perspective?

Sir Nicholas Macpherson: There are a number of reasons for that. First, the APS gave greater protection, in terms of ensuring that RBS was not ultimately nationalised. The second quite important reason was that we were not certain at that stage whether the Asset Protection Scheme might need to be used for another bank. Indeed, even now you could envisage admittedly very extreme circumstances where you might need it. So we felt that it was in the wider interests of financial stability to get the scheme up and running. I should say that the contingent capital option was quite a late runner. Had we gone down that route, it would probably have delayed eventual agreement, which in itself might have undermined financial stability because the markets—

Q6 Joseph Johnson: But the APS was not quick to get off the ground. You announced it in January and did not sign any deals until November, so it took the best part of a year. Would it have taken less time simply to offer more contingent capital? It is not a very complicated process.

Sir Nicholas Macpherson: It is not a particularly complicated process, but my recollection is that as the year went by the contingent capital option began to look more attractive, but Tom may want to expand on that.

Tom Scholar: Yes. In January, when we first announced the intention to move ahead with the scheme, a contingent capital option would not have been possible; it would have had to have been actual capital at that stage. During the course of the year, markets gradually improved, and with them, the

outlook for the two banks concerned, with the consequence that in the case of Lloyds, it was able to exit and raise capital on the markets, and in the case of RBS it became possible to imagine, in a way that was not possible a couple of months previously—

Q7 Chair: Hang on. Was it the change in confidence at that stage that changed the potential options?

Tom Scholar: Correct. For that reason, it was available only in the closing stages of the negotiation, and even at that point we felt we were not sufficiently certain about the outlook to want to give up what would have been, as Nick said, a scheme that was potentially available for the whole sector.

Q8 Joseph Johnson: Clearly, you were weighing up a lot of very difficult sets of pros and cons in every solution that you were examining. To dwell for a second on the option of injecting more capital, or contingent capital as became possible later in the year, in retrospect that would have had considerable advantages, in the sense that had you injected more capital and been forced ultimately to seek the delisting of RBS, effectively to take control of it and take it off the public market, you would not have faced the problems that we have faced over the past year, with respect to some of the objectives set out in the intervention, particularly with respect to lending. We have had a situation where RBS has breached its lending commitments—it came nowhere near meeting them. Had you been in absolute control of it, which would have been the result of an intervention along the lines of contingent capital or capital injection, we would not have faced that at all. Do you acknowledge that?

Sir Nicholas Macpherson: No, I do not accept that. The first point I make is that this year RBS is on track to deliver its lending commitments. There was a problem in 2009, to which no doubt we will come back. I think there are real risks in the Government getting into the banking business. It is always nice to think that the state will be better at lending, but in my experience, having observed nationalised banks around the world—there were some good examples in France in the early 1980s—the state is not good at managing risk. I can see the attractions in thinking that if the state was in charge of the lending process we could just go out and hand out money willy-nilly, and no doubt the lending figures would look a lot better. But speaking as a Treasury official, the Treasury is both an economics and a finance Ministry. I certainly do not think it is in the taxpayers' interest for the state to get into the banking game and, in the long run, it is not the interests of the economy.

Q9 Joseph Johnson: Why did we have lending commitments at all in this agreement if you did not believe they were enforceable and had no real interest in pursuing them? Why did the Treasury bother with them at all?

Sir Nicholas Macpherson: All of us agree that we want to see greater lending. We have just had a credit crunch without precedent in our lifetime—in fact, probably without precedent in 100 years. Banks, individuals, some companies and particularly the state

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need to de-leverage, but we do want to get lending going. As part of these interventions, there were discussions about that, to try to look at what was in the collective interest as opposed to the individual interest. Lending agreements certainly have a role, and that informed the previous Government's intervention. I think it is a matter of record that the current Government is also considering options in that space, but I think that is very different from nationalising a bank and effectively telling it to run at a loss to subsidise lending, often to individuals and companies who may not be good credit risks.

Chair: I want to come back to the issue of lending agreements, because there is a lot to explore in that, but let us stick to the earlier things.

Q10 Mrs McGuire: I do not know whether I should declare that I am a customer of the Royal Bank of Scotland, and have been for many years, but I put it on the record anyway. One of the things that astonished me about the other part of the NAO Report was the fact that a timetable was set, between January and November, for the identification of assets to gather the data, yet they were unable to provide that information within the time frame. Was that because the time frame was too tight, or was it an issue to do with governance of the banks? Alternatively, was it an issue to do with directors being cavalier and non-executive directors not conducting their own due diligence?

Sir Nicholas Macpherson: First, let me declare an interest: I am a customer of the Bank of Scotland. I think all those factors are relevant. You have to understand why the Royal Bank of Scotland was particularly vulnerable in 2008. It had expanded its balance sheet very rapidly through acquisition, not least of ABN AMRO in October 2007. It became clear when we entered into discussions on the Asset Protection Scheme that the systems of the Royal Bank of Scotland, in terms of really understanding the assets it owned, were not, to put it mildly, well developed. The problem throughout 2009 was that you were looking at several million separate assets and for the Government to satisfy itself on that was a very big task.

Chair: What does that tell you? When I read that bit I thought, "Goodness! What does that tell you about the regulatory framework of banks?"

Q11 Mrs McGuire: It is a question of whether it is an issue of regulation or an issue of incompetence on the part of the bank. As a permanent secretary, you have been here on many occasions justifying IT systems that Government operate. Here we have one of our major financial institutions, which we find out has 20 different IT systems, yet it appeared to be a successful business. Given that you have had to defend sometimes very difficult situations in terms of how Government operates, were you not astonished to find out that a leading player among the financial institutions was operating in this way?

Sir Nicholas Macpherson: It is fair to say that I was surprised, yes. This is a classic example of over-expansion taking place too rapidly, hubris and all

those things. When the music stopped, RBS was more vulnerable than any other bank.

Q12 Mr Bacon: But is this not what bank regulators are for? For example, I remember that years ago the Saatchis wanted to buy Midland Bank. The Bank of England waggled their eyebrows and said, "Hm. Not really a good idea", and it did not happen. I know that some of them were abroad, and a lot of the assets ended up being abroad, but regulators talk to each other. Why was it allowed to get to the point where it was not merely too big to fail but too big to manage?

Sir Nicholas Macpherson: The first people who were clearly responsible were the board of Royal Bank of Scotland. They had a duty to their shareholders. If I was an RBS shareholder I would feel a little disappointed by that. I have seen different forms of regulation over the years; I was working for Ken Clarke the weekend Barings went down, and I do not think Barings was a particularly happy example of good regulation. I do not think that Johnson Matthey or BCCI were.

Q13 Mr Bacon: With respect, I do not think that the failures of BCCI, Johnson Matthey or Barings were going to crash the world. RBS had a balance sheet of £2.5 trillion, which was larger than the UK's gross domestic product and growing like Topsy—like a corporate leverage artist on speed—and the regulatory system was not stopping it. That is what I do not understand.

Sir Nicholas Macpherson: Clearly, there are lessons about regulation and the Government is seeking to do something about it.

Q14 Austin Mitchell: If we are declaring interests, I am a Halifax customer, but I voted against demutualisation, so I am in the clear. What Sir Nicholas said sounded to me like this was an "anything but nationalisation" expedient. You were ideologically opposed to nationalisation—God, shock horror!—and therefore you would do anything to avoid it.

Sir Nicholas Macpherson: No, I do not think that is the case. We did nationalise Northern Rock—

Q15 Austin Mitchell: With a certain amount of distaste?

Sir Nicholas Macpherson: No. I do not want to go over Northern Rock again, but it is a matter of record that the Treasury concluded that nationalisation was probably the right approach rather earlier than nationalisation actually took place. We used it effectively with Bradford & Bingley. I do not think we should be against nationalisation at any price, but we should realise that nationalisation carries a price. Once a company or institution is 100% in the public sector, the dead hand of bureaucratic control, combined perhaps with over-optimistic political direction, can sap the value of that institution.

Q16 Austin Mitchell: We will leave that, because you are the big hand of bureaucratic control in many respects.

Sir Nicholas Macpherson: I do not want the Treasury to run banks.

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Q17 Austin Mitchell: You said this scheme was better than the Irish scheme; it had to be, because the Irish debts were huge and many of them were corrupt. How does it compare with TARP? In TARP, which has been much criticised, they were buying the assets, whereas you were just guaranteeing them. Is that the difference?

Sir Nicholas Macpherson: Tom, do you want to answer that one?

Tom Scholar: The TARP money ended up being used in a number of different ways. They used the money also to provide direct capital injections into banks, rather than the UK Government did. You raised the question of the Irish scheme. They were dealing with a very different problem from RBS. There were a number of Irish banks, which were much smaller and much less complicated. Most of their assets were property loans to Ireland and the UK. It was therefore much easier to get a handle on the exposure taken on by the Irish Government. The reason we chose an insurance scheme, rather than an asset purchase scheme, was that we felt we could implement it more quickly and would take on less unquantifiable risk to the taxpayer.

Q18 Austin Mitchell: You have guaranteed all this stuff. In paragraph 11 on page 6 of the Report, it says that the “banks encountered major difficulties in providing the Treasury” with information. They do not know what they have got, what it is worth, where it comes from or whether it is legal. This is extraordinary. Among it is my mortgage, actually. Although paragraph 11 says that a lot of the problems arose because the computer systems at RBS did not all match up, so they could not tell you what was there, it could also be that a lot of what you are guaranteeing is actually junk; it could be stuff from the States. It could be collateralised debt obligations; it could be bundled-up subprime debt; it could be simple junk. You could be lumbered with it at the end of the day. Do we know how much is junk?

Sir Nicholas Macpherson: We used the period of 2009 to do some serious diligence on those assets.

Q19 Austin Mitchell: But that is serious due diligence by a financial institution that is involved in setting up all these things. It is an interested party.

Sir Nicholas Macpherson: We reached an agreement in principle to set up the scheme in February. It did not go live until November. We used that period to do really intensive work to try to understand the assets. We did not have 100% knowledge at the end of that process, but in my view we developed enough knowledge for this intervention to make sense, in terms of value for money.

Q20 Austin Mitchell: So you can tell us what proportion is junk?

Sir Nicholas Macpherson: Subsequent events have borne that out. The Asset Protection Agency is now in charge of it; it has now developed very well-designed models to understand it. They produce regular reports setting out precisely what their expected losses are.

Q21 Austin Mitchell: Can you tell us what is junk?

Sir Nicholas Macpherson: What we can tell you is the expected loss at this time, or at least at the time the Asset Protection Agency last made an announcement. Tom will tell you what that loss is.

Tom Scholar: In last year’s annual report, the Asset Protection Agency reported the expected loss—to RBS, not the taxpayer—as of the end of March of last year as £57 billion, which is less than the total amount that they are required to meet themselves.

Q22 Chair: The figures in the report are based on September. Do you have any more up-to-date figures than that?

Tom Scholar: The figures in the report on the pool of assets that are covered are as at the end of September. The latest available estimate on the future total expected losses is end of March last year. In the next few weeks, at about the time of the RBS annual report, the Asset Protection Agency will put out a report with an updated loss estimate.

Q23 Chair: So there is only an annual update?

Tom Scholar: Every year, they publish an annual report.

Q24 Chair: But you are saying that all this is based on last March’s figures? The estimate is £57 billion—

Sir Nicholas Macpherson: Within weeks, you will have a new estimate. Given what has happened to property prices since last year, I would—

Q25 Chair: You think it will go up?

Sir Nicholas Macpherson: No. I would be very surprised if the estimate of loss went up.

Tom Scholar: For example, if you look at RBS’s third-quarter statement, you will see that the reported impairments have gone down compared with June.

Q26 Chair: I want to go back to Jo’s very important point at the beginning about why you chose the option of asset protection. You said it took you nine months to go through all the assets to try to establish what you could and could not put into the Scheme. By that time, asset guarantee became an option. Did you at that point—in September, October, November—do a value-for-money study of those two options, or did you feel that you were so far down one road?

Sir Nicholas Macpherson: We very much did. In my role as an accounting officer, I thought this was a critical decision. We put a lot of effort into understanding the trade-offs. Tom and I were certainly agreed in advising Alistair Darling, the then Chancellor, that this was the best option in the circumstances at that time.

Q27 Chair: You have said you expect the total value of the bad assets to stay within the £60 billion threshold. Is that judgment based on recent events in the UK economy, potential events in the Middle East, the euro economy—question mark, question mark?

Sir Nicholas Macpherson: Yes.

Q28 Stephen Barclay: May I come back to the letter of direction? You said that you conducted really intensive work, yet at the end of 10 months of really

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intensive work you did not know whether the assets were tainted. If there is a major failure of systems and controls in a firm, would you expect regulatory enforcement action? *[Interruption.]*

Chair: Saved by the bell.

Tom Scholar: The role of the FSA is to look at both prudential regulation and conduct of business in relation to retail business in this country. Any allegation of any kind of criminal activity clearly would be for law enforcement agencies, but would not be a matter of financial regulation.

Q29 Stephen Barclay: In the interest of declaring, I worked for the FSA for four years, and was an owner of the policy handbook, hence my question on whether you would have expected any enforcement action. As far as I am aware, no individual at RBS or Lloyds has been subject to any enforcement action. There was clearly a failure of systems and controls. You were the architects of the regulatory regime; did you have any discussions with the FSA in terms of individual enforcement actions?

Tom Scholar: As you know, the FSA have conducted their own internal review of what enforcement actions they should take, and they have concluded that they will not take any, and have given a commitment to publish a report explaining why they have taken that view. I would not want to prejudge that—nor could I, because that is work that they undertook, rather than us. Throughout this period, we have kept them very closely in touch with our work on the Asset Protection Scheme and what it was telling us about the state of systems and controls and risk management within RBS. That is something that they are concerned about; it is something about which RBS management is also concerned about. Do not forget that it is new management, and in answer to an earlier question, the new management of RBS has been fully co-operative throughout the design and implementation of the scheme. That is something that they are looking to put right, and the FSA have also said that in future they will adopt a much more intrusive approach to regulation.

Q30 Stephen Barclay: But no individual has been subject to an individual fine. There have been discussions about the role of the finance director, but as far as I am aware, no individual at RBS or Lloyds has been fined. Is that correct?

Tom Scholar: As far as I know.

Sitting suspended for a Division in the House.

On resuming—

Q31 Stephen Barclay: I think we were dealing with the fact that intensive work was done for 10 months, yet a letter of direction was required. Given your concerns about the assets being tainted, what conclusions did you draw about the work of the auditors, Deloitte, on those assets?

Sir Nicholas Macpherson: I do not think it falls to us to assess auditors' performance, but I think there is a generic question about the role of auditors in relation to banks during the banking crisis.

Q32 Stephen Barclay: You could not trust the work of the auditors?

Sir Nicholas Macpherson: Certainly, some quite serious questions have to be asked about the accounts that were signed off during that period.

Tom Scholar: On the technical issue of the direction, the direction related to the standards set out in *Managing Public Money*, which are the standards typically required in the public sector. Obviously, that is a different test from the one that the auditors must apply.

Q33 Chair: Can you expand on that? Several people around the table are interested in that issue of the auditors. What are the questions? Where does that take you, in the Treasury, with responsibility for that?

Mr Bacon: And who asks them? You said serious questions have to be asked, not that you would ask them.

Sir Nicholas Macpherson: Well, you know—

Mr Bacon: I do not know; that is why I am asking the question.

Sir Nicholas Macpherson: I think the relevant bodies who oversee auditors and the profession itself perhaps need to ask themselves some questions.

Tom Scholar: Inasmuch as this is a matter of financial regulation, the FSA is the body responsible for looking at standards of auditing and the quality of audit applied to financial institutions. As a matter of government policy on audit in general, inasmuch as it applies to companies in general, that is a matter for the Department for Business.

Q34 Mrs McGuire: Frankly, that is a rather passive answer to a question about the role of auditors and the fact that various parties were involved in what happened to the banking industry. The taxpayer was left to pick up the bill for it. Have you had any discussions with the professional bodies, and the Institute of Chartered Accountants in both England and Scotland, to look at some of the issues that this particular crisis has thrown up? We are not talking here about individual auditors; that might be a different matter, and you might be reluctant to comment on it, but I want to know whether or not you have engaged in any discussion about how, in future, the professional bodies can adopt a different way of working with an intricate financial industry.

Sir Nicholas Macpherson: That is a very fair question. We have not engaged directly with the professional bodies, but we have had conversations with both the FSA and the Department for Business. I would hope that some important lessons will be learned from this.

Mrs McGuire: I think this is different from important lessons being learned. I do not wish to draw a parallel, but after Enron and Andersen, everybody said that important lessons had been learned. What I and perhaps other Members of the Committee are looking for is something more proactive than "lessons will have to be learned".

