House of Commons

Committee of Public Accounts

# Maintaining financial stability of UK banks: update on the support schemes

## Thirty-second Report of Session 2010–12

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

*Ordered by the House of Commons to be printed Monday 4 April 2011*

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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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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).

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# Summary

In 2007, following a period of instability in the financial markets, the Treasury intervened to protect depositors and stop instability spreading. This included nationalisation and lending to troubled institutions and to the Financial Services Compensation Scheme, the purchase of a large number of shares in RBS and Lloyds, establishing sector-wide schemes to guarantee banks' debt-funding and protect their assets, and indemnifying the Bank of England against losses for providing temporary liquidity.

This was justified at the time to protect taxpayers, but the peak of the financial crisis has passed, and banks must not remain dependent on taxpayer support indefinitely. Although the level of explicit support has decreased from nearly £1 trillion to £512 billion, the Treasury still retains the ultimate risk of supporting banks should they threaten the stability of the overall financial system. The options available to deal with a failing bank are still not able to pass the costs of failure to the shareholders and creditors instead of to the public purse.

Taxpayer support for the banks, both explicit and implicit, provides a subsidy to the banking sector as a whole. Estimates of the size of the implicit subsidy vary - from as high as £100 billion to just below £10 billion in 2009 alone. But regardless of the size, the Bank of England, Treasury, and RBS all agreed the implicit subsidy needed to be removed. The explicit subsidy includes the fees paid by banks for their use of the Credit Guarantee Scheme which, to date, have been at least £1 billion less than the benefit received by the banks. These subsidies enable private gains to be made at the expense of public risk. Contracts entered into when state support was put in place have allowed some of these gains to be used to pay bonuses to certain bank staff, and dividends to shareholders, rather than enhancing the financial sustainability of the sector.

Although the banks' progress to date on reducing their reliance on the explicit taxpayer support is encouraging, the Treasury must continue to encourage the banks to manage the transition from reliance on the support schemes to private funding in an orderly and smooth way.

Whether or not the taxpayer obtains value for money from exiting from the support depends heavily on a successful sale of the shares in RBS and Lloyds. The value of the shares at the time we took evidence was still some £8.4 billion below the price paid by the taxpayer. The scale of the government shareholding is far greater than in previous share sales and will require extraordinarily careful handling. When developing its strategy for the sale, the Treasury will need to balance the legitimate desire to maximise proceeds against its other objectives of preserving financial stability and enhancing competition. Considerable regulatory and political uncertainty over the Government's intentions for the banking sector will remain until the Government has responded to the recommendations

from the Independent Commission on Banking, expected to report in September 2011.

On the basis of a report from the Comptroller and Auditor General,[1] we took evidence from the Treasury, the Bank of England, and separately from RBS and Lloyds, on the progress on repaying the taxpayer support and maintenance of financial stability. We are grateful to the Bank of England for its evidence at the first hearing, and we hope the Bank's senior officials will be able to support the Committee's future hearings on this and related subjects.

1 C&AG's Report, *Maintaining the financial stability of UK banks: update on the support schemes*, HC (2010-11) 676

# Conclusions and recommendations

1. **Banks should not be dependent on taxpayer support.** We are encouraged that the level of explicit support provided to the banks has decreased from nearly £1 trillion to £512 billion by December 2010. The Treasury must continue to manage down the explicit support and work towards a financial system where risk is borne solely by investors.

2. **Whilst parts of the banking industry believe that the time for remorse is over, so long as banks are "too big to fail" there remains an implicit expectation of taxpayer support.** This provides a very significant implicit subsidy for important banks, which, the Bank of England has estimated, could be as high as £100 billion. Currently the options available for winding-up failing banks would still not be able to cope with the failure of a major bank, and there is no way to avoid the cost of such a failure being borne by the taxpayer. Although the risk of such a failure has reduced since 2008, the Treasury must maintain momentum for international reform in this area. It should also continue to work with the Bank of England to develop a credible resolution regime capable of handling the failure of a systemically important bank.

3. **The Treasury is providing a subsidy of at least £1 billion through the Credit Guarantee Scheme.** We accept that such subsidies were initially necessary to support the banks, but it is now time to ensure the taxpayer is adequately compensated for the support provided. The Treasury should look for ways to ensure that banks are not paying bonuses or dividends at the expense of repaying the subsidy. The fees for the Credit Guarantee Scheme should be reassessed and revised upwards where necessary.

4. **Unless banks can replace taxpayer funding with alternative sustainable funding over the next two years, the Government may still be called on to provide additional support.** Stability depends on banks exiting the support schemes in an orderly fashion. Banks are on track to achieve this, but the next two years may be challenging. The Treasury, working with the Bank of England, must continue to encourage a smooth and timely run-down of the Credit Guarantee and Special Liquidity Schemes. In addition it should continue to develop its contingency plans for managing an orderly transition to full private funding.

5. **Despite our previous recommendations, the Treasury has not yet captured the experience and lessons they have learned from the interventions.** The Treasury should therefore conduct an interim lessons learned exercise now, to ensure that institutional knowledge is retained.

6. **The value for money of removing the explicit taxpayer support will be highly dependent on the Treasury's handling of the sale of the shares in RBS and Lloyds, a sale far greater than any previous privatisation.** The Treasury also has to balance the need to make a profit for the taxpayer with its wider responsibilities for financial stability and promoting competition. The Treasury has not yet set out its plans for the sale but should continue to work with UK Financial Investments to ensure an orderly programme of disposals.

7. **It is inappropriate for a bank dependent on taxpayer support to be generating excessive incomes or dividends at the expense of exiting public support.** We recognise that banks with significant state ownership still need to pay competitive remuneration to retain their staff, but only if this contributes to the value realised on exit from taxpayer support. The Treasury must explore all avenues to ensure that the remuneration packages for the part-nationalised banks provide value for money for the taxpayer, and properly reflect the burden on the taxpayer of continuing support.

8. **It is still not clear how the Treasury will manage its competing objectives of maintaining financial stability, promoting competition and realising the value of the taxpayers' investments.** Until the Government has responded to the Independent Commission on Banking, this uncertainty will remain. In formulating its response to the Commission, the Treasury will need an explicit framework for how it will manage these competing objectives. It should analyse the costs and benefits of options for the size and shape of the banking industry, and quantify the value it places on each of its objectives.

9. **The taxpayer will have to pay £5 billion a year in interest on the money borrowed to finance the support.** This is a material amount, and should be reflected in future assessments of the total cost of the interventions.

# 1 Removing taxpayer support to the banks

1. In 2007, following a period of instability in the financial markets, the Treasury made a series of interventions to protect depositors and stop instability spreading across the financial system. This included the nationalisation of Northern Rock and Bradford & Bingley; lending to troubled institutions and to the Financial Services Compensation Scheme to enable them to support depositors; the purchase of a large number of shares in RBS and Lloyds; and establishing sector-wide schemes to guarantee banks' debt-funding (the Credit Guarantee Scheme), protect their assets (the Asset Protection Scheme), and indemnifying the Bank of England against losses for providing temporary liquidity (the Special Liquidity Scheme).[2] We reported recently on the Asset Protection Scheme.[3]

2. The National Audit Office (NAO) reported that the level of explicit support provided to the banks had reduced from £955 billion in December 2009 to £512 billion by December 2010.[4] This figure includes the value of all the outstanding loans and guarantees, the cost of the shares in RBS and Lloyds, and the sector-wide support schemes where the taxpayer has assumed risk. This support must now be removed through the disposal of shares, repayment of the loans, replacement of publicly guaranteed funds by private finance, and by the banks exiting from the support schemes.[5]

3. The Bank of England told us that many of the banks were "too big to fail" in so far that the Government retained the risk of needing to provide further support to any bank that threatened the stability of the overall system.[6] Consequently, many of the banks' investors expect that the Government would intervene to protect banks' creditors before any loss to their investment occurred.[7] This provided an implicit subsidy to all the major UK banks, not just those owned or part-owned by the taxpayer, whereby the banks could borrow more cheaply than if the investors believed there was a real chance of losing their money. The Bank of England estimated that this subsidy was worth some £100 billion to the major UK banks in 2009 alone.[8] RBS and Lloyds did not agree with the methodology underpinning the calculation. Nevertheless, they accepted that a significant subsidy existed - RBS suggested that it might be around £10 billion – and they agreed that the implicit subsidy needed to be removed.[9]

4. The peak of the financial crisis has passed and some senior individuals within the banking sector have argued that the time for remorse needs to be over.[10] Taxpayer support for UK banks, however, remains extensive, and the risks to the public finance from the

2 C&AG's Report, Key facts and background, page 4

3 Committee of Public Accounts Thirtieth Report of Session 2010-12, *HM Treasury: The Asset Protection Scheme*, HC 785

4 Q18: C&AG's Report, Figure 1

5 Qq 12-13

6 Qq 21-24, C&AG's Report, para 10

7 Qq 18-20, 31

8 Qq 11, 18

9 Banking Support and Asset Protection hearing of 16 March Qq 105-109

10 Qq 95-97

banking sector are great. Even those banks that had not received capital cash injections from the UK Government continued to benefit from the implicit support, and many used the Credit Guarantee and Special Liquidity Scheme, and may have used international support schemes, including the US Troubled Asset Relief Programme and loans from the European Central Bank.[11]

5. In principle, taxpayers should not be providing any support, explicit or implicit, to the banking industry.[12] This requires two broad changes to the global banking system. First, banks and their regulators must reduce the risk of any bank failing.[13] Secondly, it must be possible for banks to be allowed to fail without either putting the financial system at risk or leaving the Government with no choice but to extend taxpayer support. In principle, the banks' creditors should take on the burden of supporting banks that is currently borne by taxpayers. [14]

6. The banks, however, are global, and it is unlikely that the Treasury can do much to bring about these changes without working with global and European authorities.[15] Progress is being made on reducing the risk of any bank failing through the Basel III proposals on capital and liquidity, although much of the practical detail had still to be worked out.[16] Little as yet has been achieved on the second challenge of ensuring large banks can be allowed to fail without the need for taxpayers to provide support. The Bank of England told us that the options available to deal with a failing bank were still not able to pass the costs of failure to the shareholders and creditors instead of to the public purse.[17] The Bank of England believed that this could not easily be done retrospectively, and all players needed to understand the terms of investment in advance.[18]

7. The Government has yet to set out its position on how it will ensure taxpayers do not need to bail out banks in future. It is due to respond to the recommendations from the Independent Commission on Banking, expected to report in September 2011, and will then set out how it will attempt to remove the industry's reliance on taxpayers.[19] Meanwhile, the Treasury told us that it continued to engage with global and European institutions to enhance the stability of the financial system and improve banking regulation.[20]

8. One cause of the financial crisis was the banks' over reliance on wholesale funding markets. The Credit Guarantee Scheme was introduced to help restore investor confidence in bank wholesale funding by providing a government guarantee on certain unsecured

11 Qq 11,14, 45, 72, 87, 90, 94, and 107; Banking Support and Asset Protection hearing of 16 March Q105

12 Qq 11-13

13 Qq 21, 31

14 Q 24; Banking Support and Asset Protection hearing of 16 March Qq 114, 205

15 Qq 55-56

16 Q 108: C&AG's Report, Appendix 3, page 9

17 Q 24

18 Q 24

19 Q 98

20 Qq 21, 108

debts in return for a fee.[21] This increased funding at a time when wholesale funding was in very short supply. The fees were set and announced in October 2008, at the height of the crisis when the Treasury believed that market prices for insuring debt were higher than could be justified by the risk. They were set at a rate that was higher than the minimum set internationally.[22]

9. The NAO identified a subsidy to the banks participating in the Credit Guarantee Scheme of at least £1 billion.[23] The scheme not only allowed the banks to access funding when it would not otherwise have been available, but also allowed the banks to borrow money more cheaply than they otherwise would have done. This difference had not been fully captured by the fees charged by the Treasury for the guarantees and therefore taxpayers have not been fully compensated for their risk. RBS did not recognise that the Credit Guarantee Scheme represented a subsidy from the taxpayer; arguing that taxpayers would make a profit and that the market price was theoretical.[24] Nevertheless, the Treasury acknowledged the subsidy and agreed to review the fees.[25] This is particularly important if the banks seek to use the rollover facility and extend their use of the scheme significantly beyond 2011.[26]

