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Treasury Committee

The FSA's report into the failure of RBS

Fifth Report of Session 2012–13

Report, together with formal minutes, oral and written evidence

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Summary

At the end of 2008, with total assets of over $3.5 trillion, the Royal Bank of Scotland (RBS) was the largest bank in the world by assets and the fifth largest by market capitalisation.[1] The failure of RBS in October 2008 gave rise to what HM Treasury (HMT) has described as "the biggest bail-out in history."[2] The Government injected £45.5 billion of equity capital and £282 billion of taxpayers' money was exposed via the Asset Protection Scheme. Following an enforcement process that began in March 2009, the Financial Services Authority (FSA) concluded in December 2010 that the issues investigated did not warrant it taking any enforcement action. It announced this in a one-page press release. The FSA, following pressure from the Treasury Committee, produced *The failure of the Royal bank of Scotland: Financial Services Authority Board Report* in December 2011.

The focus of the Treasury Committee's Report has been to identify areas that may merit further legislative or regulatory change. Our Report also considers the value of the reporting process for understanding the causes of RBS's failure and for ensuring that appropriate lessons have been learnt.

The FSA Report describes a series of failures and misjudgements in supervision ranging from the failure to analyse and understand balance sheet risks relating to capital, liquidity and asset quality, to the decision not to intervene in RBS's calamitous acquisition of parts of ABN AMRO. The failures described in the FSA's Report amount to a serious indictment of senior management not only at RBS but also at the FSA.

The FSA argues that since 2008 it has radically reformed its approach to supervision of large firms. It points to the significant increase in resources devoted to the supervision of high impact firms, a much greater focus than previously on capital and liquidity adequacy and asset quality, and the employment of a more intensive and intrusive style of supervision.[3] The Government and Bank of England should closely examine the changes made at the FSA since 2008 and endeavour to preserve positive features of the post-crisis reforms at the FSA when transferring responsibility for prudential regulation to the Prudential Regulation Authority.

In the absence of pressure from the Treasury Committee the FSA would not have produced this Report into the failure of RBS. This should not have been the case. The Board, and especially the non-executive Directors of the FSA, should have ensured that a comprehensive Report on the failure of RBS was produced without the need for Parliamentary intervention. We expect the non-executive Directors of its successor regulators, the Prudential Regulation Authority and the Financial Conduct Authority, to

1 'World's biggest banks 2009', *Global Finance Magazine*

2 HM Treasury & Department for Business, Innovation & Skills, *The Government response to the Independent Commission on Banking*, December 2011, p 12

3 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 29-30

play a more robust role in ensuring that the two bodies review their own decisions and fulfil their duty to assume accountability for their actions to the public and to Parliament, consistent with the Treasury Committee's previous recommendations in our Reports on *Accountability of the Bank of England* and the *Financial Conduct Authority*.

1 Introduction

1. On 2 December 2010, the Financial Services Authority (FSA) released a 298-word statement announcing that it had completed its supervisory inquiry into Royal Bank of Scotland Group (RBS). It said that:

> The issues we investigated do not warrant us taking any enforcement action, either against the firm or against individuals. [...] The FSA cannot publish the content of the RBS review as information gathered from the bank during the course of the review remains confidential under the Financial Services and Markets Act 2000 (FSMA).[4]

2. In the light of the scale of the failure of RBS and the widespread public interest in understanding the reasons for that failure, the Treasury Committee regarded the statement of the FSA as wholly inadequate. On 13 December 2010, the Chairman of the Treasury Committee wrote to Lord Turner, Chairman of the FSA to request that the FSA reconsider its decision not to publish the findings of its investigation.[5]

3. In response, Lord Turner wrote to the Chairman of the Committee on 15 December and agreed that the FSA would prepare a report for publication.[6] In March 2011 the Committee requested that this report by the FSA, summarising RBS's failure and the FSA's actions in relation to it, be subject to independent external review. Lord Turner, in a letter on 28 March, confirmed that the FSA accepted the need for such a review which would "add value to this process, specifically by providing external assurance that the FSA is being brutally honest about any of its own failings."[7] Sir David Walker and Bill Knight were appointed as specialist advisers to the Committee to undertake independent external review of the FSA's Report in May 2011.[8]

4. On 25 May, the Treasury Committee published a Statement of the Purposes of the Committee and Terms of Reference relating to the independent review of the FSA's

4 "FSA closes supervisory investigation of RBS", FSA Press Notice, 2 December 2010

5 Letter from Chairman of the Treasury Committee to Chairman of the FSA, 13 December 2010

6 Letter from Chairman of the FSA to Chairman of the Treasury Committee, 15 December 2010

7 Letter from Chairman of the FSA to Chairman of the Treasury Committee, 28 March 2011

8 Relevant interests of specialist advisers are as follows:

Bill Knight:

Chairman, Financial Reporting Review Panel

Director, Financial Reporting Council. RBS 2007 Accounts were reviewed by the Panel and FRC corresponded with HM Treasury regarding the Asset Protection Scheme.

Sir David Walker:

Nil

Report.[9] The Statement of Purposes set out the expectations of the Committee as to what the FSA's Report would contain:

> The FSA Report will include analysis of the causes of RBS's failure; a summary of the findings of the FSA investigation into matters relating to RBS's decisions, risk controls and governance processes; and an assessment of the FSA's regulation and supervision of RBS, identifying any deficiencies and actions taken by the FSA subsequently.[10]

The Terms of Reference for the independent review by Sir David Walker and Bill Knight stated that the purpose was:

- To review and report on the extent to which the FSA report is a fair and balanced summary of the evidence gathered by the FSA and PricewaterhouseCoopers during their review of the failure of RBS, and whether it fairly reflects the findings of the FSA's investigation.
- To review and report on whether the FSA's report is a fair and balanced summary of the Authority's own analysis of its regulatory and supervisory activities in the run up to the failure of RBS.[11]

5. On 12 December 2011 the FSA published 'The failure of the Royal Bank of Scotland: Financial Services Authority Board Report'. The Report sets out what the FSA considers to be the primary causes of RBS's failure, and also examines deficiencies in the FSA's regulation and supervision of the firm. It includes a summary of the main points contained in two reports produced by PricewaterhouseCoopers (PwC) in relation to the enforcement investigations conducted by the FSA into RBS, and a summary account of the reasons why no enforcement action was taken.