Q35 Mr Bacon: I am quite shocked by your answer. Obviously, one would expect the FSA to look at this, but you are the major finance Ministry of a major

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country. There was an enormous crisis that crashed the whole world, the consequences of which we will suffer for decades. As the finance Ministry, you have not engaged directly in the issue of auditing when plainly it was a big part of the problem, although not the whole problem.

Sir Nicholas Macpherson: There are a huge number of lessons we need to draw from this crisis, and we need to address them. Inevitably, much of the Treasury's activity until recently has been concerned with managing the crisis. The present Government is seeking to reform the regulatory system. In the coming period, I would expect the Treasury to seek to cover the waterfront of issues, and this is one of them. There is a limit to how much you can deal with at any point in time, but I totally take your point. I think there are very important lessons here. RBS is a case study. You gave the example of Enron; Enron had more, perhaps, illegal activity underpinning it, but this is a classic example of corporate hubris. The takeover of ABN AMRO should be a case study of lack of due diligence.

Q36 Mrs McGuire: I do not think we are asking for a solution here today, Sir Nicholas. I thought my question was pretty simple. I would have thought we would have a more positive response. At any point over the past two years, have you engaged with the professional bodies that regulate or work with the large firms that audit these very intricate financial institutions? Has there been a conversation about this? Have you said to them, "Would you like to look at the lessons that the Royal Bank of Scotland and HBOS have thrown up?" Has there been anything like that?

Sir Nicholas Macpherson: I can say that I have not personally directly engaged with the professional bodies.

Q37 Mrs McGuire: I would not necessarily expect you to talk to everybody.

Sir Nicholas Macpherson: I am happy to come back to you on what the Treasury is doing on this front. I just do not feel equipped to give you a definitive answer.

Q38 Stephen Barclay: Perhaps we could have a note, in terms of some time scales.

Sir Nicholas Macpherson: Yes.

Q39 Austin Mitchell: Do we know what other services the auditors were selling to the banks?

Sir Nicholas Macpherson: I cannot tell you offhand, but it is in the nature of auditors that they can often provide a number of services.

Austin Mitchell: It is also in the nature of auditors that it might colour their perception of the actual accounts. We do not know.

Q40 Mr Bacon: Is that something that the Vickers Commission on banking will look at?

Sir Nicholas Macpherson: I do not think the Vickers Commission will be looking directly at auditors. Their remit is to look at the competitiveness of the banking system and the particular issues around wholesale

versus retail banks. I am not aware that they are looking at the audit issues.

Q41 Chair: You are clear about the direction in which this Committee will go in its conclusions on this issue.

Sir Nicholas Macpherson: I am very happy to come back to you on it. If in the light of that both we and you feel that we need to be more vigorous in this space, I am very happy to pursue it.

Q42 Stephen Barclay: I fully accept the point that, at the time, no doubt your team, the regulator and the Bank of England were working very long hours; it was an extremely difficult time, and we need to recognise that, but to go back again to the point at which the letter of direction was sought, did you seek an indemnity from the bank, in terms of the assets about which you were concerned? Did you get warranties, in terms of your concerns about those?

Sir Nicholas Macpherson: A number of assets were excluded from the scheme on the basis of the information that we had. The problem was that even after those seven, eight or nine months of work, we did not have enough information to take a view on every single pound of assets.

Q43 Stephen Barclay: That was not my question. My question was: did you ask RBS to confirm ownership, or were you concerned that, for example, there were some client assets within the potentially tainted assets, because obviously there is a far higher regulatory burden attached to client assets? What I am driving at is: yes, understandably the Treasury could not confirm this; you did your best in the time available. Did you therefore turn it back to RBS and say, "Okay. We will take these on, but within a certain time frame we expect you either to have confirmed ownership or replaced these assets"? Did you seek that indemnity?

Tom Scholar: Yes, we did. At the time of accession, RBS had to give the Treasury a contractual confirmation that, so far as they were aware, and after all due and reasonable inquiry—I am reading from the letter of direction—there was no such material or systemic criminal conduct affecting the covered assets. That was at the time of accession. They were then required to report annually on that; and also if they became aware of any such activity at any point, they had to report it immediately. The rules further specified that in the event of that happening, there would be a risk of termination of the cover provided.

Q44 Joseph Johnson: What percentage of the £325 billion of RBS assets covered was being referred to in the letter of direction? How big was this pool of junk, as Austin called it?

Tom Scholar: I cannot recall the percentage figure. I think it was a small percentage about which we were directly concerned, but given what we discovered about the quality of risk management and the poor systems and controls within the business, we were concerned that there might be other problems which had not come to light.

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Q45 Joseph Johnson: So, it was a general blanket letter to the Chancellor at the time, saying that there was an unspecified amount of assets that might be fraudulent?

Tom Scholar: Again, we can come back to you with the answer to the specific question about how many assets there were.

Q46 Chair: I think it would be really helpful for us to have a copy of the letter of direction that you sent to the Chancellor and his reply, if that is possible.

Sir Nicholas Macpherson: Certainly. You should have it.

Chair: It probably went to my predecessor.

Sir Nicholas Macpherson: All of these were published towards the end of the last Parliament.

Chair: The NAO can perhaps provide that for us.

Q47 Stephen Barclay: You are spending many millions on advisers. I was slightly surprised that none of these advisers told you that your lending targets were unenforceable. Did you not expect them to point that out to you?

Tom Scholar: The advisers were looking at the quality of assets. That was the only area on which we asked them to work. That was the specialist advice.

Q48 Stephen Barclay: You did not have anyone advising you on the lending targets that you set for the banks? For all the millions of pounds that you were paying for advisers, none of them were advising you on the targets that you set?

Sir Nicholas Macpherson: I think we felt that the advisers could not tell us anything that we did not know.

Q49 Stephen Barclay: So you knew that they were unenforceable, did you? These targets were unenforceable. It would be pretty bizarre if a bank took the view that it was not creditworthy to make loans to a firm, but they would go ahead and make them because there was a target there. That would be a pretty strange decision for them to make, not to mention that the direction of travel from the regulator was for them to increase their capital base and therefore they would be less likely to be making loans to, say, a construction firm, because that would have capital implications. What I am driving at is whether, when you made this deal with the banks, you got the right concessions and whether the concession that you sought on lending targets, which we know is unenforceable—I would advise that it was known to be unenforceable at the time it was made—was anything more than cosmetic. Were you getting advice from your advisers on it, or was that a decision made purely by the Treasury? If so, why was it taken when it was unenforceable?

Tom Scholar: That was a Treasury decision. It was not within the area of expertise of the advisers, so we did not think they would be able to do that.

Q50 Stephen Barclay: Not within their expertise? The credit risk policy of the bank and the criteria on which it would lend were not within their expertise?

Tom Scholar: I am sorry; I misunderstood. I thought you were talking about the target within the context of macro-policy and macro-conditions in the economy. In terms of the specific credit decisions, the lending commitments explicitly said that they were to apply to lending based on market demand and commercial judgment, so there was nothing in the lending commitment that would make the banks depart from that. What the lending commitment did do was summarise the potential benefit to the lending capacity of the banks of the additional capital cover that the Asset Protection Scheme provided.

Q51 Stephen Barclay: But you have a huge hole in your target, which is saying, "We will put it down to the banks; it is the banks' judgment." The Bank of England said in December 2010 that the dominant influence, in terms of there not being much lending, was tight credit supply. The issue we all experience with local businesses in our constituencies, particularly if you look at industries like construction, is that they cannot get loans because the bank credit risk committees say they are not prepared to lend to them; they are not the right risk. You set a target which left it open to the banks' judgment and therefore was unenforceable. My point is: did you get the right concession? What other concessions were potentially available for you to secure, given that the concession that you did secure was unenforceable?

Sir Nicholas Macpherson: I think there are limits to the role of the state in directing lending. As I said earlier, lending agreements were part of the package of these announcements. It was a collective action problem. What we wanted to try to ensure was that banks lent where it was profitable to do so. If you look at the lending, in 2010, according to the National Audit Office, these banks were on target to deliver their lending targets.

Q52 Chair: But you have reduced the target.

Sir Nicholas Macpherson: In 2009, they did hit their mortgage lending targets; they did not hit their corporate lending targets because there was a massive repayment of debt by the business sector, largely on the back of a reviving corporate bond market, which allowed big corporates to borrow very large amounts.

Q53 Joseph Johnson: You are suggesting that there was demand for capital that went unmet, and that there were no businesses going without capital. You are suggesting there was no credit crunch?

Sir Nicholas Macpherson: I am not suggesting that at all. As I said earlier, there was the biggest credit crunch in 100 years. Inevitably, in those circumstances, there will be sectors of the economy that will try to restore their balance sheets. Banks inevitably had to restore their balance sheets to a degree. The policy challenge during that period was: would they seek to restore their balance sheets at such a rate that it would damage the economy? What the lending agreements tried to do was deal with the collective action problem. Looked at from the narrow perspective of a bank, it might not be sensible to lend, but this was to try to provide an umbrella to create circumstances where the banks would lend.

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Q54 Matthew Hancock: But in 2009, that did not happen, did it?

Sir Nicholas Macpherson: In 2009, in gross terms, both RBS and Lloyds lent a reasonable amount of money. Part of the problem was that that gross lending was completely overwhelmed.

Q55 Joseph Johnson: Why could you not foresee that there would be net repayment? In an environment where businesses need to de-leverage it is inevitable that there will be a certain amount of repayment of existing borrowings, and that should have been factored in from the start. It should not be used as an excuse to justify why the targets were missed by a mile.

Sir Nicholas Macpherson: I do not remotely seek to use it as an excuse. Lending is driven largely by economic activity in the first place.

Matthew Hancock: Is it not also driven by the rates and covenants on the lending? In the argument about whether there is not enough demand for lending—that is one of the arguments cited in the Report for why lending targets were not hit—if you try to say, “There was not enough demand and therefore the banks did not supply it,” unless you consider the net price, including covenants and all the other things that are part of a lending contract, you cannot look at the interaction of supply and demand. Because all of these costs, covenants and interest rates went up, that meant demand was restricted. That is why the lending targets were missed. They were missed in the targets put in place during the rescue.

Chair: That is a statement.

Q56 Matthew Hancock: Is that true?

Sir Nicholas Macpherson: What I conclude from this is that lending targets were a perfectly sensible approach, but it is very difficult for the Government to seek to determine the level of lending in the economy. The Bank of England has pumped hundreds of billions into the economy, yet even now net lending is flat, or even falling, so sometimes you are pushing on a string. I wish there were some simple way in which you could get out of a credit crunch and that there was, in a classic Stalinist way, a path by which we could seek to plan the economy, but sadly markets do not work that way.

Q57 Chair: There is a tension between our desire to see the banks lending more and the desire for them to get their gearing down.

Sir Nicholas Macpherson: Yes. This is the fundamental tension. What we all want is an optimal path. It is a classic economics Ministry versus finance Ministry trade-off. We want to get our money back from the banks; we want to see successful banks. It is something which Britain historically has been rather good at, so it would be a pity if we got out of the banking business as a nation, but we also want to see them lending and want to get the economy going.

Q58 Mr Bacon: Are you saying that the Treasury should be split?

Sir Nicholas Macpherson: Certainly not. I think the Treasury is uniquely placed to internalise these tensions.

Q59 Chair: Perhaps we can just deal with the issue of lending. In your discussions with the banks, was there a debate on whether it should be gross or net? That is almost a yes-or-no question.

Sir Nicholas Macpherson: Tom spent many hours, days and years negotiating with banks, so he will answer that question.

Tom Scholar: Yes, there was, particularly during the second year as it became apparent that there was a very high—

Q60 Chair: But in the first year was there a debate?

Tom Scholar: I cannot recall precisely.

Q61 Chair: So in the first year, nobody predicted the extent to which people would pay back their loans?

Tom Scholar: I think that the scale of repayments, not just in those two banks but right across the sector, surprised a lot of people, including a lot of economists, so we were not alone in being surprised.

Q62 Chair: In paragraph 3.14 on page 31, there are a whole range of sanctions that were considered to try to put some beef into the lending aspiration. They were all rejected, and I find it difficult to understand why, because some of them look more doable than others.

Tom Scholar: First, there was a sanction, which in the end has not been used, but was in the scheme.

Q63 Chair: Because it was an unusable sanction, which is really Stephen’s point?

Tom Scholar: It was there and could have been used, although in the event we chose not to. The main reason we chose not to was that in the Treasury’s assessment a year ago, the failure of the banks to meet the targets set was due to market conditions. That was the assessment published by the Government in the Budget last year.

Joseph Johnson: Which the Bank of England subsequently contradicted?

Stephen Barclay: Yes; that is the point.

Sir Nicholas Macpherson: I do not think the Bank of England did.

Tom Scholar: The Bank said that it was due to a mixture of—

Q64 Joseph Johnson: It was predominantly a tight credit issue?

Tom Scholar: Yes. I do not know what “predominantly” means; it might be 55:45, but I think the Bank acknowledges in its report that there was certainly an issue of demand.

Sir Nicholas Macpherson: Anybody who has done serious work in economics knows it is notoriously difficult to separate out the demand curve from the supply curve. That is the Bank’s judgment. I respect the Bank of England hugely, but to this day I think there is an active debate about the relative role of supply and demand.

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Q65 Matthew Hancock: Anybody who has any serious economic background knows that you cannot talk about supply and demand unless you talk about price. The price of credit in margins clearly went up.

Sir Nicholas Macpherson: The price of funding went up in this period.

Q66 Chair: I am trying to get an answer about paragraph 3.14 on page 31. There is a whole series of sanctions, some of which are pretty doable. All of them were rejected.

Tom Scholar: We felt that some of them would be counter-productive, in terms of further undermining capacity to lend; a fine or penalty would come under that heading. We thought that requiring the banks to transfer shortfalls in lending to another lender would not be practical. As to the question of linking chief executives' remuneration more directly, in the second year of the lending commitment, in the Budget in March last year, a new provision was introduced to say that the two banks, in setting their remuneration, should consider this issue directly and that UKFI should discuss that with them, and that has been happening. That was in the second year of the lending commitments. In the first year, there was clearly a policy decision to be taken as to whether to include something like that. There were arguments both ways. The argument in favour was that it would be a sanction; the argument against was the feeling that it might add to an expectation of bonuses at a time when the Government was urging restraint. There was also a concern that it might lead to counter-productive behaviour in the banks if the chief executive had a personal incentive to do something that might not be in the interests of the shareholders of the bank, who obviously included the Government. That was a finely balanced decision. The policy decision was not to include it in the first year.

Q67 Chair: And the naming and shaming, which seems to me dead easy?

Sir Nicholas Macpherson: Of course, we did publish the results, so you will know that both banks missed their commitment on corporate lending.

Q68 Matthew Hancock: I want to press you on the period between the announcement of the APS in January 2009 and November 2009, when it was completed. You said that by the end of it, you realised you would not get a full risk exercise on every single one of the millions of assets that were in a mess, and you took the decision to go ahead for financial stability reasons, which I think is entirely understandable. Did it surprise you how long it took to do that due diligence?

Tom Scholar: Yes, it did; we expected to do it more quickly. The reason it took longer was the one we discussed earlier: the poor state of systems and risk management.

Q69 Matthew Hancock: Given that by November you knew you would not get full sight of the whole package that you were to take on board, could you not have made that judgment earlier and, therefore, have signed the thing off when you first expected to, before

the summer? You would have had less sight, but you still would not have had 100% sight of it by the end of it, if you had gone on forever.

Sir Nicholas Macpherson: The important point there is that from the moment it was announced in February, both RBS and Lloyds were getting a benefit in terms of market perception from the Asset Protection Scheme, so the intervention was delivering stability well before the scheme went live. Indeed, in Lloyds' case, they ended up having to pay a fee to us for the benefit they received.

Q70 Matthew Hancock: So the expectation of the scheme was doing the job?

Sir Nicholas Macpherson: Yes.

Q71 Matthew Hancock: So it did not matter that you did not have the scheme in place?

Sir Nicholas Macpherson: It clearly did matter, because we wanted to nail it down. There were also a whole lot of issues with the European Union around state aid which we needed to resolve, but the lesson from this—and the lesson from the States and Ireland—is that all these interventions always surprise you, in terms of how long they take to get up and running.

Q72 Matthew Hancock: Do you think that in future you would make the judgment earlier that you had had enough of a look at it to know how you felt about it, and that you would therefore be able to put it in place, rather than leaving it to drag on for 10 months as you did?

Tom Scholar: I do not think it would have been sensible for us to have brought forward the final decision. First, as my colleague says, the promise of the scheme was in any case providing support. Secondly, the due diligence exercise was an exercise in diminishing returns. In the first few months the numbers moved quite significantly. Simultaneously, we were in discussion with RBS about which assets would go into the pool to be covered. By the time we got into September, October and November, which was also the time of finalising the negotiations with the European Commission, it was moving considerably less, so by the time we got to November, we felt we had sufficient assurance that we could set the first loss—do not forget that the first loss is absolutely critical in driving taxpayer value—at a level that would prove robust to future developments, and it has turned out to be.