10. The Treasury and Bank of England told us they were winding down the Special Liquidity and Credit Guarantee Schemes in ways that they hoped encouraged the banks to move to a more sustainable funding model. To do so, the banks needed to reduce their use of wholesale funding and to replace their maturing debt as it fell due. The Treasury told us that UK banks were planning to manage the refinancing challenge by increasing their deposits and reducing their assets.[27]

11. The Treasury and Bank of England assured us that the banks were seeking to withdraw from the Credit Guarantee and Special Liquidity Schemes and that they were on course to do so.[28] The largest users of the schemes (the part-nationalised banks RBS and Lloyds) had reduced both their use of the support schemes and their use of wholesale funding as a whole, but had done so in a way that had not reduced the proportion of their funding that is dependent on the wholesale funding markets.[29]

12. This Committee was of the view that it was important that the wind down of the support schemes continued to be orderly. Winding down the Special Liquidity and Credit Guarantee Schemes too quickly could be disruptive to the banks' overall funding position, because it could require them to seek too much new wholesale funding at the same time. The Bank of England had already negotiated a smoother profile of exit from the Special

21 C&AG's Report, Key facts and background, page 4

22 Q 65

23 Q 64; C&AG's Report, para 1.8

24 Banking Support and Asset Protection hearing of 16 March Qq 143-152

25 Qq 64-65

26 Q 70

27 Q 88

28 Qq 67-69

29 Qq 87-88, 99-101

Liquidity Scheme to avoid the forecast "cliff-like" withdrawal of that support.[30] The NAO report showed that the banks had successfully replaced some £150 billion of maturing funding in 2010, but there remained over £400 billion that would mature over the next two years.[31]

13. Inevitably the banking sector will have other financial crises, and the Treasury and Bank of England are highly likely to need to resolve another bank at some point.[32] In June 2010, the Chancellor announced proposals to restructure financial regulation, including conferring responsibility for prudential regulation to the Bank of England and its new subsidiary agency to be known as the Prudential Regulation Authority.[33] This makes it vital that the Treasury capture the practical and theoretical lessons learnt from managing this financial crisis. The Treasury committed to consider how it will capture the lessons from its staff and pass these on to the Bank of England and the proposed Prudential Regulation Authority.[34]

30 Q 87

31 C&AG Report, Figure 10

32 Qq 107-108

33 C&AG's Report, para 15 and 4.7

34 Qq 114, 122

# 2 Maximising the return from the Treasury's investment in the banks

14. At the time of the hearing, it was not clear if taxpayers would make a loss, break even, or profit from the banking support. The Treasury told us that it was confident taxpayers would make a profit.[35] The return to the taxpayer depends on the successful wind down of explicit support and in particular the successful sale of the shares in RBS and Lloyds.[36]

15. Taxpayers held a paper loss of £8.4 billion on the shares in RBS and Lloyds at the time of the hearing. The Treasury, RBS and Lloyds were confident that taxpayers could make a substantial return from increases in the share prices as the economy improved, profits increased, and as the Governments' intentions for the two banks become clearer.[37] The banks have already shown progress in returning to profitability. Even so, profiting from the taxpayer owned shares would require a successful programme of disposals.[38] The shareholdings as at February 2011 were themselves seven times bigger than the largest ever sale of existing shares in Europe (Figure 1). Timing was therefore crucial to avoid flooding the market, and to achieve a profit from any increase in market confidence to the advantage of taxpayers.[39] The Treasury established UK Financial Investments, an arm's length body, to advise it on these issues.[40]

35 Q 1

36 Q 34

37 Q 1; Banking Support and Asset Protection hearing of 16 March Qq 109, 132. 135, 204

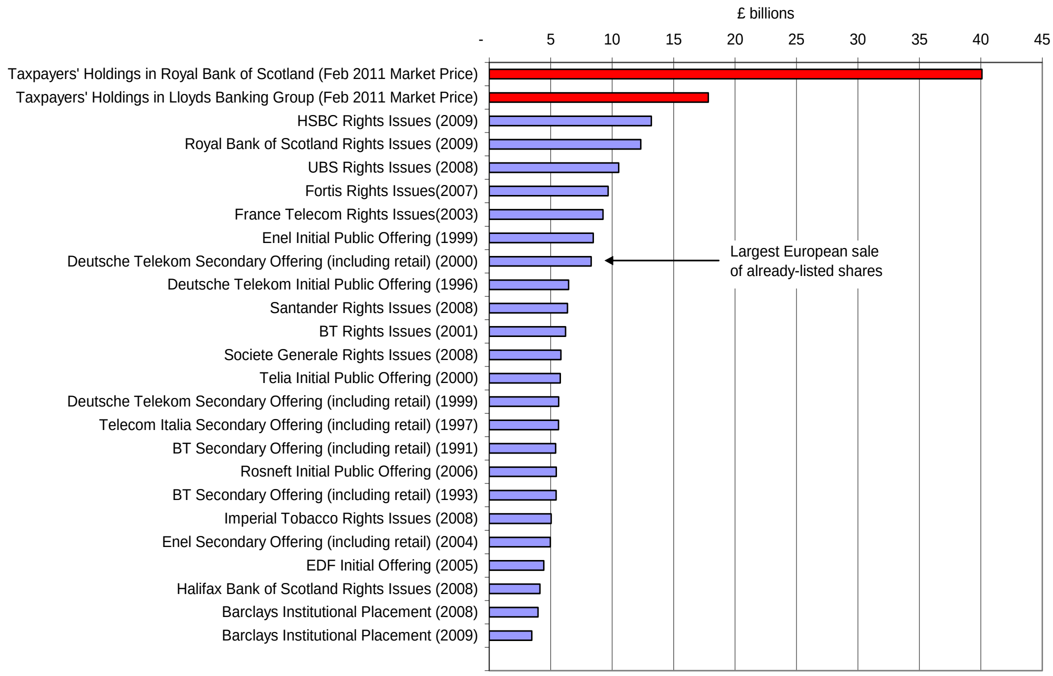
38 Q 8

39 Q 8

40 Qq 8, 30

**Figure 1**

**The size of taxpayers' holdings in RBS and Lloyds compared to previous European share offers**




*Source: C&AG's Report, Figure 11, updated to 7 Feb 2011*

16. The Treasury explained that both RBS and Lloyds required skilled management in the coming years if the share prices were to increase. The price at which the shares are sold would determine the taxpayers' return.[41] The banks had therefore sought competitive remuneration for their managers and skilled people, bearing in mind the argument that staff could leave the UK should they view alternative locations abroad as more attractive.[42] RBS believed it was amongst the leaders in terms of aligning incentives and risks through its pay and bonus structures. It told us that there had been comprehensive reform of the pay and bonus structures within the UK banking sector and that its pay and bonuses were set within these new standards.[43] The Treasury recognised the tensions of a banking system underwritten by the taxpayer where "absurd" salaries were paid, but explained that in some cases high salaries were necessary to get top-quality management who would generate income for the banks.[44]

41 Qq 32-35

42 Qq 32-35; Banking Support and Asset Protection hearing of 16 March Q169

43 Banking Support and Asset Protection hearing of 16 March Q203

44 Q 34, 54

17. UK Financial Investments is responsible for negotiating with the banks' management over the size and shape of their employees' pay and bonuses.[45] The intention is that it does so at arm's length from the Government, to insulate the banks from political interference.[46] The Treasury told us that it did not make direct representations to UK Financial Investments, although it did point to general public comments made by the Prime Minister and Chancellor.[47] UK Financial Investments had the power to veto RBS's bonus pool for the first year of the Asset Protection Scheme, but the Treasury did not seek this veto for further years when negotiating the scheme.[48]

18. The Treasury's role includes balancing its general objective of maximising the proceeds of the sale from the shares – part of its general duties for achieving value for money – with its broader economic objectives, including financial stability and promoting competition.[49] It was waiting for the Independent Commission on Banking to report in September 2011 before it set out how it intended to pursue its financial stability and competition objectives. The Treasury explained that some of the possible policy options that may help remove the implicit taxpayer subsidy of the banking sector and promote competition could be at the expense of the share prices for RBS and Lloyds, and it needed to balance the two objectives.[50]

19. The Treasury lacked clear criteria about how it would make the careful judgements necessary to respond to the Independent Commission on Banking. It could not tell us how it values the costs and benefits of having large systemic banks.[51] It did not know the costs and benefits of promoting competition and it was unclear how it would prioritise its objectives or handle the sale of the shareholdings. [52]

20. The Government borrowed £124 billion in cash to provide the loans and buy the shares in the banks.[53] At the time of the hearing, this borrowing cost around £5 billion a year in interest, which would only be partly offset by future interest and fees paid by the banks.[54] This represented 11% of the Government's overall interest on public sector debt in 2010-11 and was thus material in terms of the nation's overall finances.[55] It had not, however, been included in Treasury's previous estimates of the costs of taxpayers' interventions in the banks.[56]

21. Including the borrowing cost in the estimates of the final cost or return to the taxpayer would improve transparency. The Treasury told us that it did not usually include finance

45 Q 30; Banking Support and Asset Protection hearing of 16 March Qq 191-192

46 Q 38

47 Qq 48-53

48 Qq 35-43

49 Qq 1-3

50 Q 6

51 Qq 10-11, 15

52 Qq 10-11

53 C&AG's Report, para 5

54 Q 106

55 C&AG's Report,para 8

56 Q 106

costs when reporting the total cost of projects.[57] It explained that making a calculation on the implicit interest paid on the borrowing required a certain amount of estimation. However, the Treasury accepted that borrowing had increased as a result of the interventions and promised to consider including funding costs in its future statements of the expected profit or loss to taxpayers from the interventions.[58]

57 Q 106

58 Q 106

# Formal Minutes

## Monday 4 April 2011

Rt Hon Margaret Hodge, in the Chair

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

Draft Report (*Maintaining financial stability of UK banks: update on the support schemes)* proposed by the Chair, brought up and read.

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

Paragraphs 1 to 21 read and agreed to.

Conclusions and recommendations 1 to 9 read and agreed to.

Summary read and agreed to.

*Resolved*, That the Report be the Thirty-second 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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| **Sir Nicholas Macpherson KCB,** Permanent Secretary, **Tom Scholar,** 2nd Permanent Secretary, HM Treasury, and **Andrew Bailey,** Executive Director, Banking and Chief Cashier, Bank of England | Ev 1 |


# List of printed written evidence


| | | |
|---|---|---|
| 1 | HM Treasury | Ev 16 |

# 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

| | | |
|---|---|---|
| First Report | Support to incapacity benefits claimants through Pathways to Work | HC 404 |
| Second Report | Delivering Mulit-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 |
| 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 | HM Treasury: The Asset Protection Scheme | HC 785 |
| Thirty-second Report | Maintaining financial stability of UK banks: update on the support schemes | HC 973 |

# Oral evidence

## Taken before the Public Accounts Committee

## on Tuesday 8 February 2011

Members present:

Rt Hon Margaret Hodge (Chair)

| | |
|---|---|
| Mr Richard Bacon | Matthew Hancock |
| Stephen Barclay | Joseph Johnson |
| Stella Creasy | Austin Mitchell |
| Jackie Doyle-Price | Ian Swales |

**Amyas Morse**, Comptroller and Auditor General, and **John Ellard**, Director, NAO, gave evidence. **Gabrielle Cohen**, Assistant Auditor General, was in attendance.

**Paula Diggle**, Treasury Officer of Accounts.

**REPORT BY THE COMPTROLLER AND AUDITOR GENERAL**

**Maintaining the financial stability of UK banks: update on the support scheme (HC 667)**

**Examination of Witnesses**

*Witnesses:* **Sir Nicholas Macpherson**, Permanent Secretary, HM Treasury, **Tom Scholar**, Second Permanent Secretary, HM Treasury and **Andrew Bailey**, Executive Director, Banking and Chief Cashier, Bank of England, gave evidence.