6. Box 1 provides a summary of what the FSA takes to be the key explanatory factors in the failure of RBS. Box 2 shows extracts from the outline chronology given in the FSA Report to give a timeline of the key events described in the Report. Box 3 summarises the Report's conclusions with respect to RBS's performance, management and culture. On these matters, the Committee notes the similarities between the problems discovered at RBS and the problems with Barclays' board and culture that caused the FSA great concern in early 2012.[12] The FSA Report admits, however, that the degree of supervisory intensity that it applied to RBS's management, governance and culture before the crisis was less than it would now consider appropriate.

9 "Independent Review of Financial Services Authority's report on The Royal bank of Scotland–Terms of Reference", Treasury Committee, 25 May 2011, "The FSA and the collapse of RBS–Statement of the Purposes of the Treasury Committee", Treasury Committee, 25 May 2011

10 "The FSA and the collapse of RBS–Statement of the Purposes of the Treasury Committee", Treasury Committee, 25 May 2011

11 "Independent Review of Financial Services Authority's report on The Royal bank of Scotland–Terms of Reference", Treasury Committee, 25 May 2011

12 See Second Report of the Treasury Committee, 2012–13, *Fixing Libor: some preliminary findings*, HC 481, paras 126–59

7. On the same day that the FSA's Report was issued, the Committee published written evidence on that Report submitted to us by our two specialist advisers.

8. We subsequently took evidence from Sir David Walker and Bill Knight on 24 January 2012 and from Lord Turner (Chairman), Hector Sants, (Chief Executive) and Margaret Cole (Interim Managing Director, Conduct Business Unit) of the FSA on 30 January 2012.

9. We reiterate here our thanks to the Committee's specialist advisers Sir David Walker and Bill Knight, for the immense amount of time and effort they put into reviewing the FSA's Report.[13] We would also like to thank our specialist adviser Richard Andrews for his assistance during this inquiry.

Box 1: Extract from the Executive Summary of the FSA Report outlining the key explanatory factors in RBS's failure[14]

Why did RBS fail?: poor management decisions, deficient regulation and a flawed supervisory approach

The failure of RBS can be explained by a combination of six key factors:

- significant weaknesses in RBS's capital position during the Review Period, as a result of management decisions and permitted by an inadequate regulatory capital framework;
- over-reliance on risky short-term wholesale funding;
- concerns and uncertainties about RBS's underlying asset quality, which in turn was subject to little fundamental analysis by the FSA;
- substantial losses in credit trading activities, which eroded market confidence. Both RBS's strategy and the FSA's supervisory approach underestimated how bad losses associated with structured credit might be;
- the ABN AMRO acquisition, on which RBS proceeded without appropriate heed to the risks involved and with inadequate due diligence; and
- an overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure. RBS was one such bank.

Although poor capital and liquidity regulation made it more likely that there would be a systemic crisis and thus set the context for the failure, and while a flawed supervisory approach provided insufficient challenge, ultimate responsibility for poor decisions must lie with the firm. The multiple poor decisions that RBS made suggest, moreover, that there

13 Sir David Walker resigned as a specialist adviser to the Committee with effect from September 2012

14 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 21-22

are likely to have been underlying deficiencies in RBS management, governance and culture which made it prone to make poor decisions.

Box 2: Key events in RBS's failure and the financial crisis[15]

Timeline of key events	
Date	**Event**
2005	
1 January	Start of Review Period
24 February	RBS announces £6.9bn pre-tax profit for 2004
2006	
28 February	RBS announces £7.9bn pre-tax profit for 2005
May	RBS decides to expand GBM structured credit business
2007	
1 March	RBS announces £9.2bn pre-tax profit for 2006
19 March	Barclays announces intention to bid for ABN AMRO
27 March	RBS decides to bid for ABN AMRO
29 April	RBS receives due diligence information from ABN AMRO
20 July	Hector Sants appointed as FSA CEO
August	RBS VaR models start showing significant back-testing exceptions
9 August	Short-term money markets freeze; 'crisis period' begins
10 August	94.5% of RBS shareholders in favour of the proposed ABN AMRO acquisition
14 September	Northern Rock receives liquidity support from Bank of England
5 October	Barclays withdraws offer for ABN AMRO
17 October	ABN AMRO acquisition is completed
November	RBS added to FSA Watchlist
December 2007 - February 2008	Several major investment banks announce significant write-downs on structured credit assets
2008	
18 February	Supervision Director meets RBS CEO: agreement that capital position is tight
28 February	RBS announces £9.9bn pre-tax profit for 2007 (including ABN AMRO)
19 March	RBS Board agree plan to raise core tier 1 capital ratio
10 April	RBS confirms to FSA that it will proceed with a rights issue
21 April	Bank of England launches Special Liquidity Scheme
22 April	RBS announces capital raising of £12bn
12 May - 2 June	RBS share price falls by 35%