Q73 Matthew Hancock: But you do not think it was worth doing it earlier, given those diminishing returns in time?

Tom Scholar: No. I think we needed to take the time that we did.

Q74 Matthew Hancock: You mentioned the exit fee that Lloyds had to pay. One of the findings of the Report, in paragraph 16 on page 8, is that the analysis of RBS's exit fee, which of course it has not paid, "did not include the breadth and depth of analysis we would expect". Why was that?

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Tom Scholar: You can look at the calculation of a possible minimum fee in a number of ways. The way in which we did it, as paragraph 15 on the previous page says, was to charge the maximum fee possible consistent with leaving RBS well capitalised. Of course, we had to agree that with the FSA. They had to be satisfied that RBS would pass the stress test. What the NAO is referring to in its comment is a different approach to calculating fees, perhaps by reference to the methodology used in the case of Lloyds, but of course Lloyds was in a different position because it was exiting the scheme and RBS was continuing.

Q75 Matthew Hancock: But you would want to agree a minimum fee for exit before an exit.

Tom Scholar: Correct, but in the case of RBS the fee was the very last thing that we agreed in the whole package because our desire was to charge the maximum possible fee consistent with leaving it well capitalised. In order to do that calculation, we had to know how much capital support we were providing through the scheme and get the FSA to factor that in.

Q76 Joseph Johnson: Is that not doing it the wrong way round? Should you not work out what the fee should be based on an analysis of the cash flows, then charge it and recapitalise RBS if necessary?

Tom Scholar: I think your question shows what the consequence would have been of a higher fee.

Q77 Joseph Johnson: You would have had to stick in more capital and increase your shareholding, rather than give away value?

Tom Scholar: In any case we were an 84% shareholder.

Joseph Johnson: But you were giving away value.

Q78 Matthew Hancock: So you are saying that the fee was not based on analysis of the value to the bank of the support the taxpayer was giving anyway—it was more a finger in the air about what the market could sustain?

Tom Scholar: We were trying to balance a number of considerations. The bank had to pass the FSA stress test. The Government was concerned that the shareholding should not rise so high that in practice the bank would have to be de-listed. As the Report says, that was a policy decision taken back in January and confirmed again later in the year.

Q79 Matthew Hancock: Hold on. That says that in order to keep the taxpayer ownership down, you charge a lower fee than you might otherwise have done, so you did not have to recapitalise as much, which is not very good for taxpayer value for money in a narrow sense, is it?

Tom Scholar: We saw taxpayer value issues as being better protected by keeping the bank as it is now, with a partial private-sector ownership, because we see that as better protecting the value of the bank in the long run and as facilitating exit.

Q80 Matthew Hancock: I buy that entirely, but although the difference between an 83% and a 90%

public ownership is a difference in taxpayer value, it does not alter the structural ownership; it is still a minority shareholding.

Tom Scholar: But there comes a point at which it is no longer credible to go on treating these issues—

Q81 Chair: So were we on the cusp there?

Tom Scholar: Absolutely on the cusp, yes.

Chair: So it would have made a difference.

Q82 Matthew Hancock: But it was not due to lack of capacity. If I may say so, you were widely regarded as working heroically during this period, but you were also in a stretched team. Was it due to lack of support?

Sir Nicholas Macpherson: I think we were overstretched in 2008. Through 2009, Treasury capacity had strengthened considerably in this area, and actually I think the Treasury effort on this was of very high quality. The NAO concedes in paragraph 16 that a minimum fee in the range of £1.4 billion to £4.4 billion could have been justified. The bank had already paid £2.1 billion. If it is still in the scheme next year, which RBS certainly expects, it will be paying in excess of £2.5 billion.

Q83 Chair: I think it has been very difficult for any of us to second-guess your judgment. One can understand the issues that you took into account as you made the judgment on the fee level. As I read the Report, where the NAO criticism comes is on whether you did all the appropriate work underpinning the taking of that judgment. You knew much better probably than the NAO and certainly than us as to whether that fee was set at about the right amount, but on reflection, should you have done the extra work that the NAO suggests you should in coming to that judgment, or do you think that the way you approached it was okay?

Tom Scholar: As you might imagine, we have looked at this very carefully, particularly since receiving the Report. I think that it is a fair criticism to say that we could have done more analysis in this area. However, even with the benefit of hindsight—we have gone over this very carefully—and even with that extra analysis, we still would have ended up with a fee of £2.5 billion, because the critical thing driving that figure were the considerations in paragraph 15—the maximum consistent with financial stability.

Q84 Matthew Hancock: I want to ask a bigger-picture question. You referred earlier to trying to get the de-leveraging on an optimal path to satisfy the two competing constraints. It seems to me that in order to execute de-leveraging while keeping the domestic economy in reasonable shape there should be a focus on foreign asset sales, because the disposal of foreign assets can reduce your wholesale funding requirement without having a direct impact on the domestic economy. Do you think that the existence of the APS has any impact on whether that is a strategy that can be effectively pursued by RBS?

Tom Scholar: I do not think it does influence that strategy. It is certainly possible for RBS to dispose of assets that are covered in the scheme. Indeed, they are disposing of them, which is one of the reasons why

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the pool is shrinking. I do not think that the existence of the scheme in itself distorts that judgment.

Q85 Austin Mitchell: I think it has been a very educative session. It makes me think that instead of going into politics I should have taken that trainee job with the Yorkshire Penny Bank all that time ago. I could now be subsidised by the state, drawing fat fees in the process. I was intrigued by Sir Nicholas's sensitivity. There you are, the head of the biggest bully Department in the Government, which goes round bullying all the other Departments and snatching money from them, yet you are squeamish and sensitive about the banks; you touch them with a feather duster. How do you know that you are not being fooled by the banks? They say that they are not lending to business because people are not coming forward to demand loans, but small businessmen in my constituency, and I think in every other constituency, say, "The banks won't invest in us; we can't get the money. Everything is grinding to a halt", builders particularly. Who is telling the truth in this matter?

Sir Nicholas Macpherson: I am acutely aware of the problems that small businesses have at present in accessing loans and so on. The Treasury takes that very seriously.

Q86 Austin Mitchell: But there is nothing you can do about it?

Sir Nicholas Macpherson: I do not quite accept the "feather duster" criticism. Both the last and present Governments have applied special taxes to the banks, first the bonus tax and now a banking levy, which will raise £2.5 billion a year; I do not think the banks are overjoyed by that. I hope that it may indeed influence their behaviour. At the heart of your question is the role of the state and its ability to intervene in markets to secure a wider economic benefit.

Q87 Austin Mitchell: It's not that; that is a theoretical question. Here are the banks: you are shoving large sums of money into them; you are safeguarding them; you are preventing them from collapse; yet they are not doing what Government wants them to do—lending money to business. They are lending for mortgages, that is true; but they are not lending it to business. As a result, business has stalled in large parts of the country. All I am saying is: are you being too sensitive in saying that they cannot lend the money? Should you not push them in some way into lending more to stimulate the economy?

Chair: Would you give a quick answer to that, because we have been round that house quite a lot?

Sir Nicholas Macpherson: As I said earlier, the Government is in discussions with the banks and I do not want to prejudge those discussions.

Q88 Jackie Doyle-Price: I want to come back to the question of fees. In an earlier answer you alluded to the fact that the European Commission was constraining how you negotiated the RBS fee. Can you give me a bit more of an explanation of that and say how it affected the fee you negotiated ultimately?

Sir Nicholas Macpherson: The challenge in all state aid issues is that, quite reasonably, the European Commission, which has to police competition across banking, was keen to ensure that the Government were not somehow giving the banks an unfair competitive advantage, so they took quite an active interest in the properties of the scheme and also focused on the wider interventions involving recapitalisation. We had extensive discussions with the Commission last autumn. I do not think they influenced the scheme to a massive degree, but the Commission was keen for a consistent approach to be adopted across the European Union. As you know, in terms of wider competition issues, they have required both Lloyds and RBS to divest themselves of some of their branches and businesses. In the case of RBS, that is being taken forward at a fairly rapid pace; in the case of Lloyds, it is yet to happen, but I think that ultimately both things will encourage competition in the banking sector. For those of us who are frustrated by issues like bankers' bonuses, the long-term solution is about changing the structure of the industry rather than Government berating certain individuals.

Q89 Chair: One interesting question that comes out of it is this: why, on the subordinated debt, did you wait for European legislation to stop them getting their interest on that? That seemed odd to me. It seemed to be an advantage. If you have a subordinated debt, you can make a load of money out of it.

Sir Nicholas Macpherson: It is a very good question, and Tom will now answer you.

Tom Scholar: Again, it is a financial stability thing. A discretionary decision by the UK Government to stop paying interest on that would have risked contagion to other similar types of asset class, which could have had damaging effects on financial stability, but once an international European rule came in, it was clear to everyone concerned, investors in particular, that that was an obligation we had rather than a discretionary decision, so it made possible something that would not otherwise have been possible and we were very supportive of that new rule.

Q90 Jackie Doyle-Price: To follow that up, would it have been more advantageous to set a lower fee than the Lloyds fee in order to give a signal to the markets that RBS was moving in the right direction? Ultimately, from our perspective it would have meant that the taxpayer's involvement would cease sooner rather than later.

Sir Nicholas Macpherson: What you are highlighting is that there is a trade-off here. We are satisfied that the fees charged were reasonable. We wanted to see a reasonable return to the taxpayer, right here, right now. In the case of Lloyds, it was part of a wider package that involved private investors taking on more risk as part of the rights issue for Lloyds, but as you say, there is a delicate balance.

Q91 Joseph Johnson: I want to sum up for myself what I think is the key message of what you are telling us. The overriding objective, which you achieved handsomely, was to restore financial stability. What I conclude is that a very close second was to do so

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while avoiding, almost at any cost, full nationalisation of RBS and, if it came to it, Lloyds, even if that came at the expense of value for money for the taxpayer and the loss of your ability to enforce lending targets. Do you think that is a fair characterisation of what you are saying?

Sir Nicholas Macpherson: No, I do not, because I do not accept that we were trying to avoid nationalisation at any price. Indeed, we went over the arithmetic several times to work out whether nationalisation was an option. That informed a lot of our financial interventions from Northern Rock onwards. I guess that what informed our judgment was that 100% ownership carries a cost, in terms of the erosion of value in any institution. This used to be an issue of big political dispute, but I think there is general agreement now that nationalising companies in the competitive sector probably does not do either those companies or the taxpayer much good, so we were factoring in a loss of value there, but that does not mean that there would not have come a point when full nationalisation made sense. We were trying to avoid it, but had the arithmetic really stacked up, we would have gone for it. As for your wider point about lending, this was a massive credit crunch. I think Government interventions and Government policy prevented it from being a hell of a lot worse. If it had been a lot worse, lending would have fallen even more. Could we have fine-tuned our intervention to make it even more effective? I think that will be a matter for analysis and learned papers for many decades to come.

Q92 Joseph Johnson: Thank you. Do you accept that the Government would now probably find it easier in their negotiations with the banks vis-à-vis lending if they had 100% control, or would it make no difference at all, and would we be having exactly the same conversations with Stephen Hester if we had 100% control as we are now having with 83%? Do you think it makes no difference at all?

Sir Nicholas Macpherson: I think it depends on how Government chooses to exercise that control. There are certain countries in the world where the state instructs banks to lend. I am quite sure that for brief periods they do it quite successfully, but it carries a cost. The critical thing about lending is that it must be on commercial terms and subject to market demand; otherwise, you start really distorting decision-making. You can take a punt on the state knowing better than the market what to do—and sometimes that is the case; we have seen markets operating pretty imperfectly in recent years at certain times—but generally I would prefer to rely on the market rather than state direction.

Q93 Mr Bacon: I agree with you about that. Not only do I not have much faith in the ability of the state to get it right; the way these banks have been managed over the past 10 to 15 years suggests that we should not have much faith in them either. I want to ask about the first loss, the second loss and the £60 billion limit, which the Report describes as being based upon the most likely economic scenario. Let us hope that is right. But the NAO goes on to say that there is a

tipping point at around £73 billion, where the taxpayer's position would be particularly vulnerable, because at that point the incentives would change and RBS would be liable for only 10% of any further losses or, to put it another way, RBS knows that the taxpayer will be picking up the bill for 90% of any further losses. At that point, notwithstanding what is said in 2.22—that any payments made by the Treasury must be paid “by RBS plus interest if it wishes to exit the Scheme”—RBS might very well decide, “That is far too high a price to pay; we’ll carry on as we are, thank you”, and they can do so until 2099. Let us hope this does not happen, and let us all be optimistic about what might happen in the economy, but there are any number of things that could blow one sideways. Are you really prepared to see RBS staying in the scheme for the next 90 years?

Sir Nicholas Macpherson: Probably what you are talking about are pretty extreme circumstances. To get to £73 billion, we will probably have had to experience another really serious property downturn, for example. If that happens, I suspect—I do not want to dishearten you—that we shall be in the business of rather bigger banking interventions across the board than just RBS's membership of the scheme. Who knows? At that point, Mr Johnson may be right and nationalisation could conceivably come into play. My main point is that, having looked at the numbers, to get to £73 billion you are getting pretty much off the page in terms of the economic environment.

Tom Scholar: I was going to say something very similar. I just add one thing. In its report last year, the Asset Protection Agency gave various scenarios and sensitivity analyses involving different types of stress and consequences. To get to a loss of £74 billion, you have to assume default rates similar to those that prevailed during the great depression, plus an additional fall in commercial real estate prices, plus even-lower-than-expected recoveries at that time, so it is a really extreme scenario and, as my colleague has said, some other intervention would become necessary before getting to that point.

Q94 Mr Bacon: This crunch has already been described as worse than what happened in the 1930s. What I am getting at is: if this were to happen, and things went that badly wrong, it would be because of being hit sideways by economic circumstances rather than any misunderstanding of the quality of the assets that are already in the scheme. Is that right?

Tom Scholar: Yes. When we set the first loss, we expected it to be £60 billion. That subsequently came down to £57 billion. As my colleague said, we have reason to believe that that will come down further.

Q95 Mrs McGuire: We have been discussing 2099. Stephen Hester implied that he would see RBS staying in the scheme until 2012. There was a report in the *Financial Times* a couple of weeks ago that said that currently, RBS officers and officials from the Treasury were examining ways in which RBS could come out of the scheme this year. Would you like to comment? I am not asking you to comment on a leaked story.

Sir Nicholas Macpherson: First things first: I would love it if RBS could exit the scheme. It just takes

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another massive contingent liability off our books and they would have to pay us a fat fee to do it. If they did get to that point, it would be great. I saw the story, like you, and did not immediately recognise some of it. The public position remains 2012, so I think we should continue to operate on that assumption until we get new information.

Q96 Stephen Barclay: This is a wider question, really. On learning the lessons from this, I was interested in your estimates of what proportion of regulatory policy moving forward will come from the UK, and what proportion from outside it.

Sir Nicholas Macpherson: What the crisis has really underlined is just how integrated the world financial system is. National sovereignty is important, but you see it in the Basel group and in the Financial Stability Board, of which Tom is a member. To get international co-operation working really well is fundamental to achieving future stability.

Q97 Stephen Barclay: But as a proportion? The majority already comes from outside the UK, does it not? I mean the driver. We implement the directives in the UK, but the majority of policy already comes from outside the UK.

Tom Scholar: Yes, it does, and has done for many years. I think there is a greater push, of which the UK Government is very supportive, to have greater global adherence to global standards.

Q98 Mrs McGuire: I am interested in your answer to my question about the *FT* story. You said you did not recognise some of it. Which parts of it did you recognise?

Sir Nicholas Macpherson: I recognised that there was something called the Asset Protection Scheme and RBS. I am sorry; there is no inwardness to that statement.

Q99 Chair: I think that on the whole this is a report of a job well done within Treasury. We will see what the historical economists make of it, but clearly you have also built up within Treasury good expertise which, in the light of what we see at this Committee all too often, is a rare thing that you want to hang on to. My understanding is that they are all on civil service terms; no one is being paid huge chunks of City-style money. I can see the interest that can be excited in being around during the credit crunch. When things die down, will you hang on to them?

Sir Nicholas Macpherson: I hope we will hang on to enough of them. When we were doing the Asset Protection Scheme, we had literally 100 people working on it day and night—poring over the assets, doing the calculations and so on. Once the scheme was set up we handed it over to the Asset Protection Agency and we did not need those people doing that job any more, but you want to retain a critical mass of expertise. In the coming period, the regulatory system is going to be reformed again; indeed, as a result of legislation by the last Government, the Bank of England is now responsible for resolving banks. We had to resolve the Icelandic banks, Bradford & Bingley and Northern Rock. I will not trouble you

with why that was the case, but the Treasury had to do that. Now the Bank of England can do it, so we do not need so many people operating in that space.