**Q1 Chair:** Welcome to you all. This is becoming a regular occurrence. We are looking today at maintaining financial stability in the UK and the support scheme. In particular, I welcome Andrew Bailey and thank him for giving evidence to us this morning. Our focus—and we will try and keep it as such—is whether the interests of the taxpayer have been protected in this array of interventions and whether value for money has been secured. I am going to start off on a very specific point, which is RBS and Lloyds, and we will then move to the general. According to our Report—I have not looked at the latest share price—we would still be losing billions were we to sell our shares today. The £12.5 billion figure probably has not shifted much. Indeed, it has probably gone in the wrong direction, has it not? It has gone down?
***John Ellard:*** It was £8.4 billion as of yesterday evening.
**Chair:** Slightly better, but it is still £8.4 billion. That represents a movement since we wrote the Report. How confident are you that we are going to be able to extricate ourselves without loss to the taxpayer or, furthermore, with any profit to the taxpayer?
***Sir Nicholas Macpherson:*** As I think I have told the Committee before, I remain confident that the taxpayer will make a profit on these shareholdings. The share price obviously varies from day to day and week to week. There have been brief periods even in the last 18 months where the taxpayer has been in profit. I would expect that to happen again in future, mainly because I think both banks are making progress in terms of returning to underlying profitability. Lloyds is clearly further ahead of the curve than RBS, but the share price is moving in the right direction and profit is moving in the right direction. There is a lot of uncertainty in the market at present because of the Independent Commission on Banking. As this Committee has discussed, on the one hand we want to make a profit, while on the other hand we want a well-functioning economy, and sometimes these things do trade off against each other. Nevertheless, even taking into account all those factors, I still think we will make a profit.

**Q2 Chair:** What is your priority? I know you have to balance the two, but where would you prioritise: protecting the taxpayer's interest in getting our money back or looking at the longer term health of the two institutions?
***Sir Nicholas Macpherson:*** I think you are targeting both, and you are trying to optimise along the curve of possibilities. As accounting officer, the issue of value for money is very important. In terms of the future, were a decision taken that clearly reduced the value of shares in the interest of the wider public good, as accounting officer I would want to look very hard at that judgment. It is easy to make assertions about wider benefits to the economy, but as the accounting officer I will need to look very hard and form an assessment.

**Q3 Chair:** I take from that the priority really is your accounting officer priority.
***Sir Nicholas Macpherson:*** The Treasury has wider interest—it is an economics ministry and a finance ministry. We really want the economy to recover. Banking is critical to that and the revenue gains of a successful, functioning banking system are potentially very big indeed. Nevertheless, as accounting officer I have to weigh these things up. At this stage, no decision has been taken to sell any of the shares, but

I am just giving you an indication of what I am going to have to do in future.

**Q4 Chair:** And as accounting officer, would you be prepared to put more money into both banks if that became necessary?
***Sir Nicholas Macpherson:*** Well at the present time I do not see any immediate prospect of having to put more money into the banks.

**Q5 Chair:** But can you see circumstances—
***Sir Nicholas Macpherson:*** Well obviously if conditions deteriorated, you cannot rule anything out, but again, you have to make a hard-headed assessment at the time. I think it is fair to say that looking at the interventions over the last few years, it has been striking that successive Governments have generally taken decisions that did not raise issues for me as accounting officer or were inconsistent with the principles of managing public money. There were two occasions—we discussed one of them last week; the other related to the Iceland bank interventions, on which I had to seek a direction—but those were very small decisions against the background of very large-scale interventions elsewhere.

**Q6 Chair:** You alluded to it, but if the Independent Commission on Banking were to come up with a proposal for breaking up the banks, would that have an impact on our financial interest? It could depress the share price, ensuring that we got less back for our money.
***Sir Nicholas Macpherson:*** I do not want to prejudge the commission, but inevitably in looking at possible policy options, some may help the economy at the expense of the share price, just as other interventions might help the share price at the expense of the economy. It is the job of the Treasury to try to reconcile the two objectives.

**Q7 Chair:** But your aim is to get a profit back? You are being a bit evasive. I understand the difficulties.
***Sir Nicholas Macpherson:*** No, I am not being evasive. I do not think the Government's stated objective is to make a profit. I am sure there are certain circumstances the Government could foresee where in a wider public interest it would be worth taking a loss. Nevertheless, I remain reasonably confident on broadly unchanged policies that we will make a profit.

**Q8 Chair:** One final thing, then I want to go to Jo. These are nationalised institutions, to all intents and purposes. In previous privatisations, we have tended, I think, to affect what we have got for our money by flooding the market with most of the equity on day one. Are you sensitive to this issue? Will you therefore be watching how you actually sell the shares back into the market? Doesn't that mean that we will probably be here in two years' time talking about our shares in both RBS and Lloyds?
***Sir Nicholas Macpherson:*** That is a very good point. One of the reasons why UK Financial Investments was set up at arm's length was to advise on these issues. The Treasury will need to advise the Chancellor, who ultimately will take the decision on this in the light of UKFI's advice, but as and when these shares are sold into the market, the sheer scale of the holdings will I think make this the biggest share sale ever.

**Q9 Chair:** There is an amazing graph here. You saw it?
***Sir Nicholas Macpherson:*** Yes. And that will be the case by a very long way, which suggests to me—again, I do not want to prejudge the future—or leads me to guess that you would do it in a series of tranches and you would be very much trying to test the market. I expect to see very many PAC hearings in the future over whether the Government makes a good job of privatisation or not. We have actually been in touch with the NAO, which has drawn lessons from previous privatisations, and we will be poring over its guidance and advice.

**Q10 Joseph Johnson:** Nice to see you again. I want to go straight to the point you made about the revenue gains from having a functioning banking system being very great indeed. Have you quantified them?
***Sir Nicholas Macpherson:*** No, we have not quantified them in those terms, simply because there is a huge spectrum of what represents a well performing banking system. One of the reasons why we have a massive deficit right now is because we have a revenue problem rather than a spending problem, and the revenue problem reflects the fact that the British economy became extremely dependent on financial services and banking in particular. So we are acutely aware of how critical this is for public finances.

**Q11 Joseph Johnson:** All right, but the Bank of England has quantified the cost of having very large systemic banks to the UK taxpayer, and it has done so to the tune of £100 billion a year. So it would be good to get a sense of what we are getting in return for that implicit subsidy that the UK taxpayer is giving to the banking system every year.
***Sir Nicholas Macpherson:*** Well I am perhaps not as well acquainted with the Bank of England's analysis as my colleagues here, who may want to comment.
***Andrew Bailey:*** I think the other reason for putting that analysis forward is from the point of view that actually, it is not an appropriate situation to be in. So you are right to say, "What is the calculation on the other side of the balance sheet?" Frankly, from my perspective, the big lesson out of all of this that is captured in this Report is we should have a banking system that is not, either explicitly or implicitly, dependent on public money.

**Q12 Chair:** Can I just ask you to speak up a bit, because the acoustics are really poor?
***Andrew Bailey:*** We should not have a banking system that is either explicitly or implicitly dependent on that figure that you just quoted, or indeed any other figure. That must be the objective. So we want to get away from that.

**Q13 Joseph Johnson:** A zero subsidy?
***Andrew Bailey:*** Yes.

**Q14 Joseph Johnson:** The IMF has done some research that suggests that if we are to move away from the current system, where the taxpayer is subsidising the cost of capital to the large systemic banks to the tune of £100 billion a year, to an environment where there is no subsidy at all, the size of bank balance sheets would need to be less than £100 billion. That is significantly smaller than they are at present. I think RBS's balance sheet is well over £1 trillion still, ditto Barclays and certainly HSBC. So how are we going to get to that environment where there is no subsidy from the taxpayer to the banking system?
***Andrew Bailey:*** Well let me just step back a moment and put it in context. We introduced a couple of years ago a resolution regime for banks in this country, which gave legal powers to the Bank of England. That regime has worked effectively for small banks. I believe it can work for small and medium sized banks and indeed there was a predecessor regime for a period of time that followed the nationalisation of Northern Rock, which did the same thing. But let us be absolutely honest: it is not a regime that could work in its current form for the very largest banks. That is why there is still further to go. To come back to your question and the IMF's point, the reason why I started with that point is that if we moved to a world where the costs, as you put them, are borne not by public money but by those who invest in the capital and, if necessary, the creditors of banks, then they have to take decisions on the extent to which they are prepared to fund the balance sheets of banks. So the conclusion that the IMF draws comes out of that. It is not God-given that a bank's balance sheet will be smaller by *x*. It would then be a product of people who would be at risk—truly at risk, as opposed to the public purse being at risk—taking decisions on what they are prepared to fund and at what price they are prepared to fund it, clearly because of the risk element involved.

**Q15 Joseph Johnson:** What I am not getting very clearly is a sense that you have done a cost benefit analysis of having large systemic banks of the size of Barclays, RBS and Lloyds. I just do not think it is coming through very clearly that you have weighed up the taxpayer subsidy versus the advantages we are getting from it.
***Sir Nicholas Macpherson:*** The banking commission is looking at this in very great detail as we speak. It will report later this year.

**Q16 Joseph Johnson:** But you have done no independent work of your own?
***Sir Nicholas Macpherson:*** No, the Government will then have to take a decision on where it wants to go and that will be based, I suspect, on extremely heavy-duty cost benefit analysis.

**Q17 Joseph Johnson:** But you have done no research or thinking of any sort on this point?
***Sir Nicholas Macpherson:*** No, we do research and thinking about it. What I am not in a position to do is give you a definitive answer on the effective subsidy; the Bank of England has done an estimate, but I dare say if it had done an estimate five years ago, it would have come up with a very different answer. In a sense we are still dealing with the consequences of the crisis. The time to do the analysis, you suggest in definitive terms, is when the Government seeks to create, in a sense, a new settlement for the banks, which will come out of the banking commission.

**Q18 Joseph Johnson:** The Report does a brilliant job, as I said right at the start, at capturing the explicit taxpayer exposure to the various schemes that you have put in place. As I said, I still think it only captures the tip of the iceberg. On one of the points in particular, I think it is fair to say that the taxpayer is still implicitly standing behind all retail deposits in the banking system: £3 trillion. The last official word we have had from any Government official on this subject was I think from Alistair Darling at some point in 2007–08, when he said that all depositors in similar situations would be treated in the same way as those in, I think, Northern Rock and Bradford & Bingley. Has that position changed?
***Tom Scholar:*** One thing that has changed since the start of the crisis of course is that we have a resolution regime for banks now in the Banking Act 2009, with the Bank of England responsible for resolving banks.

**Q19 Chair:** But the Treasury stands behind that resolution scheme as well.
**Joseph Johnson:** Exactly. Yes or no? Are we standing behind the £3 trillion of retail deposits in the banking system? It is a yes or no.
***Tom Scholar:*** Well I am not sure that it is in fact a yes or no, because I think it has to be assessed on its merits in each particular case. So for example, in a world in which markets were stable, confidence in the banking sector was high and there was an idiosyncratic shock of some sort affecting just one bank and not others, I think in those circumstances it would be safe to let a bank fail, and we have seen examples of that in the past. The circumstances in 2008 and 2009 arose when markets were extremely fragile and confidence was very weak. In those circumstances, not just in the UK but in any country in the world, there was potentially a very great systemic risk from the failure of even a small institution that in other circumstances would not be considered systemic. So that may be a more nuanced answer, but I think it is an accurate reflection.

**Q20 Chair:** I just want to pursue Jo's point. You now judge, at the present time, that we are still in that systemic environment. So at present, are we or are we not standing behind the £3 trillion deposits, at this point in time?
***Tom Scholar:*** Well I think again, even at this point in time, it would be case by case. For example, you may have seen that there was a failure of a small bank in Denmark over the weekend. That has been resolved—I do not know at what cost to the Danish taxpayer—but clearly if that had happened in the autumn of 2008, even a small bank in Denmark could have had a ripple effect across the whole European banking sector. I do not think we are in that position today, but that said, the sector is still vulnerable. Of course, any

operation would have to be a decision for the Chancellor and that would be a decision where he would have to weigh up the public interest: financial stability on the one hand and the taxpayer exposure on the other.