15 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, Appendix 2C, pp310-319

2008	
16 July	RBS share price reaches a low of 165 pence
Mid-July	Evidence of deterioration in available wholesale funding maturities for major UK banks
8 August	RBS announces half-year pre-tax loss of £691m after credit market write-downs of £5.9bn
15 September	Lehman Brothers files for bankruptcy; Bank of America announces purchase of Merrill Lynch
18 September	Lloyds TSB and HBoS announce merger
20 September	Adair Turner takes over as FSA Chairman
25 September	Collapse of Washington Mutual
28 September	Benelux governments announce Fortis bail-out
29 September	RBS share price falls by 13%; government announces guarantee arrangements for B&B
30 September	Irish government announces deposit guarantee for six banks
6 October	RBS share price falls 39%; S&P downgrade RBS's credit ratings
7 October	RBS fails, requiring emergency liquidity assistance; End of review period

Box 3: Extract from the FSA Report Executive Summary: RBS's management, governance and culture[16]

24 Some of the causes of RBS's failure were systemic—common to many banks or the consequence of unstable features of the entire financial system. And a deficient global framework for bank capital regulation, together with an FSA supervisory approach which assigned a relatively low priority to liquidity, created conditions in which some form of systemic crisis was more likely to occur. But with hindsight it is clear that poor decisions by RBS's management and Board during 2006 and 2007 were crucial to RBS's failure.

25 Individual poor decisions can result from flawed analysis and judgement in particular circumstances: many of the decisions that RBS made appear poor only with the benefit of hindsight. But a pattern of decisions that may reasonably be considered poor, at the time or with hindsight, suggests the probability of underlying deficiencies in: a bank's management capabilities and style; governance arrangements; checks and balances; mechanisms for oversight and challenge; and in its culture, particularly its attitude to the balance between risk and growth.

26 It is difficult, from the evidence now available, to be certain how aspects of RBS's management, governance and culture affected the quality of its decision-making, but the Review Team's analysis prompts the following questions, in addition to the conclusion (discussed in paragraph 19) about the ABN AMRO bid:

16 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 26-27

Whether the Board's mode of operation, including challenge to the executive, was as effective as its composition and formal processes would suggest.

Whether the CEO's management style discouraged robust and effective challenge.

Whether RBS was overly focused on revenue, profit and earnings per share rather than on capital, liquidity and asset quality, and whether the Board designed a CEO remuneration package which made it rational to focus on the former.

Whether RBS's Board received adequate information to consider the risks associated with strategy proposals, and whether it was sufficiently disciplined in questioning and challenging what was presented to it.

Whether risk management information enabled the Board adequately to monitor and mitigate the aggregation of risks across the group, and whether it was sufficiently forward-looking to give early warning of emerging risks.

27 Potential areas of concern about RBS's management, governance and culture were identified by the FSA Supervision Team during the Review Period. The degree of supervisory intensity applied to these issues, however, while consistent with the FSA's prevailing practices and approach, was less than the FSA now considers appropriate.

2 The future of prudential regulation

Regulatory and supervisory failure

10. The FSA's Report into the failure of RBS includes a blow by blow account of failures at FSA as well as of those at RBS. It describes an "inadequate regulatory framework", asset quality being "subject to little fundamental analysis by the FSA", the FSA's supervisory approach underestimating possible losses on structured credit products, "poor capital and liquidity regulation", and "a flawed supervisory approach" that "provided insufficient challenge".[17]

11. Mr Sants stated that "the general approach to supervision, and the policy framework that accompanied it that was in place in the FSA before the crisis [...] in relation to overseeing [...] UK banks, was inadequate" and that it was "grossly inadequate; totally unacceptable to me."[18] He described the FSA as operating in silos, with the result that the Executive Committee "did not discuss major supervisory issues."[19] He further noted that the Executive Committee were "not encouraged to question or debate the management approach across the silos."[20]

12. One example of this was that RBS was entirely regulated by the Retail Markets Division of the FSA, which was separate from the Wholesale and Institutional Markets Division, despite the fact that RBS had a very large and rapidly expanding investment banking operation. This division of responsibilities meant that Mr Sants, as Managing Director of the Wholesale and Institutional Markets Division until mid-2007, had no supervisory responsibility for any part of RBS.[21] Furthermore, Mr Sants noted, staff in the Wholesale and Institutional Markets division "had considerable expertise in investment banking activities and they were not able to share their expertise easily with the supervisors in the UK Banks Department."[22]

13. We asked Mr Sants whether he had attempted to work across the institutional silos in the FSA or to complain about the way the institution was organised; he stated that he had indeed complained, but that his offer to oversee some aspects of the regulation of RBS was "not taken up".[23] He said that he had raised his concerns about silos in his regular meetings with John Tiner, the then Chief Executive, and the question of the general quality of management in that area, informally, in the margins in a number of the executive

17 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 21-22

18 Qq 103-104

19 Q 104

20 Q 104

21 Qq 106-108

22 Q 130

23 Qq 109-110

meetings.[24] No record apparently exists of these complaints by Mr Sants. Nor did Mr Sants seek to ensure that his concerns were formally minuted.[25]

14. While acknowledging at many points the multitude of flaws in the FSA's overarching approach to supervision and regulation, the Report argues that the FSA's supervision team for RBS was "largely doing what was expected of it, according to the priorities, processes, practices and approach set by FSA senior management, and working within the constraints of the resources allocated to it."[26] Mr Knight concurred with this assessment, arguing that "by and large, [FSA] officials were doing what was expected of them. It was what was expected of them that was wrong and, therefore, the responsibility has to lie at the top of the FSA."[27]

15. The culpability of senior FSA management for the flawed regulatory framework is explicitly acknowledged in the Report, which states:

> The fact that the Supervision Team was largely doing what was expected of it but was following a deficient supervisory approach, in turn clearly implies however, that the senior management of the FSA who determined those resources, processes and practices must have made design decisions which were, in retrospect, seriously mistaken.[28]

16. This acknowledgement of the culpability of senior FSA management is mitigated, however, by the argument that a good deal of blame for the failure of regulation should be put at the door of the prevailing global regulatory framework, ideological assumptions about the efficiency of markets, and political pressures placed on the FSA. The Report argues that FSA senior management and the Board that oversaw them "made [...] decisions within the context of a widely held, but erroneous, view about the inherent stability of the global financial system, and of political pressure to maintain a 'light touch' regulatory regime to support the competitiveness of the UK financial sector."[29]

17. On 9 February 2010, the FSA announced that Hector Sants would leave the organisation that summer.[30] However, the Chancellor stated in his Mansion House speech on 16 June 2010 that:

> I have asked Hector Sants to remain at the FSA to oversee the transition and become the first new deputy governor and chief executive of the new prudential regulator.