What the Treasury really need to retain is the ability to ask the difficult questions of our regulator. The bank will be responsible for regulation, but the Treasury needs to have sufficient expertise to be an intelligent interlocutor, and to take care of, and nurture, the system as a whole because we will remain responsible for legislation. Some perfectly good points were made during this discussion about where we might have done more; all of us have lessons to learn, but there are some people who are incredibly valuable. My friend here could command massive wages in the private sector. I think he has saved the taxpayer many hundreds of millions of pounds. He, like me, chose to forgo any bonus in the last year. Why people want to be public servants is an interesting question. All of you are public servants; you have taken the decision to operate in that space. I guess that is critical to the future of Britain.

Q100 Chair: But you really have not answered the question. I can see why people want to be around when the thing is happening; it is a life experience.

Sir Nicholas Macpherson: The Treasury is often criticised for being perhaps slightly elitist in Whitehall terms, but we are a very small institution, and to make it an attractive place to work, it kind of has to be elitist, because maintaining that expertise and ability is critical to the taxpayer and, I would argue, this Committee.

Q101 Chair: In the new regulatory framework, would it be more sensible if the Bank of England, through the NAO, was accountable to us in a more direct way?

Sir Nicholas Macpherson: As you know, the FSA is now going to be audited by the National Audit Office; the Prudential Regulatory Authority, the new institution, will be audited.

Chair: And the Bank of England?

Sir Nicholas Macpherson: This is a policy question. I think it would be inappropriate for me to say anything more, but my views given to Edward Leigh in the past are a matter of record.

Q102 Chair: Can you remind us of them, because I do not remember?

Sir Nicholas Macpherson: I do not think it would be appropriate to comment on a policy matter as a mere official.

Q103 Chair: Perhaps you could give me those views. Are you saying that you gave those views to him in private? It is a matter of record.

Sir Nicholas Macpherson: I have always believed that Parliament's role is critical. I have worked with this Committee and the National Audit Office to expand the NAO's remit to the BBC and the Royal Household. I used to be the auditor of the Royal Household; now my good friend Amyas will be. I see the remit of this Committee and the National Audit Office as critical to value for money.

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Q104 Mr Bacon: Sir Nick, a minute ago you said something very interesting about the culture and atmosphere of the Treasury and the kind of place it had to be in order to attract people. Without putting on the rose-tinted spectacles of hindsight, there is a view out there that there was a time when the Treasury, with its very flat structure and elitist approach, as you have described it, was a place that nurtured different schools of economic thought—a place where argument was actively encouraged, and there is a view that that, to a considerable extent, had become less the case; thus it became a less intellectually attractive place to work. Is there any truth in that? If so, do you seek to change it?

Sir Nicholas Macpherson: I do not recognise that. The economic crisis has forced the Treasury to take a very serious, hard look at how it works. Out of it, a lot of very positive things have happened. I would like to think that the Chancellor, whether it be George Osborne or Alistair Darling, was reasonably impressed by the candid and very open advice provided by officials, and by the capacity of Treasury officials to argue in front of Ministers, often with each other. I think the Treasury is a vibrant institution and I am determined to make it even more vibrant.

Chair: Thank you very much. We look forward to that vibrancy next week, when you come back.

Wednesday 16 March 2011

Members present:

Margaret Hodge (Chair)

Mr Richard Bacon
 Stephen Barclay
 Stella Creasy
 Jackie Doyle-Price
 Chris Heaton-Harris
 Joseph Johnson

Mrs Anne McGuire
 Austin Mitchell
 Nick Smith
 Ian Swales
 James Wharton

Examination of Witnesses

Witnesses: **Nathan Bostock**, Head of Restructuring & Risk, RBS, **Eric Daniels**, Former Group Chief Executive, Lloyds Banking Group, **Stephen Hester**, Chief Executive, RBS, and **Tim Tookey**, Group Finance Director, Lloyds Banking Group, gave evidence.

Q105 Chair: Welcome to you all, thank you for coming, and thank you particularly to Eric Daniels for making probably a last appearance—

Eric Daniels: One hopes.

Chair:—you hope, before a parliamentary select committee. I am going to start with a very general question. The Bank of England made this estimate of the cost of the subsidy to the UK taxpayer, so theoretical underpinning costs, and they came to £100 billion, across the banking system, as the 2009 cost to the taxpayer. From your point of view, as two leaders of two banks, what value for money has the taxpayer got for that £100 billion underpinning and some direct investment?

Stephen Hester: I might have a quick crack at that. Just a couple of comments: in my view there has been an implicit subsidy from Governments around the world to the banking system. It was not the UK alone; it was all around the world. The value of that implicit subsidy I think is impossible to accurately quantify—

Q106 Chair: So you do not accept the Bank of England figure?

Stephen Hester: No, I do not accept the Bank of England figures. I am not an economist and I am obviously not an econometrician, but research that we have seen, which I think will be published in the coming weeks, and I will provide you with a copy if and when it is, comes up with dramatically smaller figures.

Q107 Chair: Could you share with us what you think the figure is, because that is quite interesting. On the whole, one would accept the Bank of England's—

Stephen Hester: I have seen figures that are less than a 10th of that amount. But my point is not that one figure or another is accurate. I would accept that there has been an implicit subsidy. One can debate the size of it; I believe it is much smaller.

Q108 Stephen Barclay: Have you published those figures that suggest it is less than a 10th?

Chair: They are publishing on Friday.

Stephen Hester: I have seen work in progress, but as soon as there is something that is finished we can certainly make it available. But the second point that I would make is that all of these figures are backward

looking, however you would calculate it, and clearly one of the most important things that is under way is the reform of the banking system, such that it no longer has any implicit subsidy from taxpayers in any country, whether here or otherwise, and if one forward-projects the dramatic increases in capital for banks in liquidity and the other reforms like living wills and resolution, I believe that we will get to the place that we should be at, where there is no longer an implicit public subsidy, and we are certainly very supportive of that being the case.

Q109 Chair: The job of this Committee is to follow the taxpayer pound and to assure the public that we have had value for money for the investment of that taxpayer pound. The figure that we have been working with is £100 billion—let's not quarrel about the figure—but whatever it is, £10 billion is still, were that correct, a fantastically substantial amount. What value has the taxpayer had out of both the implicit and explicit investment that we have made since the financial crisis?

Stephen Hester: Again, I think that there are many different ways to attack that issue. Of course there are series of direct and ongoing receipts that the taxpayer has had through fees paid to the Bank of England and to the Treasury for explicit liquidity support: fees paid on the Asset Protection Scheme, and so on. Hopefully there will be handsome returns from ownership of the shares of RBS and Lloyds, but that is obviously to be seen in the future. Over and above that you then move into broader societal issues about whether the functioning of the financial markets has a benefit to all of society or not, and I think it does.

I want to be very clear: my point is not that you can do a mathematical calculation and say, "All is fine." My point is the contrary: all is not fine, such that reform is needed, such that these implicit subsidies disappear, however you might argue about the numbers.

Eric Daniels: On the methodology that I understand was behind the £100 billion number, I would somewhat agree with Nick Macpherson who said it depends on the day that you do it.

Q110 Chair: It is a 2009 figure. For 2008, the Bank of England said it was a £10 billion implicit and

explicit subsidy, total subsidy. But 2009, it was £100 billion. So they looked at calendar years.

Eric Daniels: The way in which they approached it was to look at the difference between the standalone rating and the cost associated with funds as a standalone institution versus the support rating. They took that differential and used that as the basis for the calculation. What I would say is that no bank today, or during 2009, was able to raise money at the support rating. The actual cost of funds to the bank was at the standalone rating. I think the idea that using that differential to calculate the so-called subsidy is simply not correct. I challenge the assertion.

Q111 Chair: Accepting the challenge, nevertheless we all accept that there is a substantial investment by the taxpayer in supporting the banking system during the banking crisis. Did the taxpayer get value?

Eric Daniels: I think I can only repeat what Stephen said, that the explicit support that was given—whether it was liquidity support in the form of CGS or SLS—was, in fact, at very attractive rates for the taxpayer. The investment in the equity of the banks, as Stephen said, remains to be seen, but I think we all believe that the taxpayer will get a very handsome return for that investment.

Q112 Stephen Barclay: Just sticking with the Bank of England research, that also commented that the dominant influence in the lack of lending to companies was the reduction in the supply of credits by the banks. Do you accept that finding?

Stephen Hester: That would not be the data that we have. I think that the data that is pretty consistent all around the world is that post-recessions, what happens—in the generality, of course; there are individual cases that are different—is that people try to get their borrowing under control. Savings rates go up, deleveraging happens, borrowing goes down, and so in every industrialised country around the world you saw an increase in savings rate, a paying back of borrowing as people desire to be more conservative, and I think that is by far the dominant effect on the lending.

Q113 Stephen Barclay: Absolutely, the Bank of England cited a number of factors, but within those various factors they said the dominant one was the one I cited. Given that they have access to a wider data set than you do, and they can request your data, and they can request data from the regulator, why do you think, in your opinion, the Bank of England got it wrong?

Stephen Hester: I do not think my position here is to per se criticise the Bank of England, and indeed I do not have in front of me line by line, if you like, the report that you are citing, with all its context, but all I can say to you is I believe that the dominant influence—not the only influence, but the dominant influence—in the reduction of lending has been people's desire to borrow less in the context of an uncertain economic outlook.

Q114 Ian Swales: On this topic, Mr Hester, you talked about the implicit subsidy, based on the Chair's

first question, and you seem to be suggesting in one of your remarks that you would see, in effect, that disappearing. Now, as I understand it, one of the main factors behind that is the Government standing behind deposits in the banks, and in effect standing behind international operations as well as UK operations. When you say you see that disappearing in the future, by what mechanism do you think that is going to happen?

Stephen Hester: The mechanisms, if you like, that are under way—well advanced, in fact—can possibly be divided into two categories. The first is banks holding huge amounts more capital and liquidity reserves, quite properly—obviously I am not here to defend the past, since I have only been in post two years—and that means that the likelihood of banks needing external support once those reforms have been fully worked through, the Basel III process, dramatically falls. Then secondly, there is a huge change in what happens in the less likely circumstance that a bank nevertheless fails in the future.

What the last crisis unveiled, and I have spoken about this a number of times in advocating reform, is that it was quite hard to pass on losses, pass the shareholder to creditors, which is normally what would happen in any other company, and the state found itself jumping into the middle. There are a whole series of parts of reform around things called Co-Cos and things called bail-ins—sorry to use technical terms—resolution mechanisms, changes in legislation, living wills. There are a series of things in this category that the world's regulators are advancing, designing and changing, such that in a future crisis not only would a bank be less likely to go under because they had more strength to start with, but there then would then be a smoother recourse to creditors, as opposed to Governments, and not the need for Government intervention.

So the combination of those, plus banks managing themselves, learning from the crisis, getting out of risk position, should get us to the position where Government support of the capital variety, is not needed. There will always be a role for central Bank liquidity support, but there should not be a role for capital support, and that is why I have always advocated that these reforms take place. I think we are going in absolutely the right direction, and as they bite that will be the result.

Q115 Ian Swales: On a specific, then: retail depositors. Do you see the Government's scheme to support retail depositors disappearing in this new world that you are describing?

Stephen Hester: Obviously retail depositors, or the retail deposit insurance, is funded by the banks through levies. That is true here, it is true in the United States, but I cannot speak for every country. So although the Government can offer an overdraft, in the end it is the banks that pay for that scheme. My guess is that scheme will stay; you could argue for its enhancement, but it has already been enhanced. You can clearly have a debate about its size, but quite properly it is paid for by the banks.

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Q116 Chair: I want to get you back to this value to the taxpayer. I want to get you back to the value. You believe you have value in the sense that you are paying for the money that we, the taxpayer, are lending you. One of the aspects of the deal, and it would be good if you could both answer this, was that we wanted to keep lending going, both mortgage lending and business lending, and both of you abysmally failed in 2009. RBS was £22 billion short on the business lending and Lloyds £8 billion short, on the figures that we have in front of us. 2010 looks a bit better, but only because we have changed the goalposts, so instead of looking at net lending we are looking at gross lending. I would have hoped one of the ways we could measure value for money for the taxpayer would have been your role in securing growth in the economy, particularly through the SME sector. Why did you fail, and in that context how do you expect us to say you have given value for money?

Eric Daniels: I think I would characterise our performances somewhat differently. I am very happy with the performance of Lloyds. We extended over £30 billion of new mortgage lending during the past year. We have helped over 50,000 first-time buyers. We have lent approximately £44 billion, I believe, to corporations and small businesses—£11 billion specifically to small businesses. We in fact exceeded our commitments to Government during this past year.

Q117 Chair: Only because the goalposts have changed. I am sorry to interrupt you on that, but when the targets were first set they were net targets—that was 2009—and you both failed abysmally in 2009, which was a key year for growth. In 2010 you are doing better, I accept that, but only because we have changed, and presumably in your negotiations with the Treasury, you are now on gross targets, which I do not think are a terribly helpful measure, but I accept that they are the measure that has been set.

Eric Daniels: I think that I would give you two responses. In the first place, we increased our net lending to businesses during the year, so this is not something where it is simply chicanery.

Q118 Chair: What is your net lending to business in 2010? I have it down as a negative.

Eric Daniels: I believe it is positive. I do not have the number to hand.

Q119 Chair: What is it? Does Mr Tookey know?

Tim Tookey: It was positive overall.

Q120 Chair: What? A billion or something? I think our advice from our officials was it was still a negative.

Tim Tookey: I can confirm it was marginally positive on a net basis—

Q121 Chair: Can officials help?

Tim Tookey:—for SMEs for year two.

Q122 Stephen Barclay: Just whilst they are helping, can I just clarify that gross lending to a company can go up, whilst the actual money the company gets, the net lending, goes down? In other words, if I have a

first loan with you worth £1 million, and that is under an existing loan agreement and I pay that back, because of the fee structure in terms of that loan, and I take a second loan from you worth £1.5 million, probably with higher fees, charged with more security, you would present that as gross lending of £1.5 million, but the actual money that I as a company would have from you would be £500,000. Do you accept that going to gross lending, which is the target for 2010/11, can give quite a misleading position as to the amount of the bank's money that has been placed with a company?

Eric Daniels: No, I do not believe it is misleading at all. I think it is a very accurate representation of the banks' willingness to lend. The distortion that the net lending figure causes is, as Stephen pointed out earlier, in a recovery period, when you often see demand for lending go down a great deal, and so you see a lot of repayments. Companies want to get their balance sheets in order. What we see are two factors: one is lots of repayments among mid-sized companies, and among big companies not only repayments but also going to the capital markets directly. So increasing gross lending in that kind of environment I think speaks very well to the banks' willingness to lend.

Q123 Stephen Barclay: Did you not make those points to the Treasury when they set the target?

Eric Daniels: There were lengthy discussions with the Treasury when we set the targets.

Q124 Stephen Barclay: So some of those criteria would have been factored into the original target that was set?

Eric Daniels: No, I think that the original targeting was done at the very last minute of a very complex process, so there was really no thought and no real—

Q125 Stephen Barclay: So you signed up to them with very little thought having been put into them?

Eric Daniels: No—if you will let me finish please. This was after a very complex negotiation on GAPs. At the 11th hour we were asked to commit to lending targets, which we did, but we also caveated those, because we were not given enough time to negotiate thoroughly. We basically agreed that it would be subject to demand—the demand had to be there—it was subject to liquidity, subject to having capital, and subject to creditworthiness. Those were the four conditions, and that was the agreement that we struck. It was not a lengthy negotiation: again, there was no time.

Q126 Stephen Barclay: It strikes me that there are relative priorities: on the one hand, the Government are saying they want you to lend more. On the other hand, every financial services party is saying they want you build your capital base up. The Bank of England is saying they want you to repay them more quickly, and your own remuneration is saying, "Let's get the share price up, because that is what the bonuses will be paid on." What is unclear to me is how you assess those relative priorities, or is it your argument that you can do all four at the same time?

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Eric Daniels: Is there a question there?

Q127 Stephen Barclay: There are four different priorities there. One of those, which we are just looking at, is the lending priorities, which you have missed on the commercial lending. I am trying to understand how you prioritise the lending priorities vis-à-vis what strikes me as different priorities that have been set—your own internal remuneration priority for staff, compared with some of the Government's other objectives and the regulatory objectives, which are pushing in other directions. How do you prioritise those different issues, or are you saying that it is your expectation you will deliver all four at the same time?

Eric Daniels: I think you need look no further than last year. Last year Lloyds repaid some £60 billion of Government funding, first, increased its gross and net lending, increased its share price, working for the shareholder, and what was your fourth?

Q128 Stephen Barclay: You have regulatory pressure, Bank of England pressure, Government pressure and your own—

Eric Daniels: Sorry, we increased our capital by 25% from 8.2% to 10.2%

Q129 Chair: Can I get an answer on that lending issue, because my note now tells me Lloyds did have a positive—apologies for that—but RBS had a negative on the net.