**Q21 Chair:** And the Bank of England, in our Report, suggests that we have optimistic views on the ability of banks to raise their own finance at present.
***Andrew Bailey:*** We do in the current context, but if I could finish off the answer to the point that was just being made, I do think that as Tom says it is case-specific and that with the current set of tools that we have to deal with banks, I do not think any of us should be confident that we could deal with a major bank in any case. That is why there is a great deal of work going on, both within the Banking Commission, as Nick has said, but also internationally in the Financial Stability Board, to tackle this question. This is the so-called "Too big to fail" problem. It is the big outstanding question and until we actually nail that one—I have to be honest—there is no confident answer to that question that you have just posed.

**Q22 Mr Bacon:** Mr Bailey, the alternative, of course, to too big to fail is a large number of smaller institutions and more competition. Do you think increased competition promotes stability in the banking system? Does it promote financial stability? Or do you agree with Charles Goodhart that it increases financial instability?
***Andrew Bailey:*** Well I think we have to have a system where we can deal with bank failures in a way that supports competition in an industry, because I think if you are in a world where you have an industry where entry and exit is stymied, that is bad for all sorts of reasons. It is bad for the economy and it is bad for consumers. So there are very good reasons to get out of that world and not to try to say, "Let's have less competition".

**Q23 Mr Bacon:** My question wasn't about the economy or about consumers; it was about financial stability. Do you think increased competition is good for financial stability?
***Andrew Bailey:*** My point was that if we can have a system where we can allow banks to fail without threatening financial stability, then we can get the benefits that I was just talking about, which are, in my mind, very real ones that we should seek. That is the point about financial stability. Now, at this stage, regarding splitting banks up, I come at this from a resolution point of view, having been running resolution in the Bank of England. If you were to say to me, "Let's just reduce the size of banks to the point where you can resolve them all over the weekend," I am afraid my answer to you would be with the current tools—I keep coming back to this point about the current tools—we would have to do so much splitting that I think you would regard that as both very disruptive and probably suboptimal, which is why I come back to this point that we have not yet finished the toolkit. Not because I am defending big banks as they are, but this is a very dichotomous world at the moment; we either have lots of very small banks or the world we are in, and we do not want to be in either of those.

**Q24 Chair:** So what is missing from your toolkit?
***Andrew Bailey:*** The ability to pass the cost of a bank failure not to the public purse but through the capital structure and frankly, if necessary, through to senior creditors. That, let me say, has to be done on the basis that everybody understands the rules of the game well in advance. So we cannot wake up one weekend, see a bank is failing and say, "I have just had an idea, guess what I am going to do"; this all has to be very well telegraphed.

**Q25 Joseph Johnson:** On my analysis, we would need 10 times as many banks as we have at the moment if the maximum size were to be £100 billion. I think we have £7 trillion assets in our banking system at the moment, so we need 70 as opposed to seven big ones.
***Andrew Bailey:*** I would not put any great weight on a precise number. I think that is plucking numbers heroically, frankly.

**Q26 Joseph Johnson:** But in that order?
***Andrew Bailey:*** I do not know. Let us use that as a rule of thumb.

**Q27 Matthew Hancock:** On this point, is the lack of the adequate tools, as you put it, for resolution one of the reasons why there has been so little entry into the market as well? What other reasons would you give for why there has been so little entry into the market, not only post-crisis but also over the last 20-odd years?
***Andrew Bailey:*** Well I am not an expert on what I might call the consumer aspects of it, but one of the big lessons of this crisis is we are—let's hope—coming out of it with a more concentrated banking industry. That is one of the consequences of what we have seen happen. We have seen essentially the middle tier of the banking industry disappear, so it is a more concentrated industry in that sense.

**Q28 Chair:** But that is a bad thing you have just told us.
**Mr Bacon:** The mutual building societies have not disappeared, apart from those that demutualised and then crashed. I hate to use the word "rock" in this particular context, but the mutual building societies that remain are what Alistair Darling used to call traditional boring institutions and they are fairly stable and they are middle tier.
***Andrew Bailey:*** That is right, but from a competition point of view, we have lost all the demutualised building societies.

**Q29 Matthew Hancock:** So why has there been so little entry?
***Andrew Bailey:*** I think it is quite hard in the current environment to enter on any scale, and I think this is an issue that the Banking Commission is looking at very closely, so I do not want to in any sense guess what its views will be on that.

***Sir Nicholas Macpherson:*** The history of British banking is that everybody wants more competition in British banking—everybody is in favour of it; it is a very good thing—but it is striking that despite numerous attempts over the years to get more big players into the market, you always seem to end up with the Big Four dominating it. So this is not simple or easy. Some of the biggest competition was around the sort of people who read the *Sunday Times* best interest rate tables and those were the classic Icelandic banks. It is not just big banks that failed in this crisis; at the start, it was very much the middle tier banks that got into difficulty and the niche banks like Icesave. So we are waiting on the results of the commission and we need to take decisions in the light of that.

**Q30 Stella Creasy:** You are in a difficult position now, though, are you not, because unlike previous generations you have a substantial shareholding in these banks, so you could influence some of the future direction on this? If you have identified a lack of competition and a lack of the middle players as a challenge, where does that leave the decisions that the Treasury will have to make and the advice it might give the Chancellor about either the sale of shares or when to sell or some of the issues we have already talked about? It is a different scenario, having set out all those things, to previous generations and how they dealt with the banks, is it not?
***Sir Nicholas Macpherson:*** In one sense it is, but UKFI, which is effectively taking the shareholder role, will give advice to the Chancellor purely from the shareholder perspective in terms of maximising value to the shareholder. The Treasury will then advise the Chancellor, taking those issues into account but also taking into account the wider economic and competition issues. In due course, we will need to account to this Committee that whatever decisions are taken were the right ones.

**Q31 Ian Swales:** I would just like to build on that and talk about the role of the Treasury. The Treasury, as you said earlier, has Treasury responsibilities and responsibilities to the wider economy. As Stella has just said, you have also now got responsibilities as an investor in the banking system. You are also there behind regulation in the system. So it would seem that there is a potential conflict of interest in all of this. A support regime has been put in place for banking. If I were in the banking industry, I would feel very comforted by the fact that the Government appeared to be standing behind most of what I do, and that would encourage certain kinds of behaviours in me. I suppose the job of this Committee is to convince ourselves on the very narrow definition of value for money for the taxpayer. How do we convince the man in the street that the sum total of all this activity is going to produce the optimum result for them? I think that is what we are all struggling with.
***Sir Nicholas Macpherson:*** To pick up on one of the first points you made, I think if I were a shareholder in Northern Rock, which I am glad to say I was not, this idea that somehow I got some massive subsidy from the taxpayer would not really ring true. If I was a shareholder in Bradford & Bingley, I wouldn't feel too happy either. Even if I was a shareholder in RBS, funnily enough, I would have seen my shareholding very severely diluted indeed. I think sometimes some of the statements about being too big to fail can be a bit simplistic. Some of the people who have been sacked from those banks may have walked away with money, but their reputations are pretty severely trashed and, by all accounts, their lives within their communities are not that fun. So I just want to make that point. But coming on to your wider point, I think this is going to be a big challenge. We have gone through a crisis of a nature which this country has not experienced for well over 100 years. It has been damaging. Financial services and banking are something that this country has a comparative advantage in. In taking decisions, it will be really important that we do not throw the baby out with the bathwater. It is tempting to think that this country can thrive economically without a successful and thriving banking system. I happen to think it is something that is potentially vital to Britain's economic success. Taking decisions in the coming period, whether on the shareholding or on the structure of banking, is going to require some pretty advanced analysis. I think we can do that. Coming back to your point about the Treasury, it is important that the Treasury does not seek to take every decision and interfere in every part of its decision making process, which is one reason why we have tried to divest some of our responsibilities. For example, on the banking resolution, initially the Treasury did the resolution of Northern Rock, Bradford & Bingley and the Icelandic banks. It did not have to, but that is how it ended up. But the Bank of England is now firmly responsible for resolution. The forthcoming legislation that the Government are going to introduce is going to give the Bank wider responsibilities still. I think this makes sense, because it is quite dangerous if you concentrate all decisions in one institution. The critical thing in terms of designing the governance of banking legislation, regulation and so on is to get the balance right.

**Q32 Chair:** I think that has pushed me into asking you the inevitable question. If you are the taxpayer and you hear from this morning a theoretical subsidy of £100 billion—we know from the Report just on the credit guarantee scheme about a subsidy of £1 billion—squaring that with the bonuses on the other hand is completely impossible. I do not know what we are talking about nowadays, but RBS in particular has 200 staff earning £1 million or more. The *FT* yesterday talked about Bob Diamond on his £9.5 million. All this risk for the taxpayer—£100 billion potential subsidy and £1 billion on the credit guarantee scheme, which has kept its costs down—and you have got this complete lack of control from anybody of the bonus structures that individuals get through work in the bank. That is what the taxpayer can't get. I suppose it is the inevitable question.
***Sir Nicholas Macpherson:*** It is the inevitable question and I have considerable sympathy for the taxpayer. Indeed, I am one myself. The orders of

magnitude are occasionally disturbing. First, just dealing with our shareholding issue, we are interested in securing value for money, and sometimes that means rewarding people within the banks in which the Government has shareholdings perhaps rather more than we would normally feel comfortable with.

**Q33 Chair:** Well we are interested in value for money and if you look through our proceedings, we Members of this Committee ask about salary levels of various civil servants if they exceed the Prime Minister's salary. We've managed on the whole to get quite a lot right at reasonable salary levels. RBS has not got a lot right yet and there are 200 staff who are getting £1 million or more, with Stephen Hester on a reputed £2.5 million.
***Sir Nicholas Macpherson:*** Tom was involved in some of the discussions around trying to recruit Stephen Hester. RBS was in a complete mess, so we did actually have to get a credible chief executive.

**Q34 Chair:** Maybe you should have sent Tom off to do it.
***Tom Scholar:*** No thanks.
**Chair:** At a cost of what?
***Tom Scholar:*** As the Report says, value for money for the taxpayer in all of the interventions will ultimately be overwhelmingly dominated by the proceeds of the eventual sale of the shares in Lloyds and in particular in RBS. The price at which we can sell those shares is what will determine what the taxpayer gets back. So maintaining value of the shareholding is critical for value for money for the taxpayer. Unfortunately, given the world in which these banks operate, that gives rise to tensions of exactly the kind that you describe, which are very difficult to explain and very difficult in some cases to accept. But basically, if we want to sell our shareholding and make a decent return on it, we need top-quality management running the banks, we need people working in the banks who are able to generate income for them, and because of the market in which these people operate, I am afraid we have to pay them more than the Prime Minister's salary.

**Q35 Chair:** I think we understand that, but in the market out there, if you are losing money and you are not viable and you cannot raise your finance unless you are backed by the taxpayer, it does not seem the appropriate circumstance in which you dole out £1 million to 200 of you and £2.5 million to yourself. We could go beyond, because in the Bank of England analysis, it is not just the ones that we own; it is all the banks that are benefiting from taxpayer backing. I could understand if they were making billions and they were fantastically successful and contributing to our economy. That would be great. But they are not. When they are, then maybe we can start talking about those sorts of bonuses. That is what is wrong about the argument. Of course we want skilled people, but skilled people should only be rewarded when they do a job.
**Matthew Hancock:** As a point of detail, Margaret, we all know that Stephen Hester arrived after the crash at RBS, because we all know the knight of the realm who was in charge at the time. But when the contract was put in place, I understand it was a two-year contract. Is that right, for RBS?
***Tom Scholar:*** The contract—
**Matthew Hancock:** The contract that covered the bonuses that are paid this year and were paid last year was a two-year contract?
***Tom Scholar:*** When the asset protection scheme was agreed, there was a provision in there that said for the first year UKFI would have a right of refusal or right to approve the overall bonus pool.