24 Q 133

25 Q 131

26 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 27, p 254

27 Q 76

28 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 254; A list of FSA board members and executive committee members for the Review period can be found on pp 344-345 of this same document [http://www.fsa.gov.uk/library/other_publications/miscellaneous/2011/rbs.shtml].

29 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 254

30 FSA press notice, 9 February 2010, *FSA chief executive officer to step down in the summer*

I am delighted that he has agreed. [31]

The Committee notes that before this decision, made within a few weeks of his becoming Chancellor, he did not put in place the arrangements he has subsequently put in place for the appointment of the Governor of the Bank of England. We would expect such an appointment in future to be made in a transparent manner. On 16 March 2012 the FSA announced that Hector Sants would not be assuming the role of Chief Executive of the PRA and Deputy Governor of the Bank of England with responsibility for Prudential Regulation, as had previously been announced. Instead, the FSA said that Mr Sants would be leaving the organisation at the end of June 2012, "having completed the fundamental design and delivery of the changes needed to achieve the Government's plan to separate prudential and conduct financial regulation in the UK".[32]

18. The Report gives a number of examples of the pressure that the FSA came under from Government to avoid an intrusive supervisory approach. One such example cited by the FSA refers to a Treasury press release dated 24 May 2005, at the launch of the Better Regulation Action Plan. In the press release, the then Chancellor Gordon Brown is quoted as saying "… the new model we propose is quite different. In a risk based approach there is no inspection without justification, no form filling without justification, and no information requirements without justification. Not just a light touch but a limited touch".[33] Another example, used in the FSA Report, refers to a speech on 14 June 2006 by the then Economic Secretary to the Treasury, Rt Hon Ed Balls MP. In the speech Mr Balls said "[...] we must keep the UK's regulatory system at the cutting edge—the best in the world [...] at all times we will apply a principled system of risk-based regulation, without unnecessary administration burdens [...] nothing should be done to put at risk a light-touch, risk-based regulatory regime".[34]

19. The Report further highlights that the FSA management and Board were operating in a context which entailed:

- global regulatory standards which were severely deficient but believed to be appropriate and sophisticated;
- a consensus, among practitioners and policy-makers, which confidently asserted that financial innovation and complexity had made the financial system more stable;

31 HM Treasury, Speech at The Lord Mayor's Dinner for Bankers & Merchants of the City of London by The Chancellor of the Exchequer, The Rt Hon George Osborne MP, at Mansion House, 16 June 2010

32 http://www.fsa.gov.uk/library/communication/pr/2012/028.shtml

33 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 261-2, The full speech can be found at: http://www.hm-treasury.gov.uk/better_regulation_action_plan.htm

34 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 262, The full speech can be found at: http:/www.hm-treasury.gov.uk/speech_est_140606.htm

- a regulatory structure which made the FSA responsible for the entire range of financial regulation issues—from the prudential soundness of major systemically important banks to the conduct of some 25,000 financial intermediaries; and
- a strong focus on the importance of the 'competitiveness' of the UK financial services sector and so of avoiding 'unnecessary' regulation.[35]

20. The FSA Report argues that, within this context, "it is likely that, if the FSA had proposed before the first signs of the crisis (i.e. before summer 2007) the measures that in retrospect appear appropriate, such proposals would have been met by extensive complaints that the FSA was pursuing a heavy-handed, gold-plating and unnecessary approach."[36]

21. The assessment that the global environment provides considerable mitigation for the FSA's approach was supported by Sir David Walker. He noted that "the policy environment globally was massively inadequate", and that the FSA "operated well within that very unsatisfactory environment."[37]

22. **The FSA Report paints a picture of a regulator that was severely unbalanced and with an insufficient focus on prudential issues. The prevailing assumptions about decreased risk in the financial markets, and political pressure, have been cited in mitigation of the regulatory and supervisory failures of the FSA. However, statutory independence was accorded to the FSA to enable it both to offer constructive challenge to established dogma and to resist political pressure. The FSA Report describes failures and inadequacies in the regulation and supervision of capital, liquidity, asset quality and a failure appropriately to analyse the risks relating to the ABN AMRO acquisition. This is a serious indictment of both the senior management and leadership, and in particular the Chairman and Chief Executive, in place at the time, and their predecessors, regardless of the prevailing assumptions and political pressures.**

The FSA as shadow directors

23. Although the FSA does acknowledge its own inadequacies in respect of supervision and the regulatory framework, Lord Turner argues in the foreword to the Report that the decisions that led to RBS's failure were "decisions for whose commercial consequences RBS executives and Board were ultimately responsible."[38] The Report elsewhere highlights that "ultimate responsibility for poor decisions must lie with the firm."[39] In defending the FSA's

35 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 29, see also pp260-262 for a fuller exposition of the FSA's view of the prevailing ideological and political views of the pre-crisis period.