Stephen Hester: Let me take up your points. I think the first point is that we should be very clear that since I have taken the helm two years ago RBS has done everything it can and continues to do to support its customers in the UK, and is, as a consequence of those efforts, not only lending very large amounts of money but substantially in excess of our national market shares, as was shown on the Merlin figures that were published last month.

But if I could shed some light on an important apparent misunderstanding, the lending commitments were legally binding commitments, and if we had failed under them we would, could and should have been sued by the Treasury. My understanding is that the Treasury concluded there were not grounds to do that; i.e. there was no breach of them. I am not surprised that there was no breach of them, because I was heavily involved in the discussions at the time, when I had just arrived, with the last Government, which was obviously concerned to ensure that the recession was not exacerbated by a lack of confidence in financing markets.

Q130 Chair: There was a breach. I am really sorry to stop you, you can finish, but there is just this—

Stephen Hester: I am trying to explain, so I hope it will be helpful to you. The key concern of the Treasury and Ministers at the time was that there would be a disappearance of foreign lenders in the UK market and an artificial credit crunch as a result of the disappearance of people who were previously lending a lot of money, and that artificial withdrawal of funds would make the recession worse. That was the concern. What the intervention with Lloyds and

RBS was designed to do was to give reassurance that, if the foreign banks all disappeared and if credit demand continued at a very high level, there would be adequate capacity from the domestic banks to make it. The way that the targets—at least I can speak for RBS—were calculated was on a back of the envelope assessment, on short notice, by the Government and Treasury, of the kind of figures that foreign lenders represented, what the gap in the market might be if demand did not go down and foreign lenders disappeared, and therefore what increment might be required. Therefore, we said that we would lend up to this amount if there was a demand on creditworthy terms. Now, in fact what actually happened was two things: number one, demand, as it did in every other country and as it does in every other recession, in fact fell—it did not stay at the high levels; and secondly, foreign lenders did not leave the market in anything like the quantum that was feared. Those were good things, and as a result the lending commitment was met, but was met without the full amount being required, either by borrowers or through the complete flight of foreign lenders, so that is in fact what happened.

Chair: Nick wants to come in. We are going to have a vote in two minutes. Do you want to do it before the vote or after?

Q131 Nick Smith: Very quickly: in both of your introductory remarks, Mr Daniels and Mr Hester, you talked about a handsome return for the taxpayers owning RBS and Lloyds' shares. What is your latest estimate on what that handsome return will be?

Eric Daniels: I do not believe that we can call the—

Q132 Nick Smith: I am sorry, I cannot hear you. Can you speak up?

Eric Daniels: I do not believe anyone can call the stock market in what will happen in the future. I think all the signs are very good: Lloyds share price increased quite dramatically last year as we returned the bank to profitability. I would hope that, as we continue to enhance profitability, the share price will continue to rise.

Q133 Chair: So you agree with John Varley that there is nothing—it sounds to me as we draw this bit to a close—for you to apologise for?

Eric Daniels: I beg your pardon?

Q134 Chair: You agree with John Varley, Barclays, that there is nothing to apologise for? It sounds to me, out of all this, that you are feeling fairly confident; you feel there is nothing to apologise for.

Eric Daniels: I am not sure I can draw the connective tissue from one statement to the other, but if you ask me in general, are we remorseful, or is there a cause for concern in what happened during the banking crisis, I would say absolutely yes. We had clearly a lot of shareholders who were dependent upon our dividends. We clearly have not paid a dividend, and that is disappointing.

Q135 Chair: Taxpayer? We are here representing the taxpayer.

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Eric Daniels: Again, as I stated earlier, I believe for the liquidity support that was granted, the CGS and the SLS, the banks paid at or above commercial rates, so the taxpayer did very well. In terms of the GAPS, which I understood was the primary subject of discussion today, in the case of Lloyds, we never formally entered into the programme, yet we paid £2.5 billion to the taxpayer to get out of the agreement, so I think the taxpayer did very well indeed on that.

As for the shareholding, I think I answered that question. I believe that as our share price continues to go up, and the bank continues to become increasingly profitable, the taxpayer will do very well indeed.

Q136 Nick Smith: Mr Hester, can you answer my question please, as we seem to be going through the middle of the banker's fight back here: have you got an estimate on what the taxpayer's "handsome return"—your phrase—will be?

Stephen Hester: Obviously we have put out details of the fees we pay, but in terms of our future share price I am afraid I am actually legally not allowed to forecast it, nor is it prudent for me to do so, so I am afraid I cannot give you a share price for the future. Of course then it is not in our hands, not just what happens to the stock market, but whether, how, when and in what manner the Treasury, through UKFI, decides to dispose of the shares, so I cannot.

Q137 Stella Creasy: Mr Daniels, can we come back to what the taxpayer can expect? When you do expect Lloyds to be paying corporation tax?

Eric Daniels: That would be a profit forecast, which I certainly cannot give you. What I would say is that Lloyds is well on its way to absorbing the accumulated losses, and nothing would please me more than having Lloyds pay corporation taxes.

Q138 Stella Creasy: So when do you expect to be profitable?

Eric Daniels: We are in fact profitable.

Q139 Stella Creasy: And yet you are able to defer that liability for corporation tax.

Eric Daniels: I beg your pardon?

Chair: We are going to go do a vote, and then we will come back and pick it up. I am really sorry that it gets interrupted in this way: it always provides a difficult session. But we will get into it when we come back.

*Sitting suspended for a Division in the House
On resuming—*

Q140 Chair: Apologies for that. We had a couple of votes, which is very disruptive, but that is how the cookie crumbles. I just want to get back to this issue of value to the taxpayer, which is our remit, which is why we are focusing on it. You have both really justified that you believe there has been proper value to taxpayers from the fees paid in the schemes in which you have participated. I hope you have had a chance to look at the Report that formed the basis for our inquiry. Have you had that? I am assuming that that has been distributed to you. We have taken

evidence on that from Treasury officials: Tom Scholar, who presumably you have dealt with a lot. In his evidence and in the Report, if you have a copy of it, both the Report and his evidence state that the fees were well below commercial prices to get the stability and confidence back into the market. Quite proper good objectives, but nevertheless below commercial charges. Let me just see what he said; this was in evidence to us: "If you look at what subsequently happened to the commercial price of providing a similar guarantee, yes it is true, as the Report says, that the commercial price remained higher for longer than people were expecting." So the price that the Government was charging was lower. If you accept that, and I see that Eric Daniels is frowning, but if you accept that, how do you still come forward and say that you think that there is proper value to the taxpayer—that we have been properly rewarded out of the Credit Guarantee Scheme, for example?

Eric Daniels: If I may, Lloyds never entered into GAPS: we simply paid to leave the agreement that we had made in March, so I think the taxpayer got a very good deal.

Q141 Chair: And what about you? You are well into it.

Stephen Hester: Of course. Forgive me, because at different points, I thought we might have been talking about value to the taxpayer from different things: obviously the Bank of England numbers, the price at which shares were subscribed, or the Credit Guarantee Scheme, but as I understand you now, you are talking very specifically about the Asset Protection Scheme.

Q142 Chair: I am now focusing on that.

Stephen Hester: Got you. With respect to the Asset Protection Scheme fees, I think truthfully there was no—and indeed is no—private-sector equivalent insurance policy that was viable at the time that would allow you to say that the fee was high or low against something that was demonstrable. So by definition it is a matter of opinion. Clearly the board of RBS recommended entry into the scheme, and as a matter of legal duty could not have done so if it felt that the scheme in the round, in all of its terms, was wrong for its shareholders—82% of whom are of course, in the circular process, the Government—and so in that sense we did not feel that the fees were inappropriate. But what I would say is that the Asset Protection Scheme, we believed at the time we entered it, and we said so publicly, was unlikely to cost the taxpayer anything. The taxpayer, we thought, would make a profit. At every stage of reforecast, that continues to be our view. I believe it is also the view of those concerned in the Government, and that is entirely appropriate; it was an insurance policy and I think the taxpayer should make a profit out of it. I have no complaints about that, but it continues to be the case, and as I say I think the taxpayer will make a profit out of that scheme, but I cannot tell you that there was a definite market price which the fees were higher than or lower than; there was not. So it was one entered into by both parties at the time.

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Q143 Chair: And the Credit Guarantee Scheme, where, if I just read from the Report—I will try not to read the lot—“the fees charged to banks under the Credit Guarantee Scheme to guarantee new wholesale debts were designed to be on a commercial basis, but not so large as to prevent banks from using it, but sufficient to provide a reasonable return ... However, we estimate the benefit”—I am skipping a bit, so apologies for that—“is substantially more than £1 billion.”

Stephen Hester: If you mean the benefit to the taxpayer, I do not know, but I know the taxpayer has made a big profit on it.

Q144 Chair: I think it was to the banks. That is the benefit to the banks.

Stephen Hester: I know that the taxpayer has not had to pay any money at all under the Credit Guarantee Scheme, and the taxpayer has received hundreds of millions or billions—I do not know the answer, but a lot of money—in return. But again, I think that was entirely appropriate, because the taxpayer was providing a guarantee, and you are correct to say that the guaranteed fee—

Q145 Chair: It provided you with cheaper money.

Stephen Hester:—was calculated in order to represent market prices. But it is also true that that guarantee was not otherwise available from someone else, and so one can have a debate about whether the market prices were theoretical or not.

Q146 Chair: But it allowed you access to wholesale funding at a cheaper rate. Or probably wholesale funding full stop, and then wholesale funding at a cheaper rate.

Stephen Hester: No, the cost of the wholesale funding plus the guarantee cost was calculated such that it was equivalent to the notional cost that you would have otherwise borrowed without that guarantee. However—and as a consequence the taxpayer has made a profit—what I am saying is that we are dealing in notional cost, and in fact that borrowing would not have been available in those amounts, and therefore it is impossible to know the counterfactual of what you would have borrowed at actually as opposed to theoretically.

Q147 Stella Creasy: So you disagree with the Treasury, who acknowledge this subsidy and are reviewing the fees?

Stephen Hester: If we are talking about the Credit Guarantee Scheme—

Stella Creasy: Yes.

Stephen Hester: —I do not know whether I am disagreeing with the Treasury or not.

Q148 Stella Creasy: The Treasury recognise that they have subsidised you to the tune of a billion pounds.

Stephen Hester: I am saying to you that the Treasury has made a profit, and the value of the guarantee was set in a way that was designed to be market priced. However, there was a degree of theory as opposed to practice to that because it was impossible to test, and

indeed it is entirely probable, within the market conditions of the time, the theoretical prices would not have pertained, and so that is what I am saying to you.

Q149 Stella Creasy: So there was a subsidy, then, essentially of a billion pounds? You would accept that it was not value for money for the taxpayers?

Stephen Hester: Did the taxpayer make a profit? Yes. Was it calculated in a theoretically accurate way? Yes.

Q150 Stella Creasy: Did you get a good deal?

Stephen Hester: I think that the banks needed that support. The banking system needed that support.

Q151 Stella Creasy: So it was a good deal for the banks. But from our perspective, in terms of the value for money of the deal that was done, and the acknowledgement of the Treasury that it needs to be reviewed because it essentially represented a billion pound subsidy to the banks—

Stephen Hester: I think just because one side thinks it was the right thing to do does not mean to say it was the wrong thing for the other side. It could be right for both sides, and I would submit to you in this circumstance it has been right for both sides.

Q152 Stella Creasy: So you think it is right for us to subsidise the banks to the tune of a billion pounds in the Credit Guarantee Scheme.

Stephen Hester: I do not recognise that figure; what I am saying to you is I think it is right that the taxpayer has made a substantial profit out of this scheme, because the taxpayer was giving something valuable to the banks. Theoretically that was priced on an arm's length basis. Whether in reality, and by what amount, it was not, I do not know.

Q153 Chair: I have to say that I think you have to take a very narrow view of profit, because the wider impact of the banking crisis can hardly have been a profit. Can I move back to lending, because that was where we were? I just wanted to clear up that point. You both feel that you are lending well now. I have some quarrel with the way the target has been devised. Also, I did not want to intervene too much on you, Mr Hester, but I do have some quarrel to say you did not meet the target set in 2009. Okay, nobody took action against you, but you did not meet it. Recently we have had the Engineering Employers' Federation report, which I assume you have seen and we have too, which accepts that cash is beginning to flow, but what they have said is that about a third of their companies are finding that the costs of borrowing have increased substantially, particularly—and this is the interesting thing—in the last couple of months. The impact will be more on SMEs than it will be on others, the larger FTSE companies, who can raise it through bonds and equities. Again, going back to our remit, the taxpayer's interest, the deal is taxpayer puts money in, and what we hope to get out is better lending to businesses, and particularly the SME sector. What is your comment on the Engineering Employers' Federation finding?

Eric Daniels: I do not really have much to comment on; I disagree with it. The cost of borrowing for SMEs

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has not been this low for many years, and what we are seeing is, in fact, some increase off very low levels, which reflects the higher cost of funding for the banks. As we all know, the markets, over the past year, whether it was last May, last September or more recently in February, got quite jittery when the possibility of contagion from Greece, Spain or Portugal and so on was looming. So the cost of funding for the banks has gone up, and that is reflected in some part—not across the board, but in some part—in new lines and facilities for our customers.

Q154 Chair: Do you want to add anything?

Stephen Hester: The average cost of SME loans that RBS made last year was 3.5%, and, as Eric says, that of course, by historic standards, is extremely low. What is true is that relative to base rate there have been some changes, but if I can draw an analogy perhaps apposite to the moment, it is a bit like petrol prices going up, and the reason petrol prices have gone up is because the cost of buying oil, out of which petrol is made, has gone up. Exactly the same thing has gone on for banks: the costs relative to base rate for banks to get money has gone up, and so consequently that is passed on, even though the absolute rates are historically low.

Mrs McGuire: On this subject, I would quite like to just do a very quick follow-up on what has just been said.

Chris Heaton-Harris: Mine is as well.

Mrs McGuire: Alright then.

Q155 Chris Heaton-Harris: It might even be the same thing. First of all, thank you for coming, because it is not often a group of politicians meets someone less popular than themselves, so it is really kind of you to give us that sort of charitable feel. It is really a question to you, Mr Hester. I imagine most of us around this table have had constituents and companies write to us, small businesses especially, who are having problems securing loans, and in 2009 Peter Ibbetson, who is your Small Business Chairman, said that 93% of SMEs are currently able to roll over overdrafts at RBS at the same or lower rate. I was wondering, if he measured it then, what is that measure now?

Stephen Hester: I do not have the precise percentage. I do not think it has changed a lot, but I am very happy to write to you afterwards to confirm that. But our overdraft price promise, which I think is the primary component of what was put in, remains in place.

Chris Heaton-Harris: I am happy to pass over to Anne.

Q156 Mrs McGuire: I would just like to question the 3.5% average. Obviously Mr Daniels did not give us a figure for Lloyds' average lending to small companies. Frankly, 3.5% lending to small businesses does not chime with what we are hearing out there, and I am wondering whether or not there are other costs that need to be taken into account when small and medium enterprises are trying to access finance. I do not have permission to reveal some of the details here, but certainly the small businesses in my area did

not give the impression—and it has been verified with your bank by me, through questioning the bank—that 3.5% was anything like what they had been asked to pay. Are there fees, or have the fees gone up? Have the securities that have been asked for gone up?

Stephen Hester: Clearly the figure I gave you was an average, so there will be some above and some below. You are correct to say that for some kinds of borrowing, in addition to that there can be fees associated with taking out the loan, or whatever it might be.

Q157 Mrs McGuire: Have those fees increased?

Stephen Hester: And those fees, probably on average, have increased.

Q158 Mrs McGuire: Once, twice? 50%, 100%?

Stephen Hester: I think I can say with great certainty that, even when you take account of fees, the average cost of borrowing for SMEs is amongst the lowest it has been in decades. However, it is higher relative to base rate than it was, for the reasons that I have sketched out. Another way to think about it is, if you like, are the banks profiteering? In other words, are the banks taking, somehow, an inappropriate margin out of the middle between their cost of borrowing and the others?

What I can say, again, is we publish our figures every three months on this, and if we take our Corporate Lending division, our UK division that lends to businesses of all sizes, the return on equity of that division has obviously been loss making through the recession and very low, and so is not a good advertisement for our shareholders, but has now got back to below our target, but roughly to 12%, which we think is roughly our cost of capital. So you can see no evidence either on the bottom line of profiteering, or indeed on the average for businesses. But it is certainly the case that, in the same way that petrol prices have gone up, bank input prices have gone up, and that gets passed on through different means. It has to be.