**Q36 Matthew Hancock:** Yes. And then for the second year, they should be paid at market rates.
***Tom Scholar:*** I do not think it says anything about the second year. It simply says that for the first year, UKFI have that.

**Q37 Matthew Hancock:** So if you could do that for one year, why could you not do it for longer? Because by doing it for one year, you are taking on the argument you made just then that actually you need to pay these people, because for a year UKFI had a veto.
***Tom Scholar:*** Well again, that was one element of a whole negotiation around the asset protection scheme. The judgment at the time was that there were in fact some value implications in signalling to the market, including of course the staff of RBS, that there would be a tougher regime on bonuses there—

**Q38 Matthew Hancock:** But if you had linked it to something like the taxpayer being in profit, it might have been easier to swallow. As it was, for the year before the election there were no bonuses and then after the election the contract did not have a constraint on bonuses.
***Tom Scholar:*** The general policy framework that the previous Government adopted and the current Government have also adopted for UKFI and these shareholdings in general is that the decisions on running the banks, including on remuneration, should be for the boards of those banks.

**Q39 Matthew Hancock:** Hold on. But for the first year of this arrangement, there was a constraint, as you have just set out, on bonuses.
***Tom Scholar:*** There was. So this was a specific—

**Q40 Matthew Hancock:** Why wasn't that for longer?
***Tom Scholar:*** This was a specific exception to that general policy.

**Q41 Matthew Hancock:** So if you have had an exception, then why was the exception only written in for such a short period of time?
***Tom Scholar:*** It would have been possible to have sought a provision for the second year along the same lines as for the first year. When the decision was taken, certainly RBS management were very resistant to that, because they were afraid that they would lose a lot of people.

**Q42 Matthew Hancock:** I can see why management might be resistant.

***Tom Scholar:*** They did lose quite a number of people and that is a concern to them in maintaining the value of the shareholding. So the decision was on value for money grounds that it would be damaging to the value of the shareholding to send this signal about remuneration.

**Q43 Matthew Hancock:** So the previous administration could have allowed the Government to have more constraint over the bonuses being paid this year?
***Tom Scholar:*** They could have sought it in the negotiation. Whether it would have been agreed I cannot say. That is the counterfactual. But they could have sought it; that is true.

**Q44 Austin Mitchell:** First, I would like to express my gratitude to Mr Bailey for clearing up the Icelandic payments situation in 2008. The Grimsby fish trade and I are very grateful.
***Andrew Bailey:*** I remember it well.
**Austin Mitchell:** I was at a meeting with Icelandic owners last Thursday and they were gibbering with gratitude. In fact, I had to suggest to them that their proposal to erect a statue of me in Reykjavik would be better with a statue of Andrew Bailey.
***Andrew Bailey:*** You did offer me trips to fish and chip shops.

**Q45 Austin Mitchell:** Fish and chip shops are grateful too. But it means that I shall not be asking you any critical questions about the Bank of England today, so I want to turn to the Treasury.
***Andrew Bailey:*** You can if you want.
**Austin Mitchell:** I want to ask three simple questions. One is why are we charging the banks a 4.1% rate of interest but charging Ireland 5.9% for that loan? How much are we paying on the money we are borrowing to give those rates of interest to the banks?
***Sir Nicholas Macpherson:*** Sorry, what does your 4.1% refer to?
**Austin Mitchell:** It is in the briefing here. I can turn to it.
***John Ellard:*** It is an estimate of the gilts rate on the investments in the banks, I think.
**Austin Mitchell:** "Lower than long-term gilts (4.2%)".
***Sir Nicholas Macpherson:*** Is this the gilt rate?
**Austin Mitchell:** Yes.
***Sir Nicholas Macpherson:*** That is the rate that the NAO is using to calculate the opportunity cost of the financial interventions. It is not the rate we have charged anybody; it is the rate that implicitly we have charged gilts holders.

**Q46 Austin Mitchell:** What rate are we charging the banks? Is it lower than the rate we are paying to borrow?
***Sir Nicholas Macpherson:*** We are charging the banks extensive fees for any intervention we have made, whether it is the credit guarantee scheme, the special liquidity scheme and so on. So we are not—and I think this Report bears this out—subsidising the banks in terms of the actual return we are seeking from them[1].

**Q47 Austin Mitchell:** Are they paying less than Ireland?
***Sir Nicholas Macpherson:*** Ireland's rate reflects European circumstances, the length of the loan and so on. If we were lending long to banks, I am quite certain we would be paying something reasonably in that territory. Tom, do you want to add to that?
***Tom Scholar:*** Yes, my colleague is absolutely right. For all of our guarantees and other support operations we charge fees, and as the Report says, we have already collected £10 billion in fees. There are three principal loans: one to Northern Rock and one to Bradford & Bingley. Those banks are entirely in public ownership so, in a sense, the loan is from one part of the public sector to another. The third loan is to the Financial Services Compensation scheme. That was a very short-term loan agreed in the crisis that now needs to be extended, and so of course we will be looking at the rate as part of that.
**Chair:** I want to bring Stephen in.
**Austin Mitchell:** Well, hang on.
**Chair:** Can you come back a bit later, Austin, because Stephen wanted to come in on the previous issue before we lose it? I will come back to you, I promise you.

**Q48 Stephen Barclay:** We had just moved on to bonuses, so could I just clarify what representations the Treasury made to UKFI regarding the pay of the new chief executive of Lloyds?
***Sir Nicholas Macpherson:*** The new chief executive of Lloyds?
**Stephen Barclay:** Yes. What representations Treasury made to UKFI.
***Sir Nicholas Macpherson:*** Tom?
***Tom Scholar:*** Well under the general policy framework that I described earlier, hiring the chief executive and everything that goes with that is a decision for the board of Lloyds. Obviously in doing so they consulted UKFI as their largest shareholder. I cannot recall precisely who said what to whom and when, but it was very clear that the Government wanted to see somebody hired who would run the business well.

**Q49 Stephen Barclay:** No, I get all that, but at the recent Treasury Select Committee hearing, the head of UKFI said that Treasury officials made representations to him regarding the pay of the new chief executive of Lloyds. Now what I am trying to understand is, as the two senior civil servants of the Treasury, what were the representations you made?
***Tom Scholar:*** Well the board and UKFI were very keen to hire Mr Horta-Osório, who indeed was hired. That was a very good choice and we are very comfortable with it. We said to them that we would like them to hire him on the lowest possible overall package and clearly a negotiation had to happen. We were not having that negotiation, but the parameters

[1] *See response to Q64 below and para 1.8 & 1.14 of the NAO report Maintaining the financial stability of UK banks: update on the support schemes (HC667)*

were very reflective of what the Prime Minister has said: that he wants to see pay and remuneration in these banks as a backmarker of the market, rather than at the forefront.

**Q50 Stephen Barclay:** What I am trying to understand is how independent UKFI is. So was the Treasury happy with the £8.3 million package he received?
***Tom Scholar:*** Well UKFI as an independent body does not take instructions from us on this. I think the Government welcomed the appointment of Mr Horta-Osório as the right person for the job.

**Q51 Stephen Barclay:** Do you make representations to other major shareholders or just to UKFI?
***Tom Scholar:*** The comments I am referring to I think have been public comments by the Prime Minister, the Chancellor and others and so all shareholders are very well aware of what the Government's position on remuneration in general is.

**Q52 Stephen Barclay:** Sure. What I am confused about is you seem to be facing both ways. Either UKFI is independent—in which case why is the Treasury making representations?—or it is not independent, in which case I would have thought you would be making representations to other major shareholders regarding your stake in RBS, Lloyds and other publicly funded banks.
***Tom Scholar:*** As I said, we did not negotiate the package—

**Q53 Stephen Barclay:** But you did make representations.
***Tom Scholar:*** Well we pointed to the public comments of the Prime Minster and the Chancellor and others.

**Q54 Joseph Johnson:** I would like to go back to the point Sir Nicholas was making about us having a comparative advantage in financial services. We have certainly got a comparative advantage and investors continually supply capital to the sector, which suggests we do have a comparative advantage there. But is it one that generates wealth for those in society as a whole—taxpayers foremost among them—as opposed to just those investors who are continually underwritten by the state? I guess it would be preferable from a taxpayer perspective to have a comparative advantage in a sector that generated wealth for everybody, not just for the people who supply capital to the industry. I wondered whether you think we genuinely do have a comparative advantage in financial services from a taxpayer perspective.
***Sir Nicholas Macpherson:*** I think from a taxpayer perspective we do, because there are huge sections of the financial services sector, in particular in the City of London but also in Edinburgh and elsewhere, that are not subsidised, even on the Bank of England's definition of subsidy, and are generating income and wealth. Now there is a separate question about whether that trickles down to the rest of the population. On the whole, I think it does. It creates demand and it creates income and wealth across the economy. But coming back to your point, clearly none of us wants to see a protected banking system underwritten by the taxpayer where absurd salaries are paid. Coming back to the Vickers commission, I think this is why you have to look at the structure of the industry. If there are monopoly rents that somehow the workers can cream off just like professional footballers cream off economic rent from the Premier League, then you may think that the competition authorities should do something about it.

**Q55 Joseph Johnson:** I guess that leads me on to the follow-on point, which is that banks are global in life, as they say, but national in death. In order for Britain to have this thriving financial services industry operating here and generating wealth in the economy, do we actually have to have the UK taxpayer standing behind them, or could we not move to a system whereby the City of London was effectively more like Wimbledon, where we have lots of foreign players operating here and creating wealth and jobs in the economy, but without the UK taxpayer having to stand behind large universal banks with trillion-pound-plus balance sheets of the likes of RBS, Lloyds, HSBC and Barclays? Can we not let foreign governments take responsibility for underwriting all their balance sheets and just allow the tiny British banks to dart in and out like minnows as they would?
***Sir Nicholas Macpherson:*** That is an interesting point of view and you may want to make that representation to the banking commission. I think these are precisely the trade-offs. My experience with the Icelandic banks is that if you are going to have foreign banks operating here, you certainly want to ensure that they are properly regulated. There is a trade-off. There are some economies of scale in banking that might be a cause of regret if we just ended up with very small banks indeed across the sector.

**Q56 Joseph Johnson:** But in your view does the City of London, to remain a preeminent financial centre, certainly in Europe, need to have large British taxpayer-backed banks or could it retain its competitive advantage as a financial centre just in offering a playing field to the world's banks? Do we need British-backed banks?
***Sir Nicholas Macpherson:*** I think there probably are some benefits in having some British banks, but if the price is that the taxpayer continually has to put his hand in his pocket, then I would question that.

**Q57 Stella Creasy:** I just wanted to come back to Tom's comments about the bankers' bonuses and some of the challenges that you face in terms of attracting people to the industry to deal with some of the issues that we are talking about. How do you square that with the announcement this morning that we have seen in the press about the increase in the bankers' levy? What impact do you think that is going to have?
***Tom Scholar:*** Well you have seen the announcement this morning. The Government had said that the intention back in June in the Budget in introducing the banking levy was to raise £2.5 billion a year from the banking sector through the levy, but given the

uncertainties at the time, it was a transitional rate for the first year. What the Government have concluded, having looked at events since then, in particular with a clearer outlook on the regulatory side and a strengthening banking sector, is that it is now possible and indeed safe to introduce the full levy this year without the transitional period and that is what has been announced this morning.

**Q58 Stella Creasy:** But what impact do you think that is going to have? You said, "Look, the reason we have to pay these people the kind of bonuses we do is that we do not want them to walk away," and yet you are now slapping the banks with another £800 million bill to pay. It does seem slightly disingenuous.
***Tom Scholar:*** Clearly an extra tax will reduce post-tax profits by the amount of the extra tax. Also, I think if taxes were increased ever further, there would come a point at which that would affect the competitiveness of the sector compared to other countries. I do not think we are at that point.

**Q59 Stella Creasy:** So this isn't a long term solution then; this is just a short-term fix because of some of the problems with the Project Merlin negotiations?
***Tom Scholar:*** No, the bank levy is a permanent feature of the system and will raise £2.5 billion a year.