36 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 29

37 Q 7

38 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 6

39 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 22

decision not to intervene more actively in the running of RBS, and in particular not to intervene in RBS's acquisition of parts of ABN AMRO, Mr Sants said:

> The general principle that still prevails, and was certainly prevailing at that point, was that boards take responsibility for running their own firms, and that ultimately the decision for running the firms well rests with the boards and their executive. For the FSA to act as shadow directors, and second-guess the judgements that executives and boards have made, was absolutely not the philosophy prevailing at the time.[40]

24. Sir David supported this, stating that "the deep tradition of supervision and regulation of financial institutions—not just here in the UK but widely—was for the regulator not to become shadow directors on matters of strategy, but to leave these matters to the judgment of the board."[41]

25. In describing changes in the supervisory framework since the crisis, the FSA Report notes that "Supervision of high impact firms now places much greater emphasis on the FSA reaching its own judgement, through detailed investigation, of the risk in firms' strategies and business models, governance (including the size and composition of the board and the challenge it provides), risk management, capital and liquidity."[42]

26. **Mr Sants has maintained that for the FSA to have interfered with the running of banks would have risked acting as a shadow director. We agree that were this to transpire, boards of banks would be less accountable. Boards might attempt to deploy the argument that the regulator had become a shadow director as a defence in any subsequent enforcement action against them. The PRA's use of judgement-based regulation in the future may, at times, also lead to the appearance that the PRA is acting as a shadow director. A similar risk is run by the FCA in undertaking product intervention. We expect both the PRA and the FCA to examine how they will minimise the risk of appearing to act as shadow directors under their new approaches to regulation, and publish their findings.**

Ability of the FSA to take action on acquisitions

27. The clearest failing of the FSA that becomes apparent in reading the FSA's Report is the failure to intervene to stop the bank's disastrous acquisition of ABN AMRO. RBS decided to bid for ABN AMRO as the head of a consortium involving Santander and Fortis in March 2007. It announced the terms of its bid in July 2007, and 94.5% of shareholders voted in favour of the acquisition in August. The acquisition was completed on 17 October 2007. The FSA's Report describes the acquisition of ABN AMRO as "a misjudgement with catastrophic consequences."[43] It states:

40 Q 139

41 Q 80

42 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 286

43 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 407

> The acquisition of ABN AMRO by a consortium led by RBS greatly increased RBS's vulnerability. The decision to fund the acquisition primarily with debt, the majority of which was short-term, rather than equity eroded RBS's capital adequacy and increased its reliance on short-term wholesale funding. The acquisition significantly increased RBS's exposure to structured credit and other asset classes on which large losses were subsequently taken.[44]

28. Sir David Walker highlighted that the largest failure of the FSA was:

> Failing to see that the proposed ABN AMRO acquisition, despite the fact that they had no formal power to stop it, was wholly special and posed questions for capital, liquidity, leverage and risk assessment of a dimension that justified putting a taskforce on to it, which they palpably failed to do.[45]

29. The FSA Report supports this, noting that "the FSA was not sufficiently engaged from April 2007 [...] in testing in detail the potential capital and liquidity implications of the acquisition. Nor did it challenge sufficiently the adequacy of RBS's due diligence."[46] The FSA Report also questioned the judgement of the FSA management in not setting up a review team to examine the risks around the acquisition.[47]

30. As Box 2 shows, RBS announced its decision to bid for ABN AMRO on 27 March 2007. At that stage, Mr Sants sat on the FSA Board as well as the Executive Committee.[48] After his appointment as CEO on 20 July 2007, Mr Sants continued to sit on both bodies through the period of the takeover deal. Mr Sants confirmed the extraordinary fact that within the FSA at the Executive Committee and Board level "there was no discussion, and the then Chief Executive did not convene any discussion, on the merits of the deal. [...] there was no formal consideration of it in the Executive Committee or the Board".[49] **This reflects a grave weakness in the corporate governance of the FSA.**

31. The question remains as to whether, despite the lack of a specific power to halt the acquisition, the FSA could or should have intervened, and if so, when. The FSA Chairman (at that time, Sir Callum McCarthy) and CEO (Mr Sants) considered intervention in September/October 2007, in the early stages of the financial crisis. Mr Sants noted repeatedly in evidence to us that the FSA had no regulatory basis to intervene in the acquisition. He argued that:

> The only basis under which we could have intervened would be if we had concluded that the bank, on completion of the transaction, would not meet threshold

44 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 25

45 Q 7

46 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 25

47 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 28, p 276

48 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 344-345

49 Q 104-105

> conditions. I am absolutely clear [...] that there was no regulatory basis for an intervention. So no, on the information available at that time, it was not possible to intervene at that point after the offer document was published. I did not have the power to intervene.[50]

Mr Knight largely supported the conclusion that the FSA did not have a specific basis on which to intervene in September/October 2007, saying: "They were advised in memoranda, which I have seen, that the capital and liquidity requirements—the legal requirements—would be met following the takeover. So they didn't actually have anything to go on at that point."[51]

32. However, Lord Turner in his foreword to the Report, says that "Arguably the FSA, if really determined, could have blocked the takeover by other less direct means."[52] Sir David Walker also said that the FSA could have intervened indirectly. He argued that:

> One of the indirect things they could have done would have been to set capital buffers, to have set an individual capital guidance level for the combined entity that would have made the transaction commercially unattractive. That was an option that they could have followed.[53]

33. The main tool that the FSA had to influence the level of capital held by firms was setting Individual Capital Ratios or, after 2007, Individual Capital Guidance (ICG).[54] There is however no indication that this was considered as a means of blocking the ABN AMRO acquisition. The Report also acknowledges that, more generally, the FSA did not make use of the ICG tool in 2007, illustrating "a supervisory approach which did not fully utilise the tools available."[55]

34. Sir David acknowledged that there were difficulties in a late intervention:

> If there had been an intervention in August or early September, which would have been a time when technically it would have been possible, this would have destabilised RBS. There is no question that the time for intervention of the kind that we now all see would have been highly desirable, appropriate, necessary, would have been much earlier.[56]

35. He later noted:

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50 Q 118

51 Q 72

52 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 12

53 Q 70

54 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 82

55 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 84

56 Q 13

> It is important to recall that this [September] was relatively late in the process, after 95% plus of the shareholders had voted in favour of the transaction. So for a regulator without direct power to stop it, in the face of such strong shareholder support, would have required a very strong view that liquidity, capital and whatever were a problem. Of course they should have had that sense, but they didn't have it at the time.[57]

36. There was a large degree of consensus among our witnesses that early (before the consortium published its offer on 20 July), and preferably not public, intervention was the only option that would not have been destabilising. It appears that no consideration was given by the FSA to a later intervention, trading off some destabilisation to force reconsideration of what turned out to be a calamitous deal.