Q159 Mrs McGuire: So if I say to you that a farmer in my constituency came to me who had previously had an arrangement fee to sustain his overdraft, or to maintain his overdraft, increased from £500, I think, if my memory serves me correctly, to almost £5,000, that would not be considered profiteering? I have to say to you, one of the arguments that is constantly put to Members of Parliament is that as a taxpayer I own 83% of this bank, and people feel that those dramatic increases in arrangement fees are perhaps hiding the true costs of borrowing.

Stephen Hester: As I said, I think our numbers are very transparent, and you could look at them every three months, we publish them as to what our profits are, and what that is in each of our business lines, so you can see the aggregate. Of course, that does not tell you the answer for any particular borrower, but you can see what the average is. And again, using my petrol price analogy, petrol prices have gone up fast and a lot, but that was because oil prices went up fast and a lot, and exactly the same has happened with the cost of borrowing for banks, which in turn is, if you

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like, our goods that we sell to customers in the form of lending.

Q160 Mrs McGuire: But they have not gone up 10 times. An arrangement fee from £500 to £5,000 sounds to me like a tenfold increase.

Stephen Hester: As I said, the total cost of banking services in lending is lower than it has been in decades

Q161 Chair: Mr Daniels, do you want to add to that at all on this exchange?

Eric Daniels: That is a very complete answer.

Q162 Mr Bacon: We have heard different Members from different parts of the country. In my own constituency, which is in East Anglia, in Norfolk, I met with the Federation of Small Business on Monday morning, and the predominant theme that I was told about—it was really for them to talk to me, rather than me give them a speech—was the difficulty in accessing bank lending.

Austin Mitchell: The same here.

Mr Bacon: When I was first elected in 2001 that was not the case. I did not get business people banging on my door about that, nor in 2002, nor in 2003, and so on until the banks between them crashed the whole world in 2007/08. Obviously there have been huge problems since then—we are all trying to get out of the mess, you are all trying to get out of the mess. I do appreciate that you are being told to do things that are contradictory. I think Mr Barclay alluded to this earlier: you are being told to lend more; you are also being told to conserve your capital—your natural instinct, I suppose, is to protect your capital if you are not sure about the quality or the value of your assets—and you are also being told to strengthen your capital and improve your balances sheets, and it is very difficult to do all of these things simultaneously. In fact, some of them are obviously completely contradictory. But nonetheless it is the case that you are saying that there is a lot of lending happening, and we are all getting the message from different parts of the country that it is very difficult for business owners to access the loans that they need.

I had one example of an individual who set up a business three or four years ago. He found it easier to access money then, when he was setting it up, than he does now when it is successful, cash generative, and he wants to invest in equipment because it will help him to get leading edge, blue-chip customers and help him to grow and possibly take on more staff. Why is there this disconnect between these two world views? Mr Daniels, do you want to start perhaps?

Eric Daniels: I think that we have a couple of things to look at. One is: what is the real demand for credit? I know there are a lot of anecdotal stories, and if there is a particular member of your constituency that has an issue with Lloyds, I would very much appreciate it if you would write to, in this case, Mr Tookey, but we would be very anxious to hear about that in Lloyds. But I think if you look at the evidence it says that the actual overdraft usage or line utilisation usage—so in other words, we extend the line of credit and you can draw it down any time you wish to—is actually falling. So this is already pre-agreed, there is a

pre-agreed price for it, the facility is there, but customers are not drawing down; they are drawing down less than they did before. So that says something about demand.

The other thing that I would tell you is that, if we look at the market in 2006/07, which you alluded, to when your constituent was starting up, we had an awful lot of flaky lending in the marketplace. You need look no further than Ireland or Iceland or some of the continental banks that were very much in the SME market in the UK. They were in the mortgage market. It was a lending free-for-all. So covenants came down, conditions were almost non-existent, pricing was ridiculously low: that is not an appropriate way to bank. What was happening was we were seeing an awful lot of competitors—especially not the main competitors—changing conditions and changing the market, and an awful lot of people who probably were not really terribly creditworthy, and if we had been sensible as a society we probably would not have allowed them to get into debt. It was not good for them, it was not good for the economy and it certainly was not good for the banks. But that was the frenzy that we were in. Today we have hopefully all learned lessons. We have returned to some much more traditional practices and rules around prudence.

Q163 Joseph Johnson: A question to Mr Hester and Mr Daniels please. You have both, to a greater or a lesser degree, got the dead hand of the state gripping the entrails of your respective organisations. Mr Hester, you have been quite explicit in recent weeks in identifying a certain amount of talent flight from your organisation. I would be interested to know to what extent you feel that is due to the large Government shareholding in your organisation.

Stephen Hester: This is in some ways a difficult position, because I think we need to be crystal clear that RBS would not be here today were it not for support from the state, and so while some consequences go with that, I think it would be entirely unbalanced to not start with that recognition and say, if there are some consequences, the outcome is worth the consequences. So that would be my first answer.

The second point I think is that all businesses, whether or not they are owned or partly owned by Government or by the state, I think have a duty, and it is good business practice, to try to be sensitive to the environment in which they operate, the communities that they serve, and there are sometimes tradeoffs in doing that, and I would like to think that a number of those issues would be true of us whether or not we had compromises, if you like, and whether or not we had state ownership. But in a sense there is a time for everything, and I think what I would say to you is that the time, I believe, is fast approaching when the benefit to both the state and RBS of the state privatising increases. Clearly the state can use the money in terms of budget deficit, and in terms of the symbolism of economic recovery that a privatisation would represent. In the case of RBS, there is the worry that RBS is somehow subject to different, more conflicting and more complex requirements than all of its competitors. So I think the right answer to this is not to, in a sense, bemoan the past—far from it, we

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have to be grateful for the past—but more to say the right way going forward, the win-win, is to advance privatisation when that is possible.

Q164 Joseph Johnson: Can I put the same question to Mr Daniels, please?

Eric Daniels: I do not believe that we have lost significant numbers of people. We have a natural attrition in Lloyds of somewhere around 10% of our people per year. We are not seeing anything really remarkably different from that.

Q165 Joseph Johnson: Great. The follow-up question to both of you is what top rate of personal income tax do you think is consistent with London maintaining and perhaps enhancing its position as one of the world's important financial centres?

Austin Mitchell: It is an optional question.

Eric Daniels: I would not begin to know how to answer that question.

Q166 Joseph Johnson: You do not have a view?

Eric Daniels: I could not begin to answer it.

Q167 Joseph Johnson: In what sense?

Eric Daniels: I have never studied it; I do not have a basis to offer an opinion. I think it is a complex subject, and if I were to give you an answer, it would superficial at best.

Q168 Mr Bacon: How much truth do you think there is in the point—made by a parliamentary colleague of mine who used to be a swaps trader for many years—that a lot of this bonus culture is nonsense in the sense that lots of people would not leave London because they like London too much. London has too much to offer compared with virtually everywhere else. If you are out in Geneva at eight o'clock in the evening it is dead; there is nothing to do. Whereas in London there is plenty to do, everything to do, and it is one of the world's greatest cities, and that in itself has a centripetal force that is probably more important than bonuses, and the talk that somehow you have to keep up the bonuses at the right level, otherwise everyone will suddenly up sticks and get on a plane, is overstated.

Eric Daniels: Is there a question?

Q169 Mr Bacon: Yes, the question is do you think it is correct that that is overstated?

Eric Daniels: I think that that may not be the right measure. I might ask, "How does change happen?" It rarely happens with the bank: it happens over time and it happens on the margin. What we do know is that a particular bank hired more people in Singapore last year than they did in the UK. If you look at the rise of the Dubai financial centre, again, you are seeing more and more jobs going over there. It is not the middle-aged derivatives trader who has two kids in school and so on: it is the young, up-and-coming 25-, 28-year-old who is looking to build a career, and they see that their prospects are brighter elsewhere.

Q170 Mr Bacon: So you might not see it other than almost imperceptibly, but if you look back on it

several decades later, you might suddenly realise there had been a very big change.

Eric Daniels: Yes.

Q171 Jackie Doyle-Price: I am just reflecting on what you particularly said, Mr Daniels, about the fact that risk had been in the price for many years in the run-up to the banking crisis, and that is what got us into this mess, and looking also at the targets and the caveats you have placed on it in respect of demand and creditworthiness. Where that takes me is, I am reassured from a taxpayer value-for-money point of view that the taxpayer is not just going to be standing in there supporting poor credit risks. But in that sense, to what extent are those targets having any meaning at all? For you, are they targets, are they aspirations, and how confident are you that you will meet those lending targets for businesses particularly?

Eric Daniels: I am absolutely confident I will not since I am no longer in the chair.

Q172 Jackie Doyle-Price: As a sector then, how confident, looking at it—can I then conclude that they are meaningless?

Eric Daniels: I think that question might be better asked of Mr Hester, who has something to do with it.

Stephen Hester: I think that the job of maximising support for customers in the UK is one that, in any event, the banks should be doing the most on because that is their business, and I believe the banks certainly—it is true of RBS—are doing even more than perhaps in any event they would be in response to the obvious needs of society, one manifestation of which is the political dialogue and the lending commitments that are associated with that. We can see that as an example in the context of RBS's market share, but I see that every day in our internal workings.

What, however, is unfortunately the case for those who would like a neater world is that no one can tell you today what amount of borrowing UK business can usefully use in the coming year, and we do not have a centrally planned economy, and even if we did I do not think you could answer that question. It is of course the case that an element of what is being done is to build confidence. I think this is a crucially missing bit of the dialogue: crucial to economic growth—and the UK is in trouble if we do not get economic growth—is confidence. There are lots of bits of confidence: a piece that the banks can help with is the confidence that if people have a good proposition, a bankable proposition, that money is there and people are trying to help them now. Banks have many flaws, there are many individual cases where I am sure they can do better, but I do think that we take it very seriously that it is our job to first give people confidence and second to back that up with substance where it is bankable. What we cannot do is, in a centrally planned way say, "That will definitely be amount of money x or y , and here you can have it regardless of whether you have the right proposition or not."

But this issue of confidence should not be ignored, and I do think that one of the important changes in recent months is that people have realised that looking

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backwards all the time and recriminating all the time and, if you like, looking on the negative side of life, is not going to help us grow. It is very important to learn from the mistakes and put them right, but in the end what we need to be doing is looking forward, trying to get growth and wealth creation, and the banks have an important role to play in the business confidence to start with, and then in the provision of support when the right propositions come along behind that, and that is what we need to do. We are doing it imperfectly; we need to try to continually perfect that.

Q173 Jackie Doyle-Price: And the continued presence of the taxpayer in the banking system is enabling you to do that, let's be frank. One of the things you said is that you are doing more than perhaps you wanted to. What we have seen is—and you have both made this point in different ways—that many businesses have been reducing their credit exposure and turning to other sources of finance. To what extent is the taxpayer being asked to prop up the riskier side of lending?

Stephen Hester: Although you could not often tell it from public debate on the subject, I do not believe, when you sweep aside the debating points, that Government is actually asking the banks to go back and do some more reckless lending. I do believe that most people think that the banks should try to lend responsibly and support their customers in that way. In that sense I think the banks are trying to both lend responsibly—as Eric has pointed out, in some instances that means differently than in the past—whilst at the same time trying within that envelope to support their customers. Certainly when I think of the people on the ground in RBS, and again I am sure there are many individual cases where we get it wrong so I am not in any way trying to say that we are perfect, they know that they have to try and find a way to support the customer. We do not always succeed. 85% of the time, if a small business asks us for a loan, we say yes. Sometimes with us that small business has to jump through more hoops than it might have done in the past: more covenants, more financial disclosure. Because the business may be weaker, it may be suffering with the recession; standards may have changed. One way or another we are trying to keep the same flow of money going as we did before, at least in terms of your likelihood of getting a loan.

Q174 Jackie Doyle-Price: Are you pricing that risk effectively or is the taxpayer supporting that?

Stephen Hester: Of course hindsight is a wonderful thing; the banks thought they were before and they were wrong. Right now the banks are trying to price risk effectively. Whether that is indeed what we will have done will take some years to find out, when you look in the rear-view mirror and find out what actually did happen to the economy and so on and so forth. That is certainly the intent.

Q175 Chair: Mervyn King said rather worryingly in the interview he gave recently in the *Telegraph*, which I assume you also saw, “The search for yield goes on.

Imbalances are beginning to grow again.” You paint this rather rosy picture, but the Governor of the Bank of England appears not to agree.

Stephen Hester: I do not know whether this was what he was meaning, because I was not present when he made the remark—I am always nervous about interpreting from newspaper articles—but I think the point is very important to understand, and I think we do all understand: what happened to the world was as a result of a series of unsustainable economic imbalances, many of which are still out there. The banking system had a big part in that but not a sole part in that. It is incumbent upon the whole world to keep working away at economic imbalances, whether it is, in the UK, our fiscal imbalance, our balance of payments imbalance, the imbalance of household saving versus borrowing, the imbalance that was in banks' balance sheets. There are a whole series of these things which still have not been corrected and will probably take a lot of years to correct. That is why it is so important that all of us work together to do so.

Q176 Chair: Take his comment at face value, which is the only way we can do it; it was in quotation marks so I assume that he did say it. “The search for yield goes on. Imbalances are beginning to grow again”. You would challenge that, would you?

Stephen Hester: I am not going to comment on remarks that I only read about in the newspaper. I think it is wrong to do that. All I can say to you is: the problem of imbalances in the world has not been fixed. To some extent the first steps of the cure made worse imbalances, because the first steps of the cure in some countries were to increase budget deficits and other kinds of imbalance which then subsequently need to be worked down.

Q177 Chair: I do not think he is talking about Government budget deficits, he is talking about banks. If you do not want to answer it, say you do not want to answer it.

Stephen Hester: I am doing my best to answer it.

Q178 Chair: It is pretty clear to me. Mr Daniels, do you want to comment on that?

Eric Daniels: I have nothing further to add.

Chair: What does that mean? Do you think he was right? He is wrong?

Eric Daniels: I did not read the article

Q179 Stella Creasy: Let's turn to something else he also mentioned in the article, which is a very big debate that is happening here in Parliament and something that I think all of us look at when we look at the value for money of the decisions that were made over the last couple of years to invest in the banks. We have not solved the “too big to fail” problem. In fact, let me quote from Mervyn King directly. He said, “We've not yet solved the ‘too big to fail’ or, as I prefer to call it, the ‘too important to fail’ problem. The concept of being too important to fail should have no place in a market economy”. If your banks were to collapse, the Government would have to step in to protect your customers. As we have all talked about,

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many of our constituents are customers of yours and to prevent there being a contagion to other banks is something that we dealt with the first time. Implicitly you are still guaranteed by the taxpayer. What needs to be done to end the “too big to fail” culture? Is it to break you up into smaller banks? If not that, what else can be done?

Eric Daniels: Think about what has happened over the past couple of years in terms of the much stiffer capital requirements; Core Tier 1 did not exist as a concept in 2008, and today all banks run with very high levels of shareholder capital, much higher than there has ever been in the past. In the case of Lloyds, we now carry 10% of Core Tier 1 and 15% overall capital. Those levels were unheard of a few short years ago. In addition to that there has been an enormous amount of work done on liquidity regimes. We all know that banks do not go bankrupt because of capital but rather because of access to liquidity. Again, an enormous amount has been done. The amount of liquidity that any bank holds today is many multiples of what they carried in the past. I think those are two important changes that should not be overlooked.

In addition to that, I think there has been a tremendous amount of re-examination of the system of regulation, of understanding some of the risks that probably were not well understood before. That gives a better safeguard to society in terms of managing those risks. The final thing that I would point out is “too big to fail” is perhaps a misnomer, or perhaps does not aid understanding. What is probably more difficult is when a bank is enormously interconnected and complex. That is what makes a resolution regime very difficult. In the case of Lloyds, for example, we are a very straightforward business. The Bank of England has basically told us that they believe we are in fact straightforward; it is easy for us to be resolved, if you will. I do not think it is a bigness issue, it is a complexity issue.

Q180 Stella Creasy: Just so I am clear Mr Daniels, you dispute the analysis of Mervyn King. Can I also check, then, whether you think there should be any concerns to us as taxpayers about the size of market share that Lloyds now has as a result of the changes over the last couple of years, that, in terms of competition for consumers, the dominance that you play within the mortgage and savings industry is not a problem? You do not see that there is a problem for us as consumers, that you are too big for the British market now.

Eric Daniels: No. I think this is a very, very highly competitive market. It is a good deal less concentrated than many other markets, for example, Canada, Australia, and France. In fact it is less concentrated. I think that every study that I have seen has said that UK consumers get very, very good outcomes in terms of pricing. What really matters is not the size or concentration, it is the contestability. What you see in the UK is a lot of discounting. You see a lot of free offers, a lot of interest free periods and so on. That is because it is such a fiercely competitive market. A zero balance transfer on a credit card is a relatively common thing because the banks fight each other for

market share. That leads to very good, top quartile consumer outcomes. I do not believe that the size of Lloyds or any other UK bank impedes competition. Indeed, the OFT is charged with looking and examining whether they think the consumers are getting a worse outcome because of the size or structure of the industry.