**Q60 Stella Creasy:** From our perspective as shareholders, we have seen this morning that there has been a sell-off of shares as a result of this. How is that going to square with some of the decisions that you say the Treasury is going to make about what is good for the public purse?
***Tom Scholar:*** I do not think that the measure announced this morning would have a long-term impact on share prices across the whole sector.

**Q61 Stella Creasy:** But you have said it could have an impact on the competitiveness of these banks, which obviously will have an impact on some of the issues that Mr Bacon was raising about the competitiveness of the banking industry and some of the concerns that we might have as public taxpayers.
***Tom Scholar:*** Well what the Treasury needs to decide—and the Chancellor needs to make this judgment in successive Budgets in looking where to raise tax to finance public services—is what is both the fairest and the most efficient way of doing that. That is a very difficult question, which is repeated in every budget.

**Q62 Stella Creasy:** How should we judge the value for money of this decision that has been press-released this morning?
***Tom Scholar:*** Well the Government have said that their intention is to raise the maximum sustainable amount of revenue from the banking sector. That was said back in the Budget in June and that is very clear policy. Within that policy, it was judged that it would be possible not to have this transitional first year.

**Q63 Stella Creasy:** But your colleague said obviously there was a trade-off for us in terms of what we would get from the share prices—and as I say, this has now made the share price run—versus what we would get for longer term banking stability and some of the issues Mr Bailey was raising about long term competitiveness in the banking market.
***Tom Scholar:*** You are of course right that in reaching taxation decisions the Chancellor needs to consider what the impact is. Clearly, other things equal, raising the tax on the banking sector is not going to be something that will in general be supporting the share price of banks. But that is a judgment that has to be made.

**Q64 Chair:** Can I move us on and get you back to the schemes we are considering? If I take just the credit guarantee scheme first, you said earlier, Sir Nicholas, that there was not any subsidy. As I read the Report—I may have read it wrongly—the scheme has effectively subsidised the banks to the tune of £1 billion. Page 17, paragraph 1.8. I am assuming that you agree with that.
**Stephen Barclay:** Market prices.
**Chair:** "We estimate this latter benefit is," and so on; it appears at paragraph 1.8. Can you see?
***Sir Nicholas Macpherson:*** I can see it.
**Chair:** Do you accept that?
***Sir Nicholas Macpherson:*** Yes I do accept that. To that extent, I want to correct what I said earlier.

**Q65 Chair:** Thank you for that. In those circumstances, are you thinking of increasing charges—this is all back to protecting the taxpayer's interest—if there is £1 billion playing around here that we are subsidising them? Or is there a way in which you are looking at recouping that subsidy? Reading further into the Report, this scheme is going to go on, because they are not going to be able to raise their money, so they are going to have to refinance through the scheme.
**Ian Swales:** And paragraph 1.7 says, "The fees … were designed to be on a commercial basis". Those words are there in paragraph 1.7.
***Tom Scholar:*** Let me answer this. The fee was set and announced in October 2008, right at the height of the crisis. At that point, the overriding imperative was to avoid the collapse of confidence and provide certainty to banks in the market that they could fund themselves. It was very difficult to know exactly what fee to set. We set one that was both stronger than the minimum conditions set internationally and in fact at the higher end of the spectrum internationally, so we charged more than people did, in general, in other countries. 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. We will certainly look—and are looking—at this issue as we go forward.

**Q66 Chair:** What does that mean? Be more explicit. Are you going to raise fees? What are you actually doing to recoup?
***Tom Scholar:*** Let me refer the Committee to the chart on page 26, which shows the evolution of the scheme. Most of the paper issued in this scheme has been

three-year paper and the scheme closed at the end of February last year, so nothing new has been issued since then. As you see from the chart, gradually this paper is maturing. Now the question that you raised, Chair, is whether we would expect banks to roll over that. They are only allowed to roll over up to one-third within the rules of the scheme, so that is why you see even the maximum possible coming down. My guess, though, is that banks will seek not to renew their funding with a Government guarantee. There is a great interest for the banks themselves in returning to the market, as they are doing. The Report talks about the progress that they are making in funding themselves in the market without Government support and the market is certainly distinguishing between those banks that need Government support and those that do not, so I think it is in the interest of the banks not to roll over that funding.

**Q67 Chair:** I understand that that is clearly what they do not want to do, but if you look at the Bank of England's views on this, that is where I think there might be some tension. Do you believe that that view is over-optimistic? Then back to you, Tom: if it is over-optimistic, are you going to raise the charges so we don't lose a billion quid on it?
***Andrew Bailey:*** We made that comment because frankly we felt that it was important to make it clear to the banks that we thought they had more to do to get themselves into a position where their funding positions were sustainable. We looked, with the Treasury, across all the banks at the assumptions that they were making looking forwards for the next two or three years. We aggregated them as far as we could and we said, "We think you have more to do than your projections would assume." That is the important message in that. I should say that I think to date—and we made this point in the Financial Stability Report that we published just before Christmas—over the course of last year, the banks did what they needed to do to stay on track to come off these schemes and get themselves in the market, funding as they should be.

**Q68 Chair:** So your view now is that they would not want to roll over and carry on having that guarantee?
***Andrew Bailey:*** I am very clear that they do not want to do that.

**Q69 Chair:** No, of course they do not want to, but they will not have to?
***Andrew Bailey:*** I think it is just a case of so far, so good. They have been encouraged to get themselves into this position. I use that word "encouraged" advisedly. They have done that, but they have to keep going. This is not over by any means.

**Q70 Chair:** And then if they come back to us for more guarantee, as they can do, will you ensure that the taxpayer's interest is protected by raising charges?
***Tom Scholar:*** We will certainly ensure that the taxpayer's interest is protected. I would not want to say now what the fee would be.
**Chair:** It is a lot of money.
***Tom Scholar:*** That would depend.
**Chair:** It is a lot of money we have lost.
***Tom Scholar:*** But if they come back for roll-overs, we will certainly re-examine the fee; the circumstances of today are very different from the circumstances of October 2008.

**Q71 Stephen Barclay:** Can I just clarify: are any of the banks benefiting from these taxpayer schemes now paying dividends?
***Tom Scholar:*** I believe that Barclays has paid a dividend and Barclays is certainly one of the banks in the scheme.

**Q72 Stephen Barclay:** So if a bank has rebuilt its capital base and has sufficient money to be giving away back to its shareholders, should it not be speeding up the point at which it pays back the taxpayer?
***Tom Scholar:*** The two schemes that we are talking about here have slightly different rules. Under the special liquidity scheme operated by the Bank of England, the banks do have the option of early redemption. Under the credit guarantee scheme operated by the Government, they do not have that that option; the paper is out there and that is because it is a market-based instrument rather than the Bank of England scheme, which is off-market. So a bank that has CGS paper does not have the option to repay earlier, but what I think all banks are doing is looking at how to get their funding in earlier so that they do not run into the kind of problems that the Report envisages as possible.

**Q73 Stephen Barclay:** So are you satisfied that there is nothing further those banks could do to extricate themselves from Treasury support that they are not doing because they are paying dividends?
***Tom Scholar:*** As I say, with regard to the credit guarantee scheme, they cannot repay it earlier. The question then will be, as and when their paper matures, whether they will be able to fund themselves without further recourse to the Treasury. Clearly that will depend in part on market circumstances, but I think that banks in general are very keen to get themselves off state support.

**Q74 Ian Swales:** They will have the option to roll over still. Despite what Mr Barclay is saying about them paying dividends, they will still have the option to roll over in the scheme, will they?
***Tom Scholar:*** They have the option to request a roll over of up to one third of what they currently have and of course that would be for discussion with the Treasury at the time and that discussion would include the question of the fee.

**Q75 Ian Swales:** And would the Treasury have the power to prevent them rolling over, or is it part of the original agreement?
***Tom Scholar:*** No, it is at the Treasury's discretion.

**Q76 Stephen Barclay:** Can I just clarify, where the taxpayer-supported banks—RBS and Lloyds—are prohibited from paying a dividend for the five-year period, which they cannot do unilaterally, have there been any discussions between the Treasury or Bank

of England and any of those taxpayer-supported banks about a dividend being paid for any period within those five years?
***Tom Scholar:*** They are prohibited under the state aid agreement.

**Q77 Stephen Barclay:** But that is not to say, for example, they could pay a dividend for 2011 in 2012.
***Tom Scholar:*** They are prohibited until, I think, the end of April 2012.

**Q78 Stephen Barclay:** I guess what I am driving at is that unilaterally they cannot do it, but have there been any discussions? Eric Daniels was quoted at some point in terms of making suggestive comments as to the fact that they cannot unilaterally make the decision to pay a dividend. What I am just getting confirmation from you on is, from your point of view in the Treasury, there is no potential for RBS or Lloyds to pay a dividend in terms of business for that five-year period.
***Tom Scholar:*** That is my understanding; it is not an option.

**Q79 Austin Mitchell:** Sir Nicholas said just in passing that he likes to be sure that foreign banks are properly regulated. Now if that is the case, I would refer him to this article in *Vanity Fair.*
**Chair:** We all read *Vanity Fair.*
**Austin Mitchell:** It can be taken into the Treasury under plain cover, Sir Nicholas. What it shows is that all of the Irish banks were run as a gigantic Ponzi scheme to diddle not only foreign markets but the Irish investors as well. I think you should read that article; it is fascinating. But my question is different. The possible threat to stability that most concerns us is instability in the euro and the threat to the Mediterranean economies, primarily, of having some kind of breakdown. Now one wonders what we are doing to stop UK taxpayers having to finance other breakdowns in Eurozone countries. I see that figure 5 on page 19, which actually is not a figure at all—I like pictures in a Report, but this is just dense type—says that there is a financial stability facility with the power to guarantee up to €440 billion and we do not have to contribute to that, because we are not a euro member. But is there not also a requirement—clause 122 in the Lisbon treaty—that we will have to contribute in the event of a breakdown caused by a natural disaster? When our outgoing Chancellor Alistair Darling went to the last meeting after the election, he was told that we would not only have to contribute, but that the decisions there were taken by majority voting. Now that referred to natural disasters, but it has been extended to include disasters within the euro. So isn't there still an obligation to contribute to disasters in the Eurozone under clause 122?
***Sir Nicholas Macpherson:*** Well I do not think clause 122 would apply in future to—

**Q80 Austin Mitchell:** It applies up to May 2013.
***Sir Nicholas Macpherson:*** I think that was using money within the existing spending ceilings of the European Union, which, if it had not been spent on that, could have been spend on something else. But that was a one-off. The Eurozone has developed this facility, which is now—

**Q81 Austin Mitchell:** So it is not connected with the funding to Ireland?
***Sir Nicholas Macpherson:*** I think the European Union has made it clear that it will use the facility in the future, and the facility is financed by the Eurozone countries and we are not liable for it.

**Q82 Austin Mitchell:** We contributed to the loan to Ireland.
***Sir Nicholas Macpherson:*** Well we contributed a loan to Ireland because the Irish economy is inextricably linked with the economy of—

**Q83 Austin Mitchell:** So is the Portuguese.
***Sir Nicholas Macpherson:*** Well no, it is not. Not to the same degree. Ireland is one of our biggest export markets and I think our national interest is tied up with a stable and successful Ireland in a way where, important though Portugal is, it is not.