37. The regulatory scope for such intervention, although difficult, already existed under existing legislation. Mr Sants noted that even in the absence of changes to the regulatory framework, the FSA is already more proactive in intervening in acquisitions before the intention to acquire is made public:

> When we have deals now notified to us in advance, we have now demonstrated, we have a visible track record, of intervening at a very early stage before offer documents are published, to minimise the risk or even sometimes try to dissuade management from acting. In those cases, it won't have been visible to the marketplace at all. That approach is one that we now take as part of the new proactive supervisory approach.[58]

The Report supports this, stating that: "Since the crisis, Supervision has fundamentally changed its approach to the assessment of major acquisitions, using existing powers far more aggressively."[59] As we have seen with the regulators' recent action to remove Bob Diamond as chief executive of Barclays, a regulator can act even when it does not have a specific power to do so.

38. Nonetheless, the FSA Report recommends "making it a formal requirement that banks obtain regulatory approval for major acquisitions (relative to the size of the acquiring bank)."[60] Mr Sants believed that it would be desirable for the regulator to have a concrete power to intervene in future acquisitions.[61] Mr Knight and Sir David Walker told us that it is "unsatisfactory that existing statutory provision does not require a UK bank of which the FSA is the lead regulator to obtain the specific agreement of the FSA for a proposed

57 Q 72

58 Q 178

59 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 181

60 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 30

61 Q 120

acquisition."[62] In oral evidence, Sir David supported the idea of the regulator having such a power which could be operated at the very outset of an acquisition process. He said that:

> "the regulator should have control, clear control in black letter primary legislation, and the way that control should be operated is right at the front of the process before all this gets into the public domain."[63]

The written evidence from our specialist advisers argued that:

> The existence of a specific statutory power would not only give the lead supervisor a clear locus in the process, facilitating probing and questioning to an extent that may not hitherto have been practicable, but should also promote greater discipline and challenge in the Board's own assessment of the proposed initiative.[64]

39. Mr Knight and Sir David put forward another suggestion with respect to what the process for regulation of acquisitions should entail:

> We would recommend additionally that, as an aid to its own appraisal process of any major acquisition proposition, the supervisor should encourage a board to seek independent external advice. Such advice would be independent in the sense that its remuneration does not depend on completion of the proposed transaction and would be wholly separate from the banking advice and capital markets capability that is applied to and remunerated largely or wholly on completion of the proposed transaction.[65]

40. The FSA appears to support this recommendation; its Report states that "the FSA should consider whether and how the Board of a firm considering a major acquisition should obtain independent advice, from an adviser whose remuneration is not linked to successful completion of the transaction."[66]

41. One further question raised both by the FSA's Report and by Sir David Walker in evidence to the Committee is whether contested takeovers in financial services firms should be allowed at all.[67] The FSA Report suggests that the decision of RBS to "make a bid for ABN AMRO on the basis of due diligence which was inadequate in scope and depth"

62 'Evidence to the Treasury Select Committee by Bill Knight and Sir David Walker, specialist advisers to the Committee in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland', p 4

63 Q 13

64 'Evidence to the Treasury Select Committee by Bill Knight and Sir David Walker, specialist advisers to the Committee in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland', p 5

65 'Evidence to the Treasury Select Committee by Bill Knight and Sir David Walker, specialist advisers to the Committee in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland', p 5

66 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 31

67 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 161, Q 87

was "the inevitable consequence of making a contested takeover, where only limited due diligence is possible."[68] The Report further notes that:

> The level of due diligence conducted was in line with market practice for contested bids. The regime for public contested bids did not (and does not now) make it possible for bidders to insist on more thorough due diligence than RBS conducted. And market practice for contested bids in the UK and other European countries did not (and does not now) require higher standards of due diligence in the case of bank acquisitions than non-banks.[69]

42. The FSA has suggested as an alternative to an outright ban on contested takeovers that as part of a new regime that would require FSA (or PRA) approval for any sizeable acquisition there could be "a strong presumption that major contested takeovers would not be approved, or would only be approved if supported by exceptionally strong capital backing, given that specific risks are created by an inability to conduct adequate due diligence."[70]

43. **The argument put forward in the FSA's Report, that the absence of a formal statutory basis to intervene was sufficient justification for regulatory inaction, was contradicted by the evidence, both of our advisers and of Mr Sants. We support Sir David Walker's conclusion that the FSA should have done more to examine the risks of the deal. It should have intervened at an early stage. It should and could have intervened at a late stage, albeit with more difficulty. Early regulatory examination of such deals now takes place, in the absence of further statutory support. The FSA's failure to assess the risks of the deal represents a serious misjudgement on the part of the supervisory team and the senior management. We need a regulator with the self-confidence to intervene, even if it might cause some destabilisation in the short-term. We recommend that Government include an explicit requirement for the PRA to approve major bank acquisitions and mergers in forthcoming legislation. This should be considered in the context of the Treasury Committee's previous recommendation that the House of Lords consider amending the Bill to make competition an objective of the PRA.**

44. **We note the FSA's and our specialist advisers' recommendation with respect to independent advice being sought in cases of major acquisition, and recommend that this matter be consulted on, and if necessary, included in legislation. Sir David Walker questioned whether contested takeovers are appropriate in the banking sector at all. In such cases, because only limited information on the takeover target may be available, management and the regulator both face difficulties in being able properly to understand, plan and manage capital and liquidity. We recommend that HM Treasury,**

68 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 25

69 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 8

70 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 186

working with the relevant public bodies, report on the legislative or other changes it proposes to make to the current regime regulating acquisitions in the banking sector.