Q181 Stella Creasy: So the Governor of the Bank of England is wrong and a 30% market share is not a problem. Mr Hester, what is your view about what the Governor of the Bank of England said?

Stephen Hester: Again, I am not going to be tempted by your invitation into a slanging match with anyone as distinguished as the Governor of the Bank of England.

Q182 Stella Creasy: I am not tempting you to a slanging match at all; I am asking your opinion. Are the British banks too big to fail?

Stephen Hester: What I would say to you is as follows. Of course, coming in to RBS as I did at its point of near failure, it was of intense professional interest to me as to what caused failure; what to do about it; using RBS as a specific example, how to make banks safe again, in addition to what parallels there were in the rest of the banking industry. It was something I have spent a great deal of time on and thought on. RBS is, I hope, an exemplar of the things we needed to put right. I believe that I have been very clear that very substantial reform was needed in the banking system.

What I have also been clear about, though, is my belief that size and shape are complete red herrings in this debate. When you look at the banks that were weakened and failed, or nearly failed, there is no pattern of size and there is no pattern of shape. In fact, the majority by far were small and simple: Bradford & Bingley, Dunfermline Building Society, Northern Rock. Think of, today, banks that are relatively weak: the Spanish Caixa and so on. Regardless of size and shape, it has been my view that the banking industry needed very substantial reform that would apply whether you are big or small, simple or complicated. As I said earlier on, but just simply to reprise it for you, the two components of that were to make each bank safer with more capital and more liquidity—Eric has spoken about that—then to put in place mechanisms that, even if despite that extra safety there was failure, you did not go to the Government for capital support, but you went through Co-Cos, bailouts, your own creditors in a resolution regime. I believe that when the current banking reform process has been completed and the international Basel Committee, on which the UK is well represented, is mid-stream, that we will indeed have achieved those goals and made banking safer for society as we should have done. That would be true whether you are a big bank or a small bank, a simple one or a complicated one.

Q183 Stephen Barclay: Firstly can I say, I agree with Mr Hester’s comment that it is important that we learn from the mistakes and look forward. Could I just pick upon something that a senior executive at

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Lehman Brothers said to the Fed, or was quoted as saying. He said, "We do not know what the value of our derivatives liabilities are, and frankly neither do you". Just starting with Mr Daniels, what has changed in the way you managed your derivatives liabilities? Was it right to present those in terms of a net position and is that still the case in your approach; I am talking about how you manage your counterparty risk?

Eric Daniels: I am not quite sure I grasped the question. You are asking "Have we changed the way in which we manage derivatives?"

Q184 Stephen Barclay: What I am asking is: you as a senior executive have to understand what is on your balance sheets, the assets, what we as taxpayers have invested in and the risk that is posed to them. A lot of companies, in term of their derivatives trading, were presenting that in terms of net—you understand these issues very well—for example, in terms of the position between your trades with Barclays. There is a counterparty risk if Barclays goes down and there is a difficulty in terms of how that is quantified, how that is then studied. PRIN 3 and PRIN 4 and SYSC have certain requirements in terms of how you manage your liabilities there. What I am saying is there are clearly faults in the way it was happening two or three years ago. What has changed in your approach?

Eric Daniels: I think one of the things that I should clarify before answering is that Lloyds is a commercial and a retail bank. While we will use derivatives, for example, in investment banking products, we use them only really for flow. In other words, if a manufacturer in the Midlands wants to hedge their interest rate—in other words they have a floating rate loan, and they want to lock in the rate of interest—we will sell them a derivative. Once we sell to them we have an open position. We lay that off within an investment bank. So for a very short period, what we will do is in fact have a derivatives exposure. But really the use of derivatives for us is mostly flow to serve customers. We do not use it as a trading position, a proprietary position. Do we in fact have some exposure to it? Yes, of course we do. What we do is we manage our limits very carefully, as we always have.

Q185 Stephen Barclay: If you had been here three years ago you would have said you manage your limits. That was not my question. My question was, have you changed your approach? Do you still present that from a net position, or have you changed your approach in term of counterparty risk?

Eric Daniels: Tim, I don't know whether you have anything to add.

Tim Tookey: We report this information gross. As Eric said, we manage it very tightly and we know what our positions are and how they are valued on a daily basis. On top of that we very carefully analyse the counterparty risk that you are referring to on the asset side of all exposures, whether that is the company in the Midlands that Eric was using in his example, or indeed the third party to whom the risk would have been laid off.

Q186 Stephen Barclay: Perhaps you can help. I am a generalist; I am not an expert as you are in these matters. I just had a scan this morning of your preliminary report from a couple of weeks ago, and on page 125 it says, "The Group reduces exposure to credit risk by using master netting agreements ... These do not meet the criteria under IAS 32", whatever that is. What that suggested to me was that you are presenting these in a way that does not meet international accounting standards. As I say I am not an expert, but why are you not presenting them in a way that meets international standards? Are you presenting them in the same way you would have done three years ago?

Tim Tookey: I am very happy to confirm that we do present all of our financial information in accordance with international financial reporting standards. That is the basis upon which our accounts have been done since IFRS were introduced in 2005. Our auditors report publically on the basis of preparation of the accounts, and that is indeed what they have given us.

Stephen Barclay: Sure, you go through the various legal checks before one signs those off.

Tim Tookey: It is more than that. It is actually a certificate from the external auditors who obviously owe a duty of care to shareholders to ensure that we do indeed comply with international accounting standards.

Q187 Stephen Barclay: You bring me very nicely onto the auditors; I was going to come on Mr Hester's auditors in a moment, but it is timely. After 10 months of intensive work by the Treasury, the Accounting Officer of the Treasury had to seek a letter of direction because—it was before your time I accept—they were unable to confirm the validity of what your firm was saying in terms of the assets of the company. What does that say about the quality of the external audit work that was done?

Stephen Hester: I think that the first thing I would say is that there were lots of things RBS did not do well. Our job is to improve on those things. One of the things that it did not do that well was to have perfect books and records, computer systems and so on and so forth. There are countless amounts of millions of pounds and man hours and management effort going in to improve that alongside the many other things that we are trying to improve. That would be the first point that I would make to you.

The second point that I would make to you, in relation to the specifics that you are referring to—to which my first point also refers—is that the Asset Protection Scheme I think covered something like 3.5 million individual loans in RBS. No bank in the world, RBS or any other, ever had designed its systems to aggregate information in the particular way that was called upon by the Asset Protection Scheme and the different safeguards that a Government agency was used to getting. If I can give you a parallel, it would be a little bit like someone suddenly coming along the top of the UK Government saying, "We want to get every patient record from the NHS, every record from Work and Pensions and bring them together".

Therefore there were imperfections in the systems but, simply, systems were not designed to gather

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information in that particular way. I believe that even though I think RBS needed to improve and has been improving, not for this reason but in general, it remains substantively the case that there have been no instances that threaten the taxpayer as it relates to APS. There is no prospect that the taxpayer is going to be on the hook for anything under this category or otherwise in APS, as we do not expect to claim. So I think as it relates to materiality, the Treasury were quite right to sign off and nothing has come out since that suggested that that was a misjudgment.

Q188 Stephen Barclay: That is a different issue you are moving onto. First of all, Mr Tookey's whole argument a moment ago was this was looked at by the external auditors. What that case demonstrates is a serious failure by the external auditor in all of this.

Stephen Hester: It is not necessarily my job to defend the auditors and you should obviously invite them to testify if you would like to. What I would say to you is the auditors were never called upon to audit data in the format and the fields that were—

Stephen Barclay: I'm sorry—

Stephen Hester: Do you want me to finish or not?

Q189 Stephen Barclay: You are suggesting it was perhaps the unreasonable request of the Treasury asking for information in a particular form that was different. Look at what Tom Scholar said when he gave evidence: "Given what we discovered about the quality of risk management and the poor systems and controls within the business, we were concerned that there might be other problems that had not come to light." He was not suggesting we were asking for information in a particularly unique format. The point is there was a regulatory duty under SYSC for you to manage your controls. You had external auditors who also were under a duty. Yet after 10 months of intensive work by the Treasury they could not rely on it. What I am trying to drive at in my question to Mr Daniels in terms of how they present their information on derivatives is, what has actually changed? What has changed in the way these are being done and in the way that these risks are being presented?

Mrs McGuire: For example, do you still have 21 different IT systems, which was one of the issues raised by the Treasury?

Stephen Hester: We still have lots of different IT systems. It will take many years for us to reduce them, and the work is ongoing to do so. If I may, I am not saying that RBS's systems were up to scratch; I said to the contrary. What I am saying, though, is that the shortcomings that were pointed out were not of a magnitude to have led to losses to the taxpayer. Since I have come into RBS I have tried to understand whether there were things hidden in cupboards that were unknown that represented big risks and loss. Perhaps sadly, what I can say to you is that from the inside of RBS, what I discovered was really just a Technicolor version of what one could have seen from the outside. Indeed, though there were many of them, the specific shortcomings in the systems area have not led to material losses for either the taxpayer or our shareholders. The material losses, and they have been

huge, came from big things, big misjudgments, big areas of concentration that were on display.

Coming to your point on derivatives, I think the management of derivatives has substantially changed and continues to change across the industry but certainly in RBS. By the way, the overwhelming majority of losses that RBS will have suffered across the cycle—and it is true of other banks—comes from bog standard lending, not from derivatives. Derivatives was a tiny fraction of where the losses arose.

Q190 Stephen Barclay: The report suggests a £1 million deterioration in three months on junk bonds.

Stephen Hester: Junk bonds are not derivatives; they are loans, they are bonds. There has been a huge amount of work on derivatives to improve the ability, which was a problem in Lehman, to offset liabilities in a legal way if you like, netting agreements. There is a huge amount of ongoing reform to clear derivatives and trade them across exchanges and through central counterparty clearing. Then there has been a huge amount of work done by all banks, certainly by RBS, to refine valuation to make more conservative reserving and to improve the risk management overall. I can certainly say to you that there has been a great deal of work. It is ongoing. It is certainly true of RBS, and it is true of the industry as it relates to management of derivatives.

Q191 Austin Mitchell: I want to move on to bonuses, which are effectively part paid by the taxpayer. I see that RBS paid out £28 million in bonuses to nine executives. We are told that this was done after exhaustive consultation with our shareholders, one of which is me. How was I consulted? How was the public consulted? How was the Government consulted on this?

Stephen Hester: There are two forms in which that took place. Every year the remuneration policy and the remuneration decisions are up for vote and all the shareholders can vote as they chose on the remuneration report. Secondly, the objectives that are set both in the remuneration report and the objectives that are set for me have been reviewed each year by UKFI on your behalf. Thirdly, prior to the payment of bonuses at RBS, the Chairwoman of our remuneration committee conducted an extensive shareholder consultation, including UKFI and our major institutional shareholders, with a big fat presentation pack going through all the aspects of bonus policy and taking into account that feedback. That is the format in which the consultation has taken place. I think it is more extensive than was the case before.

Q192 Austin Mitchell: It was given effectively by UK Financial Investments.

Stephen Hester: I cannot speak for them as to what processes they go through to decide their vote, but obviously they are the holder of the shares in RBS and Lloyds. I think they undertake that task with great thoroughness.

Q193 Austin Mitchell: Just in passing, I see from *Private Eye*, which is an infallible source on banking

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matters, that the head of UK Financial Investments is Mr Robin Budenberg who was a great giver of bonuses at UBS. He had his bonuses at UBS channelled through Jersey so he did not pay tax. Did you do that?

Stephen Hester: No.

Q194 Austin Mitchell: But the bank has lots of subsidiaries in tax havens like Jersey.

Stephen Hester: I think we have subsidiaries in all sorts of countries with high and low tax rates. I do not believe that RBS has been particularly up in lights as in some way dodging on tax, au contraire

Q195 Austin Mitchell: The taxpayer now owns lots of banks in tax havens doesn't it?

Stephen Hester: I think the population of the Isle of Man, where we happen to be one of the larger banks, would feel a little bit resentful if you were characterising them as all there because it is a tax haven. There are real economies in places that have got low tax rates, as well as high tax rates.

Q196 Austin Mitchell: So these are just for tax avoidance purposes then.

Stephen Hester: Do people live in the Isle of Man for tax avoidance purposes? You must draw your own opinion.

Q197 Austin Mitchell: Profits made in this country, channelled through the Isle of Man, are done for tax avoidance purposes.

Stephen Hester: As I was saying, I do not believe that RBS has been the subject of particular criticism as it relates to its aggressiveness on taxation. If you can show me contrary evidence, obviously I would be very pleased to look at it. We have signed up to the tax code and I think our affairs are completely in order.

Q198 Austin Mitchell: Let me ask you about your bonus of £7.7 million, which is well beyond the dreams of your average PPE graduate when he leaves Oxford. Is it that you had produced some outstanding enormous profit for the bank or was it just that you are a greedy banker? What have you done for the £7.7 million?

Stephen Hester: I think this is a subject that is perhaps inappropriate for me to go on about for long, because I do not set my own pay. That is set by my Board of Directors and in turn voted on by shareholders, including UKFI. As you well know it is at the low end of comparable jobs in the UK and globally, albeit at the high end of society if you want to put it in those terms. One can have a philosophical discussion about pay differential.

Q199 Austin Mitchell: The taxpayers wants to know why we are paying, we are contributing, to giving you £7.7 million.

Stephen Hester: Your job as a politician is to have that philosophical discussion. What I am charged with doing is to try to run a large bank, on which many customers depend, in which the taxpayer has a great deal of financial exposure, to the best of my own and my colleagues' abilities. It is in the hands of others

how they want to pay me for that. It is in my hands whether I want to do the job for that. I think by the standards of each profession, which is in the end how these things are measured, the governance process is gone through in a very thorough way. As I say, I am not going for a second to engage you in the philosophical discussion about pay levels in society. Fortunately that is not what I am charged with doing. I have to protect your investment.

Q200 Stella Creasy: You do not have to accept bonuses though do you?

Stephen Hester: No, you do not have to accept your salary either.

Q201 Stella Creasy: A bonus is a different thing. Mr Daniels, have you accepted your bonus?

Eric Daniels: No I did not.

Q202 Austin Mitchell: That is a feeble comeback: that we do not have to accept our salary. £7.7 million is huge and the taxpayer is contributing to it, effectively.

Stephen Hester: No one is forced to employ me.

Q203 Austin Mitchell: Do you see these bonuses as an incentive to take risks at different levels in the banking industry? The bigger the risk you take, the bigger the bonus you collect.

Stephen Hester: I think that it is extremely important that the incentives that go in any industry, but in this case in the bank industry, have been reformed. There has been very comprehensive reform. In fact, RBS has been amongst the leaders in doing that both in terms of alignment of incentives and their measurement, and the ability to claw them back if the incentives retrospectively are seen to go wrong. The UK today has, in those regards, the toughest regime in the world. I think RBS is at the forefront of that process. I do believe the issue of risk and misalignment of incentive has been very comprehensively addressed. What is clear is that there are parts of the banking industry which remain highly paid, and of course it is clear that that is a matter of controversy depending on where you look. Fortunately, that is not what I am charged with. What I am charged with is trying to run this bank as well as I can by the standards of its environment.

Chair: I am going to stop that conversation because it can go on. I think others will have probably said it to you Mr Hester and to you Mr Daniels, but it is just very difficult in the situation. We come in, again defending the taxpayer. Our interest is not as the Treasury Select Committee. We are just here saying: did we get value for money from the money that was put in? I think, in the same way as we as MPs have had to understand the impact out there of some abuses of the allowance system by some Members of Parliament, you have to understand that the people are suffering from a credit crunch, which they feel you in large part caused; to then see large bonuses is a bridge too far. I think a sensitivity to that in whether or not you accept your bonuses is all we ask for; especially when we are in a position where the taxpayer continues at this point to prop you up, hopefully not

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for too long, but we do. I think it would just be nice to get a feel from some of the people that have benefitted from the bonus system that they understand that and respond to it, in the same way that we have had to respond as MPs to criticism of us. I think it is a very simple issue.

Q204 Ian Swales: I would think it is very likely we will be voting down our own £1,000 pay rise on Monday as MPs. I do not know what people are doing around the table, but that is the discussion we will be having on Monday. My real question is, hopefully you have given us a lot of comfort in a way that things are secure and we are never going back to the days of two years ago. If we did, I think there is an element of saying: to what extent the UK taxpayer stood behind international operations of banks, to what extent that was justifiable and whether that should happen in the future. One of our colleagues who is not here was talking about breaking up the banks geographically which I think is clearly not the type of thing we should be asking industry to do. But the UK taxpayer, explicitly or implicitly, aids the banks, stands behind risk, possibly less so now and hopefully even less in the future. Should we get into that situation again, to what extent should the UK taxpayer be backing a huge international bank?