**Q84 Austin Mitchell:** I would be grateful if you could give us a note on 122 and whether it applies and what it applies to, because it is a complex issue.
***Sir Nicholas Macpherson:*** I am very happy to give you a note on it, but I am confident that—

**Q85 Austin Mitchell:** Thank you. Second question. I was attracted by an article in *The Guardian* this morning by George Monbiot. I read his name as Monoblot because I am very short sighted, but it says that the Treasury is going to change the Tax Acts of 1988 and 2009. This information comes from Richard Brooks of *Private Eye*, who is a very good source. It is going to change it so that large institutions—that means banks primarily—when remitting profits home from overseas operations, will not now be charged the difference between the corporation tax rate they pay in the country where the subsidiaries operate and our higher corporation tax rates. So they will not be charged for that difference in the way they have been up to now. Now this is a massive bonus for the banks and also for multinationals headquartered in Britain. Isn't there an implication that the Treasury has now become so stuck into to the banks and so determined to see them prosper that it is influencing its judgment in respect of tax legislation on the banks? That inference can be made, surely.
***Sir Nicholas Macpherson:*** I simply do not agree with that. Only this morning, the Chancellor of the Exchequer has announced an increase in tax on the banks and let me assure you that the Treasury—

**Q86 Austin Mitchell:** But he is giving them this large loophole on the advice of Treasury.
***Sir Nicholas Macpherson:*** So intent was I on getting here on time that unlike you I have failed to read my copy of *The Guardian* this morning.
**Chair:** Did you read *Vanity Fair*?
***Sir Nicholas Macpherson:*** *Vanity Fair* I shall definitely read.
**Austin Mitchell:** I recommend that you read this, but I think we should have an answer on that.

**Q87 Jackie Doyle-Price:** I just want to come back to this issue of refinancing maturing debts, because I am getting more and more alarmed that the taxpayer is going to have to stand behind the banking system for much longer than we would all like them to. In particular, the Report, at paragraph 3.9, actually highlights that we still have a global problem with the lack of wholesale funding. It actually quotes the IMF as saying that "exits from extraordinary financial system support, including the removal of government guarantees of bank debt, will have to be carefully sequenced and planned". What do you think that means in terms of the time scale of these projects? Obviously your individual schemes have lifespans, but clearly with the ongoing global problem of contraction in credit, we are going to have to be in there longer, aren't we?
***Sir Nicholas Macpherson:*** This is something that we identified as an issue well in advance and the Bank of England has been playing a critical role in encouraging the banks to, in a sense, line up their refinancing in a way that will smooth the exit from the various schemes. Andrew, do you want to expand on that?
***Andrew Bailey:*** Yes. There is also a critical point about the way our schemes work, which is different from a number of other major economies. I will take the Special Liquidity Scheme, because that is the one we deal with. It is not a money lending scheme; it is a scheme by which we have, in effect, with the assistance of the Treasury and the Debt Management Office, swapped assets that the banks held on their balance sheets that were (a) difficult to value at the time and (b) difficult to use to finance themselves with, for Government securities. The reason I say that is that when we unwind that scheme, as we are now doing, we are not withdrawing money from the economy; we are in effect unwinding that facility and saying in simple terms to the banks, "You now go out and finance yourself using your assets rather than HMG's assets". That is a rather different process from taking money out. We are not taking money out. However, as I said earlier, we spent a lot of time in the early part of last summer with the banks going through, in the context of the Special Liquidity Scheme, what was a sensible profile to come out of this thing by the end point, which is actually just under a year from now. We encouraged them to smooth that profile, because frankly the profile—and it has been published—looked too what I would call cliff-like; too much was left to the end. So we encouraged them to do more sooner; that is what has been going on for the last seven or eight months. So far so good, and there is a need to keep doing it.

**Q88 Jackie Doyle-Price:** Ultimately, however, where are RBS and Lloyds going to get these higher deposits from? If they want to reduce their dependence on wholesale funding and want to withdraw from taxpayer support, is it really realistic for that extra capital to come from customer deposits? Where else is it going to come from?
***Andrew Bailey:*** Well there are a number of things going on there. First, as I said, we are not withdrawing money out of the economy; they have to raise the same deposits using their security rather than ours. Secondly, they are both in the process of running down what they term non-core assets, which is frankly the stuff that should never have been on their balance sheets and we certainly do not want on their balance sheets in the future. Of course, when they do that, they reduce the need to fund those assets, so they reduce the balance sheet and that reduces the funding need. The third question is a good one, because there is clearly pressure in this country on retail deposits, in the sense that there is more competition to attract retail deposits. If you look at the rates on retail deposits relative to the risk-free rates, you can see that. Now in one sense that is a good thing in an era of low interest rates for savers. But we do, as you rightly say, have to be very careful—it goes back to the warning we issued that the Chair referred to—that this is not unsustainable competition. That is why we look very carefully at their funding positions constantly.

**Q89 Jackie Doyle-Price:** How is it that America has been able to divest its shareholding of Citigroup so quickly and what can we learn from that?
***Tom Scholar:*** Perhaps I can say something about that. There were two features of the Citi shareholding that are quite different from the situation that we have here. First of all, the Citi share price recovered rapidly from the very low level at which the shares were bought, so that since the summer of 2009 the Citi share price has consistently been above the in-price that the US Treasury paid. So they have had an extended period where it has been possible. Secondly, the actual size of the shareholding was much smaller than either in Lloyds or RBS, so it was possible to do it more quickly.

**Q90 Joseph Johnson:** I just want to go back to the Special Liquidity Scheme and the credit guarantee scheme that Jackie was asking about. What is Barclays' use of these two schemes?
***Andrew Bailey:*** We have not published anybody's use of those schemes. One or two banks have published their own use of the Special Liquidity Scheme in the context of prospectuses to raise debt. I do not think Barclays is one of them. I think you can infer from that and actually you can infer from one or two of the numbers that other banks have used that it is a relatively smaller use of the scheme.

**Q91 Joseph Johnson:** In the absence of these schemes, would Barclays be able to stand on its own two feet in the wholesale funding market, in your opinion?
***Andrew Bailey:*** Are you asking that question today, or when the scheme was introduced?
**Joseph Johnson:** Today.
***Andrew Bailey:*** I think there is every reason to believe, because they are on track to withdraw these schemes smoothly, that they are able to do that.

**Q92 Joseph Johnson:** They are self-funding? They do not need taxpayer-supported schemes?
***Andrew Bailey:*** Well, they are coming off those schemes.

**Q93 Joseph Johnson:** But today? Bob Diamond the other day told the Treasury Select Committee that the time for remorse was over. If he is still using these schemes, is that not premature?
***Andrew Bailey:*** Well we have said that we want, certainly in the context of the SLS, for the scheme to be removed smoothly. So we do not want all the banks to just come off it today, because the wider implications could be disruptive for the overall funding position. So we want them to do it smoothly. I should say also in the context of the SLS that, as the Report says, there is no subsidy in the SLS. They are paying a rate above the relevant reference rate in the market for their continuing use of those.

**Q94 Stephen Barclay:** But also, in terms of the moving on, Barclays took huge amounts from the Fed as well. Barclays took the single biggest loan from the Fed: $47.9 billion in 2008. Barclays was the biggest cumulative borrower from the TAF as well.
**Joseph Johnson:** And when you say small, what are we talking about? Tens of billions? Hundreds of billions? Tens of billions, presumably.
***Andrew Bailey:*** Yes.

**Q95 Joseph Johnson:** Sir Nicholas, when you heard Bob Diamond, the chief executive of Barclays, say that the time for remorse was over, what was your reaction as the head of the Treasury and as a taxpayer, as you told us?
***Sir Nicholas Macpherson:*** I think remorse is a difficult concept and I do not want to get into some great morality discussion, but I think there are still a lot of lessons to learn from this crisis.
**Chair:** That is a very civil service answer.
***Sir Nicholas Macpherson:*** I think all our institution have shown remorse.—I have shown remorse and I would like to think that the FSA and the Bank of England have shown remorse.

**Q96 Joseph Johnson:** Has Bob Diamond shown remorse, do you think?
***Sir Nicholas Macpherson:*** I think some of these institutions should be remorseful too.

**Q97 Joseph Johnson:** Can you think of any way to make him more appreciative of the extent to which the taxpayer continues to subsidise Barclays' cost of capital and his stonking bonuses?
***Sir Nicholas Macpherson:*** Well I am always open to suggestions.
***Tom Scholar:*** I think the work of the Vickers commission will very directly address the question of implicit subsidy that you have rightly raised.

**Q98 Stella Creasy:** So we have to wait until September before there is any contrition?
***Sir Nicholas Macpherson:*** Well you will wait until September to see the Report and I do not know precisely when the Government will take decisions, but decisions there will be.

**Q99 Matthew Hancock:** I just want to come back to the issue of wholesale funding, because Andrew, you said clearly that some assets are being disposed of that perhaps should not have been bought in the first place. But then I would like to bring you back to figure 8 on page 24, which shows the very broadly defined liabilities side of the balance sheet. It shows that senior debt and securities have remained at 44% of RBS's balance sheet from June 2009 to June 2010. Would you not have hoped that in getting rid of some of the assets that allowed RBS to shrink the balance sheet they could have shrunk that bit of the other side of their balance sheet?
***Andrew Bailey:*** I think, frankly, this is a process of several stages. The first stage—and this was absolutely critical, given where RBS got themselves to in October 2008—is to lengthen the maturity of the funding. As we know, they were not just at the cliff edge; they went over it. So the first stage is to lengthen the maturity of the funding. That is critical, because that gets them back from the edge of the cliff. Then as you rightly say the next question is what the right mix of funding is for the balance sheet that they will have in the future once the APS works through and they adjust their balance sheet to what is a sustainable balance sheet. So I would see it as two stages. There is a term issue of funding, which is critical because that is what killed them, and then there is a mix of funding question.

**Q100 Matthew Hancock:** This chart implies that the mix of funding question has not been addressed at all. Is that right?
***Andrew Bailey:*** Yes, and I do not think there is a single objective right answer to that at the moment; we really have to sort out what a sustainable RBS is for the future and therefore what the funding of that sustainable RBS would look like.
***Sir Nicholas Macpherson:*** Just to pick up on that, we all want to see their balance sheets become stronger and they are. But I think implicit in what you were saying is that you might want to see the balance sheet shrink even faster, and there are risks in that.

**Q101 Matthew Hancock:** I was talking about the mix, because I totally understand the macroeconomic risks of trying to reduce the balance sheet too fast, but the mix on this side of the balance sheet. Are you therefore disappointed that the customer deposits, which many regard as a more stable source of funding, have fallen so sharply? We can see that the wholesale funding has fallen; the problem is it has not fallen as a proportion.
***Andrew Bailey:*** Well as I was saying earlier, there is very stiff competition for customer deposits out there at the moment. It is also worth saying, of course, that when you define customer, you may be thinking of man in the street, whereas that is all their customers. So as their balance sheet shrinks and they go to a smaller, more sustainable form, it does of course affect the definition of their customer, so you have to bear that in mind.

**Q102 Matthew Hancock:** You mean if they sell off assets, then some of the liabilities will go with it?
***Andrew Bailey:*** Yes. So you have to bear that in mind. It is not man in the street stuff entirely here.

**Q103 Stephen Barclay:** Just coming in on the bonus point, I think one of the drivers for the high bonuses, we are told, is the fear that people will exit the UK. I was just wondering whether the Treasury has asked the banks for any data about the number of senior executives leaving the UK.
**Chair:** Those earning over £1 million a year, you mean?
**Stephen Barclay:** Whatever level. Just to understand the problem with the banks.
***Tom Scholar:*** We have had quite a lot of examples and anecdotal evidence. We have not got a systematic study.

**Q104 Stephen Barclay:** We know HMRC is not tracking it, in response to FoI questions. I was just wondering whether you had done any actual analysis to see what the trend is and how real a problem it is.
***Sir Nicholas Macpherson:*** There is a wider set of issues around the incidence of taxation and the impact of tax rates on labour mobility. We have had a series of tax changes over the last year or two and I think it is going to be very important to monitor the effects. Are they actually going to raise revenue or is it going to displace labour, which is inevitably more footloose at the high end than it was? It is something we have to pay attention to.

**Q105 Stephen Barclay:** It would just be good to have data on that. I think what flows from that is one of the points that sometimes can be made to constituents: if someone is getting a very high bonus, they are paying a high rate of tax. But were you very concerned given the UBS case—and not least that the current head of UKFI was at UBS at the time—for which they have just paid a big fine for tax avoidance? Are you satisfied that HMRC, which reports into a Treasury Minister, has the right resources focused on potential tax avoidance?
***Sir Nicholas Macpherson:*** I cannot give you chapter and verse around how HMRC is managed, but I think Dave Hartnett, the Permanent Secretary for Tax at HMRC, is fully appraised of the challenge here and we do have a regular dialogue with him.