Changes at the FSA since the crisis

45. The FSA's Report argues that since the financial crisis, alongside significant changes in global capital and liquidity regulation, it has significantly overhauled its own supervisory practices. Lord Turner writes in his foreword that "the FSA's approach to supervision has been radically reformed in almost every respect—with more resources, better skills, a more intensive approach and far greater focus on the key prudential issues of capital, liquidity and asset quality."[71] He also notes that when he arrived as Chairman in September 2008, he "found an organisation already strongly committed to learning the lessons of the past and to changing its approach."[72]

46. The FSA Report argues that "the lessons learned from the failure of RBS and from the FSA's deficient supervisory approach [...] have already been reflected in the complete transformation of the FSA's approach to the supervision of the largest high impact firms."[73] Mr Sants supported the view that considerable change has already taken place at the FSA. He said that: "From March 2008 [...] we embarked on a radical change to the entire approach to supervision and a wholesale change to the people involved."[74] The FSA Report supports this, stating that "the vast majority of changes [to the regulatory and supervisory framework] have already been made. This reflects the radical overhaul of the FSA's approach to supervision, and of global regulatory standards, which had begun even before the failure of RBS and has continued since."[75] According to the Report these changes have resulted in:

- Dramatic increases in the scale of total resources devoted to the supervision of high impact firms. RBS is now supervised by a team of 23 people, rather than six in August 2007, just before the onset of the market crisis. In addition, this team is able to draw on greatly increased specialist resources.

- Far greater focus on the core prudential issues of capital adequacy and liquidity, supported by increased specialist skills and informed by far more detailed firm reporting.

- Far greater focus on asset quality issues, including through the use of detailed stress-testing.

71 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 11

72 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 12

73 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 254

74 Q 104

75 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 29

- A more intensive and intrusive style of supervision, with the FSA more willing to challenge management judgements and decisions.

- A far greater focus on the competence and expertise of top management and non-executive directors involving, for instance, pre-approval interviews for all those occupying significant influence functions.[76]

47. Sir Mervyn King, Governor of the Bank of England, in his 2011 Mansion House Speech called into question whether some of the changes undertaken by the FSA were of use. He argued that, "Process—more reporting, more regulators, more committees—does not lead to a safer banking system. [...] Targeted and focussed regulation, allowing senior supervisors to exercise their judgement, does not require ever-increasing resources."[77]

48. The Treasury Committee inquiry into LIBOR in July 2012 led us, on the basis of its dealings early in 2012 with the board of Barclays, to believe that the FSA has recently altered its regulatory approach to a more judgement-led one, in line with what the Governor was advocating. We concluded:

> The messages that Lord Turner and Mr Bailey gave to the Barclays board this year provide evidence of the evolution of a more judgement-led approach on the part of the FSA. Lord Turner said that the change to this approach began as long ago as 2008, and it featured in his Mansion House speech in 2009. Judgement-led regulation is welcome: the FSA has concentrated too much on ensuring narrow rule-based compliance, often leading to the collection of data of little value and to box ticking, and too little on making judgements about what will cause serious problems for consumers and the financial system. In February, though, the FSA judged that it was the overall culture, rather than just a particular behaviour, of Barclays that represented a risk, and so took steps to address this directly. This intervention was not routine or coded. It was a loud and clear expression of the concerns the FSA had about the culture at Barclays and should have been clearly understood by the board. This innovative action is also welcome. The episode shows, however, that judgement-led regulation will require the regulator to be resolutely clear about its concerns to senior figures in systemically important firms.[78]

49. The Financial Services Bill currently before Parliament proposes the establishment of a macro-prudential regulator, the Financial Policy Committee, within the Bank of England, to monitor and respond to systemic risks. It also proposes that the current FSA be split into two bodies: a micro-prudential regulator, the Prudential Regulation Authority (PRA) created as a subsidiary of the Bank of England, and a conduct of business regulator, the Financial Conduct Authority (FCA). Lord Turner argued that the establishment of the

76 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 29-30

77 Speech given by Sir Mervyn King, Governor of the Bank of England At the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 15 June 2011

78 Second Report of the Treasury Committee, Session 2012–13, *Fixing LIBOR: some preliminary findings*, HC 481, para 159

PRA will ensure that a focus on prudential issues is maintained[79], thereby addressing one of the problems currently faced by the FSA which Lord Turner argued is that "the sheer span, from prudential regulation of major banks to the conduct regulation of IFAs [independent financial advisers], is just too much to do".[80] As noted in the FSA's Report the current regulatory structure makes "the FSA responsible for the entire range of financial regulation issues – from the prudential soundness of major systemically important banks to the conduct of some 25,000 financial intermediaries."[81]

50. **While there is a good deal of agreement that the FSA's approach was flawed, there is less agreement about what should replace it, with criticism of some aspects of the new regulatory arrangements proposed by HM Treasury. With the Turner review in 2009, the FSA began adopting several reforms to its supervisory approach, including a move to intensive supervision. However, the new statutory structure proposed in the Financial Services Bill places considerable discretion in the hands of the Bank of England for the conduct of prudential supervision. It appears from the remarks of senior Bank of England executives, that a fundamentally different approach to the task is being developed by the PRA. Outcomes are however what count. The Committee welcomes the emphasis on the exercise of judgement before process.** The Committee notes that the Bank of England published a document outlining the PRA's approach to banking supervision on 15 October 2012, but we have not yet been able to digest it. **The Parliamentary Commission on Banking Standards should examine *The PRA's approach to banking supervision* in the light of our recommendations.**