Stephen Hester: I think that firstly, hopefully the UK taxpayer will make a profit not a loss from its support; in the event, it looks like that is going to happen. Secondly, I think one of the very positive things that came out of the negative of the world financial crisis is that the world did not turn in on itself and that protectionism in all its forms did not take over. The world realised that the future still lies in a small world where we trade with each other and where we exchange all sorts of goods, services, cultures and so on. That is particularly true in Britain because we are one of the world's most open economies with the most to lose, of any economy, from a world that turned on itself, became completely nationalistic and pulled up the drawbridges. I would say to you, in my own view, with financial services, which is a huge part of the UK economy anyway, as with the whole of the UK economy, that it behoves us to encourage a global system in which all of us play a role. I think that was what happened in the aftermath of the financial crisis on all levels and it was the right thing to do.

Q205 Ian Swales: If we had got it wrong and one of these large banks had actually crashed and burnt somehow after the taxpayer had stood behind it or rescued it—UK taxpayer money went in the direction of the Icelandic banks in effect for UK depositors. I know we have got corporate bails and so on, about foreign subsidiaries and we know some of the severe losses of some of your competitors over the Atlantic. I understand your point about global competition and the importance of financial services to the UK. But as the Chair keeps saying, we are here for the taxpayer. To what extent should their money be used for activities that take place overseas?

Stephen Hester: The taxpayer should not. The whole point of the reform of the banking system is to make sure the taxpayer here, or in any other country, does

not. I am a fierce advocate of the reforms that are in process, not complete, to do that. To my mind, the right answer is to ensure that the global financial system is reformed such that this is not an issue. The wrong answer is for countries to draw up their own drawbridges and isolate themselves from the world, whether in financial services or any other form of global trade.

Q206 Ian Swales: That is one test we should be applying to the new banking world, that is the sort of area we have just been talking about then.

Stephen Hester: Absolutely.

Q207 Chris Heaton-Harris: In a way I look at you and I see a bit of John Galt from *Atlas Shrugged*, except John Galt was never really supported by the taxpayer. Can you see the point in time when RBS is a huge success again in the future? Is it within grasp even though it may take a number of years? Secondly, and just going back to a previous question, you said that there was a risk of misalignment of incentive within the system. Do you think it is right that the shareholder dividends were cut by up to 90% but staff payouts have been barely changed?

Stephen Hester: Clearly we are putting in every effort that we can to make RBS a success again. We have set out a plan which we believe will do that. Two years into what I thought was roughly a five year process we are on or ahead of that plan by its different matrices. I believe that so far we have reason to be encouraged. That success needs to be measured in simple terms across three dimensions. As I see it, we have three simple roles although there is a great deal of complexity beneath them. Part of it is to make the bank safe for all constituencies; part of it is to continue to serve our 40 million customers; and part of it is to get some of the shareholder value back which of course is substantially about taxpayer value. Across those three matrices I think that we have made good progress in two years, but we have a few more years of hard work to go before we can say that the job is done, if you can ever say that the job is done. Nevertheless, I think so far so good is the right way to answer that question.

Q208 Chris Heaton-Harris: What about the shareholder dividends cut by 90% but staff payments remaining roughly the same?

Stephen Hester: We are not allowed to pay a dividend, even if we wanted to, by the European Union. That is a choice that is currently outside our control. Obviously we will review it once that has been lifted in the context of whether it is prudent to do so or not.

Q209 Nick Smith: You mentioned Project Merlin and your commitments there. Mr Hester, you have already talked about committing to HMRC's new code of practice on taxation, not just complying with the letter but also the spirit of the law. Are you confident that all your highly paid directors are not getting paid overseas to avoid paying their tax to us?

Stephen Hester: I believe that to be the case, yes.

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Q210 Nick Smith: Is that the same for Lloyds?

Eric Daniels: Yes.

Q211 Stephen Barclay: Just on remuneration, again I think we are asking you to face both ways. We want you to retain your talent, we want you to return the company to profit and get the share price up so that we get our money back at the same time as we are asking you not to pay staff too much. There is an obvious inherent tension there. Can I just ask quickly, in terms of derivatives, does either bank sell derivatives to retail customers?

Eric Daniels: Not that I know of.

Stephen Hester: Not in a direct sense, although in an indirect sense I could give you an example.

Q212 Stephen Barclay: Perhaps you could write a note on it to clarify.

Stephen Hester: 25% of all farmers in the UK take out derivative products to hedge their farm payments in foreign exchange terms against Europe. A number of people take out investment products where returns are linked to the stock market, but have a protection if the stock market goes down.

Q213 Stephen Barclay: I was thinking of things like complex interest rate swaps, and whether retail customers understand interest rate swaps if you are selling those to retail customers.

Stephen Hester: I am happy to write to you about the answer that I have given.

Q214 Mrs McGuire: Over the last two years there has been a great deal of public and private anguish in relation to the banks both at a personal level and at a corporate level. The taxpayer has invested an enormous amount of money. Dare I say it, some politicians have invested a great deal of their own credibility in looking to how we can support the banks through this. Yet when I look at the wider market, I still see share prices for both Lloyds and RBS at a level way below what one would expect for banks that are appearing to be successful. Why has the market not responded in a more generous way to some of the efforts that you have made over the last two years and some of the massive investment, and indeed insurance policy, that the British taxpayer has given you?

Stephen Hester: I will have a little crack with RBS. I am afraid it is a glass half full/glass half empty answer. When we announced the situation that we faced after the financial crisis in January 2009, or in the middle of the financial crisis, our share price went to 9 pence per share. After the end of the first year, i.e. at the end of 2009, in round numbers it had gone to 30 pence, so it had tripled. At the end of this last year it had gone to about 40 pence, so it had gone up about another third. On the one hand I think the stock market has indeed measured progress back from the brink. On the other hand it is true that there are many issues still ahead of us. Going back to the answer that I gave earlier, RBS still has more risks in places than it should have. We are still an unfinished work of progress, and so I think the stock market is recognising that—which is specifically about RBS—as well as generally worrying about things that impact

all banks like things happening in the Middle East, the eurozone, the path of the economy and the uncertainties over regulation. There is a combination of industry-wide things that are a restraint on share prices and RBS specific things, which is why, while we have made very good progress from a starting point, we are still very much a work in progress.

Q215 Mrs McGuire: Do you have a comment about Lloyds' position given again the taxpayers' investment?

Eric Daniels: I thought that was a very complete answer.

Q216 Chair: One final question Mr Daniels. You retired a couple of weeks back and I would just be interested in any observations that you have got, from that position, to leave with us from your experience of living through the banking crisis that would benefit the taxpayer over time. This is the final thing.

Eric Daniels: I think so much has been written I am not sure I could really add to the body of knowledge. I think it was Stephen that said before that we saw huge global imbalances, whether it was in the US where we saw a huge increase in money supply, whether it was the lowering of credit standards and covenants in virtually every country. I think that the world wanted to see continued growth and we were willing to take more risk, consciously or unconsciously, to continue that growth. What happens of course is when you have those kind of imbalances you create asset bubbles. Throughout history you see asset bubbles, and when the bubbles burst it is very painful indeed.

Hopefully we will learn from that. We will have seen much different capital levels, much different liquidity levels with the Basel reforms. I think what is also terribly important is that we recognise that if we continue to run the macroeconomic imbalances we will inevitably have bubbles and we will inevitably have another crisis. It may not be a banking crisis. We saw property prices boom in the US in the early 1990s and then we saw the LBO, leveraged buyout, crises and so on. Booms can manifest themselves across a variety of assets; the dotcom boom would be another example. What we have to do is be very careful in terms of our macroeconomic policy, and we have to address the issues with very specific changes in regulations, which I think is well under way.

I do not think I can add too terribly much further than that. I am very hopeful that as a society we can have a very thorough debate about the role that banks play, we can have a very thorough examination of the causes for the banking crisis. Then at some point I think we need to move on and try and advance the economy, and try and advance society. I think that we do need to examine carefully what has happened over the past years, but at some point we should turn our attention to growing again and making this a more prosperous country.

Q217 Austin Mitchell: Do you regret that you were bullied into taking over the Halifax and the extra strain that that imposed on the bank?

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Eric Daniels: I understand there is a wide range of opinion about it. I have always been steadfast in maintaining that I think this will be a very good deal for our shareholders. There has undoubtedly been short-term pain, but I believe if we look at the results of the past year, if we look at how quickly our impairments are coming down, and how quickly the Lloyds Banking Group has returned to health, this will be a very good deal for shareholders.

Chair: Thank you very much indeed. Thank you to both of you, and I am sorry that we kept you waiting in the middle with our voting. Thank you.

Written evidence from H M Treasury

PAC HEARINGS ON 2 AND 8 FEBRUARY 2011

At the PAC hearings on the “Asset Protection Scheme (APS)” and “Maintaining Financial Stability of UK Banks” on 2 and 8 February respectively, I committed to provide you with further information on:

- HM Treasury’s engagement with the audit profession since the financial crisis;
- the application of section 122 of the Lisbon Treaty and the UK’s financial obligations to the Eurozone;
- information on how many taxpayers in the 50% tax rate work in financial services; and
- any enforcement action taken by the authorities against Royal Bank of Scotland (RBS) employee.

AUDIT

Turning first to engagement with the auditing profession; whilst the banking crisis was not primarily a matter of a particular audit that went wrong, as the Treasury Select Committee concluded, it did bring to light deficiencies in the audit framework.

Alongside the Department for Business, Innovation and Skills (BIS), who take the lead in Government on the implementation of standards relating to accountancy and audit, the Treasury has been working closely with the Bank of England, the Financial Reporting Council (FRC) and the Financial Services Authority (FSA) to improve the audit framework. The particular focus has been on:

- better reporting by audit committees;
- more disclosures around the “going concern” judgement;
- investigating the scope for assurance on narrative reporting;
- enhancing auditor scepticism; and
- improved processes and standards for supervisor and auditor dialogue.

Some examples of ongoing work in this area may be helpful. They include:

- FRC-led work on encouraging sufficient professional scepticism into auditors’ work. The FRC’s Audit Inspection Unit, in their 2009–10 Annual Report led to the UK Auditing Practices Board publishing a Discussion Paper in August 2010: “Auditor scepticism: raising the bar”,ⁱⁱ
- the Bank of England and the FSA have been working together to introduce changes to the British Bankers Association Code. Credit institutions will meet regularly with the FSA to discuss relevant disclosure points and related matters for each reporting methodology. There is also a proposal for greater disclosure of changes in accounting methodology, and, for some financial instruments, greater disclosure around: accounting judgements relating to market conditions; complex fair values and complex products; and risks arising from off balance sheet arrangements; and
- work to follow up the ongoing House of Lords Economic Affairs Committee’s inquiry into audit, to promote dialogue between auditors and prudential supervisors, which was provided for in the 19B7 Banking Act, but weakened in the Financial Services and Markets Act 2000. BIS and Treasury officials have been working with the FSA and FRC on this, and feedback on their joint consultation “*Enhancing the auditor’s contribution to prudential regulation*”,ⁱⁱⁱ is expected soon.

The Treasury, along with BIS, has also been working with the European institutions and internationally. For example:

- in the UK’s response to the European Commission’s Green Paper on Corporate Governance in Financial Institutions, we highlighted the potential benefit of measures to improve the frequency and quality of reporting by auditors, and of the need for greater contact between external auditors and national supervisory authorities;
- the UK’s response to the European Commission’s Green Paper on Audit sets out the Government’s view that audit has an important role to play within the broader corporate governance and regulation regime, and highlights the importance of delivering improvements through: enhancing audit quality through improving auditor scepticism; enhancing the content of the report of the audit committee in relation to listed companies; and through exposing the expectation gap in audit; and

- support for the work of the International Accounting Standards Board (IASB), which has taken significant steps to improve financial instrument accounting, through a portmanteau standard known as IFRS 9—Financial Instruments. The first phase of these changes was published in November 2009 and addresses the appropriate accounting treatment for, for example, off balance sheet transactions.

ASSISTANCE UNDER THE LISBON TREATY

At the Maintaining Financial Stability hearing, the Committee raised some questions about the UK's financial obligations towards the Eurozone, and whether and how Article 122 of the Lisbon Treaty applies to this.

The European Financial Stabilisation Mechanism (EFSM) was established by EcoFin Council on 9 May 2010. EcoFin Council agreed that up to €60 billion would be available from the EFSM. The EFSM had been established under Article 122(2) of the Lisbon Treaty, which foresees the possibility of granting Union financial assistance to a Member State in difficulties or seriously threatened with "severe difficulties [...] or exceptional occurrences beyond its control", EcoFin Council decided, given the circumstances at that time, that these criteria now applied.

The EFSM is financed by the European Commission raising funds on capital markets, guaranteed by the EU Budget. There is no direct impact on the EU Budget from any such borrowing by the Commission. Only in the unlikely event that a beneficiary Member State defaults on loan repayments the EU Budget would be affected.

In those circumstances, Member States would be liable for a share based on their contribution to the EU Budget at that time. Contributions to the EU Budget vary over time, mainly driven by the Member States' share in national income. As an illustrative example, based on contributions to the 2010 EU Budget the UK's share is approximately 14%. Therefore the contingent liability to the UK from the EFSM loan to Ireland would be around 0.15 billion.

The December European Council agreed that a permanent mechanism to safeguard the financial stability of the euro area as a whole (European Stability Mechanism (ESM)) will be established by "the Member States of the euro area" from 2013. The UK will not be part of the ESM, which will replace both the EFSM and the EFSF.

The December European Council also agreed that "*as [the ESM] is designed to safeguard the financial stability of the euro area as a whole [...], Article 122(2) TFEU will no longer be needed for such purposes*".

50% RATE TAXPAYERS

Turning next to the Committee's questions on the proportion of taxpayers within the 50% tax rate band who work in financial services firms; there are estimated to be 275,000 taxpayers in this band in 2010–11, and of these, around 63,000 are classified as working in the financial intermediation sector. The definition of financial intermediation used here includes those working in banks, insurance and pension funding (excluding compulsory social security contributions), and in activities auxiliary to the financial intermediation sector.^{iv}

FSA ENFORCEMENT

Finally, at the Asset Protection Scheme hearing, the Committee asked about any enforcement action taken against individuals in RBS as a result of the bank's failure.

The FSA carried out an enforcement investigation into Johnny Cameron, former Executive Director of RBS and former Chairman of Global Markets. The FSA did not find any incidences of regulatory breaches against Cameron and he did not make any admissions. However, on the basis of information available, the FSA believes that Cameron would not meet its current standards for approval for a "significant influence function". Following the investigation, Cameron agreed that he would not:

- perform any significant influence function in relation to any regulated activity; or
- undertake any further full time employment in the financial services industry.

More broadly, the Government has welcomed the proposal by the FSA to produce a publishable report on the events that led to the failure of RBS.

The FSA is aiming to deliver a publishable report to the Government and the Treasury Select Committee by the end of March.

In order to publish such a report, the FSA considers that it would need permission from RBS and perhaps other individuals, to use confidential information provided by them in the course of the supervisory investigations now concluded, as well as those to whom the information relates. The FSA is conducting the discussions with RBS and, where necessary, other individuals, to secure the necessary permissions.

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- ⁱ Audit Inspection Unit Annual Report 2009–10 (21 July 2010) Financial Reporting Council <http://www.frc.org.uk/pob/audit/reports.cfm>
- ⁱⁱ Auditing Practices Board: Auditor Scepticism: raising the bar (August 2010) financial Reporting Council <http://www.frc.org.uk/apb/publications/pub2343.html>
- ⁱⁱⁱ FSA DP10/3: Enhancing the auditor's contribution to prudential regulation (June 2010) http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf
- ^{iv} This is based on information from the 2007–08 Survey of personal incomes (SPI), uprated to 2010–11 using economic determinants from the office for budget Responsibilities autumn forecast. Information on Industry classifications is based on 2007–08 (SPI) data, and projections take no account of sectoral variations in trends

Supplementary evidence from HM Treasury

At a hearing of the Committee on 2 February Sir Nicholas Macpherson and Tom Scholar provided evidence on the Asset Protection Scheme. In response to a question by the Chair, Tom Scholar stated that the Asset Protection Agency (APA) was about to report an updated loss estimate for the Scheme. The APA did this in its interim report for the period 1 July 2010, which was published on 15 February.

The report gives an expected loss outcome as of the 31 December 2010 of £51 billion. This is down from £57 billion reported in the APA Annual Report and Accounts 2009–10. The first loss in the Scheme is set at £60 billion, meaning that all losses on the assets covered by the Scheme up to this level are borne by RBS. The lower expected loss outcome means that the likelihood of RBS being able to make a claim under the Scheme has receded. It also means that the APA is no longer projecting any temporary pay-out under the scheme (the previous projection was for a small temporary pay-out between Q4 2012 and Q1 2015, to be repaid later out of subsequent recoveries).

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