**Q106 Chair:** I want to move us on a little bit, if I can, to the annual financing costs, which is another issue raised. The Report claims that the cost to us of just financing all this investment is about £5 billion. There does not appear to be transparency of it in terms of showing it as a cost for the stabilisation programme. I just wondered whether you were thinking of putting that right. The Report also says that in the coming year, it will not be covered by the income you get from fees and charges, so what are you doing to try to ensure at least that that is covered?
***Sir Nicholas Macpherson:*** We are certainly open to suggestions on this. We have tried to be very transparent about the direct cost of the interventions, and I think that is reflected in this Report. Making a calculation of the implicit interest rate paid on the borrowing to finance this does require a certain amount of estimation; there are not a certain amount of gilts out there about which we can say, “Yes, those are the bits that were financing the banking interventions”. So I think the NAO acknowledges that this is a by-and-large estimate. Normally when the Treasury spends money on something else, we do not add on the implicit interest rate charge, but I do take the point that we have had to borrow more as a result of these interventions and I would be happy to take away that point. No doubt we will need to respond to your Report in due course.

**Q107 Chair:** Can I ask you another general question? We have a lot of schemes here. We have one scheme that you were thinking of launching called the asset-backed securities guarantee scheme, whatever that was, and it never got off the ground. Did we need that many? Did we need them all? Are there some that you feel on reflection you might not have bothered with? Are there some that worked better than others?
***Sir Nicholas Macpherson:*** Well I think these reports are very helpful and inevitably—this is the point I made last week—some of the interventions we had to come up with very quickly indeed. The credit guarantee scheme was invented really over the course of a weekend. On some interventions like the special liquidity scheme you had invested more time in before they were announced. But we were responding to a very severe crisis and inevitably you were testing the market. Your point about the mortgage scheme where take-up was zero is a very good case in point. There was this view that there was a market failure out there and that banks could not raise finance for supplying mortgages. The Treasury came up with a scheme, no doubt influenced by the work of this Committee and others. We did not want to provide this service for free, and then the banks obviously took a look at it and decided they could raise the money elsewhere more cheaply, which is why they did not resort to us. Now coming back to the earlier part of the conversation, the dust has not settled yet. We are not out of these schemes; we are reviewing them as we go along. But when it is all over, I hope—this may fall to my successors—we will produce a manual about what works and what does not work in a banking crisis. Some of this is still in our collective heads, but we need to save it for posterity. Inevitably, the next banking crisis will not be like this. One of the risks in the coming period is that we all spend our time trying to refight the last war, doing lots of things that make perfectly good sense in relation to the last crisis, but actually make no sense whatsoever in relation to future crises. One thing is for certain: there will be future bubbles. Fear is in the market at the moment, but greed usually wins out in the end. So we need to be ready for whatever lies ahead.
***Andrew Bailey:*** I do not think I can say anything as eloquent as that. I do think the point is right about being prepared for other wars than the one we have just fought. I must have done something wrong in a past life, because I have been involved in bank resolution for about 20 years now and although we did not, of course, support Barings, we were involved behind the scenes. If you take a Barings thing, it is a completely different scenario from the one we have been going through for the last three and a half years. So that is a fairly stark illustration of Nick’s point,

which is that we must be ready to fight a different war next time because it will not be alike.

**Q108 Stella Creasy:** Surely the best form of defence is attack. What are you doing to avoid the next banking crisis? If we have seen the impact on taxpayers so far in some of the costs we are talking about today, it is quite worrying that you are already saying, "Well, this will happen again." It will happen in a different format, I accept, but what are you doing to avoid some of those problems?
***Sir Nicholas Macpherson:*** We are doing an extraordinary amount. Huge swathes of officials, both in the UK and elsewhere, are doing little else other than designing new systems and there is a lot of international co-operation going on. The Government is going to introduce a pretty big Bill reforming financial regulation. It is always tempting to think that this is going to solve it this time, but—

**Q109 Stella Creasy:** That is good to hear; it is just that it stands slightly against some of the measures you are talking about now as the resolution for this financial crisis. For example, you are looking primarily at selling the shares and at what point you sell them. Some of us who come from a co-operative background would like to see the Government exploring mutualisation and perhaps looking at some of the longer, more substantial stabilising measures that you could put in that would answer some of the concerns that Mr Bailey put about the tension between recouping the public purse and a more stable situation. What work have you done on those kind of ideas?
***Sir Nicholas Macpherson:*** Well we have looked quite extensively at mutualisation and we certainly do not want to rule it out.

**Q110 Stella Creasy:** Well obviously selling the shares and being concerned about the share price, as the UKFI is primarily, as you said earlier, would rather preclude it.
***Sir Nicholas Macpherson:*** That is one consideration. If we concluded that turning the RBS into a giant co-operative was a sensible way forward, we would no doubt recommend it. We have looked at it, because we have received a lot of representations, in particular in relation to Northern Rock, about options around mutualisation and I certainly do not want to rule it out. There have been some pretty ropey mutuals. Indeed, Andrew had to deal with one of them fairly recently.

**Q111 Stella Creasy:** But they have on the whole performed better over the course of the last—
***Sir Nicholas Macpherson:*** Some have. We have a real interest in diversity in the sector and we want to see strong mutuals just as we want to see strong plcs. Ideally, none of them should depend either explicitly or implicitly on the taxpayer.

**Q112 Stella Creasy:** So there would be a case, therefore, for perhaps widening the remit of what the UKFI is looking at to take into account that point about public benefit?
***Sir Nicholas Macpherson:*** I think your point should apply to the Treasury. The Treasury needs to look at that. I think the risk about diluting UKFI's focus is that it does need clarity. If they are focusing on the shareholders' interest, we can then rely on the Treasury, no doubt consulting the Bank of England, to look at the bigger picture.

**Q113 Stella Creasy:** But we are all shareholders.
***Sir Nicholas Macpherson:*** We are all shareholders and that is why it is very important.

**Q114 Chair:** Amyas wanted to come in quickly.
***Amyas Morse:*** Despite all the things about not fighting the last war and all that sort of stuff, there has been some very valuable experience garnered and we are now beginning to see a bit of a changing of the guard. So I hope we are going to do things about capturing and preserving knowledge. That is a question but also a statement.
***Andrew Bailey:*** We certainly are, if I could start on that one. One of the very good, key things that has been started in the last year is what I think was originally called living wills for banks and is now called recovery and resolution plans, rather more prosaically but probably a bit more accurately. This is now being embedded into the system of supervising banks, because it is very important when we supervise banks, as a number of us have said, that this must not be a no-failure regime. This comes back to where we started this session this morning. It is important that the system of supervision embeds into it how you deal with a bank when it gets into trouble. That is one of the big lessons out of this crisis. It is rather obvious in a way, but it is a very big lesson. As Nick said earlier, we have got a resolution regime that we did not have when Northern Rock happened and that was a big part of the Northern Rock problem, but we are now busy designing a system of supervision that embeds into it how you deal with a bank when it gets itself into serious trouble.
***Amyas Morse:*** Forgive me, but just to press for a second, it is a bit wider waterfront than that in the experiences. That is important, but what about the experience that the Treasury team has had of living through this alongside yourselves? Are you going to transfer that knowledge in some sustainable way?
***Sir Nicholas Macpherson:*** I have always been very focused on how the Treasury can retain knowledge. One of the challenges for the Treasury is that there is fairly rapid staff turnover. That is part of the Treasury's business model; you want to attract young, enthusiastic, bright people whom you probably are not going to be able to retain in the medium term, because we cannot pay the wages, and you need to retain enough people who have a bit of a folk memory. I am very lucky; I think we were, Andrew, working together at the time of the Barings crisis, so I can remember that. I can also remember working through previous recessions. But there are not huge numbers of people who have that experience, so we are working very hard to instil deeper knowledge management. Indeed, one of the reasons why the quality of the papers you have has improved with each successive Report is that we have an extremely effective knowledge manager, who I think is sitting

behind me. There are lessons there. We are getting better and we need to distil this for future generations.

**Q115 Joseph Johnson:** A bit on the knowledge management and corporate memory in the Treasury point. In the late 1980s, when Nigel Lawson lowered the top rate of tax to 40p, he found that yields went up, ironically. We have gone in the other direction and we have raised the top rate of tax to 50p again. Have you changed, or are you in the process of changing, your estimate of what the marginal increase in the top rate of tax from 40 to 50 will yield this tax year? I think Labour scored £2.7 billion against it.
***Sir Nicholas Macpherson:*** That is a very interesting point. Indeed, I co-ordinated the Budget during the Nigel Lawson era. Now costing is a matter for the independent Office for Budget Responsibility and so we will be ultimately relying on its estimates, but I would expect the evidence base to expand as we go through this year, because bear in mind these changes are only beginning to take effect. Even compared to 1988, global integration has increased considerably and there are risks with tax rates that as you push them up, you get behavioural responses.

**Q116 Joseph Johnson:** And of the 230,000 or so 50p rate payers, how many are bankers and working in financial services? How effectively have we targeted the community that got us into this problem with this higher rate?
***Sir Nicholas Macpherson:*** I cannot give you the answer off hand, but I think quite a lot of these people are in the financial sector.

**Q117 Chair:** That is a really interesting question. Have you got that?
***Sir Nicholas Macpherson:*** I would be happy to see if we have data on the occupations of top-rate taxpayers.
**Chair:** Which would enable us to look at that? That would be really interesting.

**Q118 Austin Mitchell:** If you are going to consider remutualisation, you should look at the Halifax. It would be good to have all those signs saying “Lloyds Banking Group” taken down around Halifax. However, that is not my question. The question is as follows. You have passed these interest shares over to UK Financial Investments Limited, which is presumably another quango. Very naughty, but having done that, you want it to behave like an institutional investor. Now institutional investors, like the big pension funds, can influence bonus policy, for instance, by voting against the remuneration report. Is it envisaged that UK Investments will be enabled by the Treasury to vote against the remuneration reports of any of the banks it is invested in?
***Sir Nicholas Macpherson:*** Yes, it certainly can, and my understanding is that it has been quite active in this particular market. If you are as big an investor as UKFI, in a sense to get to the point where there is an open vote at an annual general meeting is a sign of failure, because you ought to be able to exert your influence before you get there. Tom, do you want to expand on that?
***Tom Scholar:*** UKFI did in fact vote against the remuneration report of RBS in 2009 because it did not agree with what had been done in relation to the pension of the departing chief executive.

**Q119 Austin Mitchell:** So they are not emasculated?
***Tom Scholar:*** No.
***Sir Nicholas Macpherson:*** No.

**Q120 Chair:** Did that change the remuneration package, then?
***Tom Scholar:*** I am afraid not.

**Q121 Chair:** They are emasculated. Thank you very much indeed. That was a really helpful session, so my thanks to all of you. I just wanted to end on this. Amyas asked you about getting the lessons and you said you were looking at that. Have you a time frame in which you will be able to publish a document or report on what you think we have captured out of the interventions we have done so far?
***Sir Nicholas Macpherson:*** I haven’t got a time frame. It would be nice to do it when we have sold the shares, but I recognise that could still be some time off, so there may be a case for an interim report.

**Q122 Stephen Barclay:** Paragraph 19.3 refers to an interim and then the formal.
***Sir Nicholas Macpherson:*** Yes. We are thinking very hard about this and in light of this discussion, I would be happy to expedite our decision on that point.
**Chair:** Thank you very much indeed.

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## Written evidence from HM 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-Ied work on encouraging sufficient professional scepticism into auditors' work. The FRC's Audit Inspection Unit, in their 2009–10 Annual Report[i] 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 1987 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' contribution to prudential regulation*",[iii] is expected soon.

The Treasury, along with BIS, has also been working with the Europeannstitutions 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 ESMJ is designed to safeguard the financial stability of the euro area as a whole [...JArticle 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.

*February 2011*

### References

[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

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