Making the FSA/PRA Board effective

51. It is clear from the FSA's Report that the FSA Board did not perform adequately in the run-up to the financial crisis. In evidence to us Mr Sants stated that "the Board primarily restricted itself to its policy role of rule making, and took relatively little interest in the supervisory model. In my view, there was very little challenge by the Board of the executive on the way we went about supervision. Clearly, in my view, that was a failing of the Board."[82] Mr Sants went on to note, however, that this had "since been rectified, and in bringing in the new supervisory enhancement programme, the Board rigorously engaged with the executive team as to the nature of that model and whether that model would address the shortcomings of the past."[83] The FSA Report supports the suggestion that the role of the FSA Board has changed considerably since the summer of 2007.[84]

79 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 12-13

80 Q 162

81 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 29

82 Q 154

83 Q 154

84 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 266

52. It is clear that prior to the onset of the crisis the focus of the FSA Board was disproportionately on conduct of business matters at the expense of prudential issues. The FSA Report gives the following figures to illustrate this:

> Looking at the FSA Board minutes, it is noticeable that during the period between January 2006 and July 2007:
>
> - Of the 'major topics' discussed at the FSA Board, one out of 61 related in some way to bank prudential risks and issues.
> - Of items reported to the FSA Board within the CEO's report, one out of 110 related to bank prudential issues either in general or in relation to specific banks.
> - Of 229 items reported by the Managing Director of Retail Markets (who was responsible for the supervision of major banking groups such as RBS), there were five items which in some way concerned bank prudential issues.[85]

53. Sir David Walker entered a plea of mitigation for the performance of the FSA Board leading up to the crisis:

> The FSA board were, like just about everybody else, victims of the intellectual environment. They thought that markets were inherently stabilising and efficient. Many of us certainly were part of that belief, which proved to be wholly erroneous, massively, dangerously wrong. I think that criticism of any board does need to aim off for the fact that the policy environment was one in which the areas of concern that were appropriate for a regulator were to do with conduct, mis-selling, all that stuff, and that the dispersal of risk into the wider markets made the system more whole and stable, which was, as I say, a massive misjudgment.[86]

When asked whether the FSA Board was culpable for what had occurred in relation to RBS, Sir David answered:

> No, not culpable. I think we have to change the policy expectation of what the board [...] does and, therefore, the Committee's views and the legislation in relation to the PRA and so on are hugely significant. In the circumstances of the time, given the pressures that were on the board in other matters to prioritise conduct issues, I think it is quite hard to fault the board.[87]

54. He did, however, support the idea that boards in general needed to change their function:

85 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 264

86 Q 25

87 Q 27

> I would be in the camp of saying that the responsibility of non-executive directors—not only in financial services, which is our focus here obviously—in a board environment, which is after all the most important policy decision-taking entity in the free world after elected bodies like parliaments and councils and so on, is to be much more challenging of the executive proposition in the normal course than has ever been the practice hitherto.[88]

55. It is clear that there are lessons from the RBS failure for how the board of the PRA should be constructed. Mr Knight and Sir David Walker argued that the opportunity presented by the move to the PRA should:

> Be taken to give greater weight than in the past to constituting the regulatory Board at least in part with independent members who can draw on current or immediately recent relevant institutional and market experience.
>
> [...] The benefit for the PRA Board and for the whole regulatory process of having better access to such topical relevant experience should in our view be regarded as outweighing the negative associated with the increased conflict problem on the occasions when specific regulatory decisions were the subject of Board discussion.[89]

56. Mr Sants supported the idea that the PRA Board would need this type of experience: "it is vitally important for the independence that the PRA board do come with current industry experience."[90]

57. **We agree with the suggestion of our specialist advisers that the PRA Board should have independent members with extensive current or very recent market experience. We recognise the potential for conflicts of interest. As we concluded in our Report on the *Accountability of the Bank of England,* the interpretation of what constitutes a conflict needs to be assessed on a case-by-case basis at the time of appointment, and particular conflicts should be dealt with by committees as they arise. When a potential conflict arises in relation to a member of the Board of the PRA, the rest of the Board, led by the Chairman, should therefore exercise its judgement as to how to deal with it, as is standard practice on the boards of major public companies. The exercise of that judgement needs to be supported by a set of rules to which all members of the Board would be required to agree, and which should be published. In response to the Treasury Committee's request in June 2011, the Bank disclosed its code of conduct for members of the Financial Policy Committee.**

Need for higher quality people to deliver higher quality regulation

58. With the move to a separate Prudential Regulation Authority the question arises of how that should be staffed. The importance of having higher quality senior managers and

88 Q 25

89 'Evidence to the Treasury Select Committee by Bill Knight and Sir David Walker, specialist advisers to the Committee in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland', pp 7-8

90 Q 162

staff at the new regulatory bodies is highlighted in the FSA's Report, which notes that "In future it is important that the prudential supervision of the largest UK banks includes significant direct involvement of the most senior PRA and FCA executives."[91] However, two issues were raised in evidence about staffing of the PRA and FCA: What resourcing would be required and the degree to which the PRA should go for a career-regulator approach as opposed to utilising private sector experience.

59. Resourcing the regulator was something that was self-evidently a problem in the pre-crisis FSA. Hector Sants told us that: "the quality and quantity of the supervisory staff that I inherited in the summer of 2007, as well as the procedures and philosophy they were operating to, was inadequate".[92] Mr Sants elaborated that "We had almost no investment banking expertise in the FSA. We had very limited risk analysis expertise in the FSA. We had a very small number of supervisors. [...] We had a very, very small number of competent professionals."[93] The Governor of the Bank of England, Sir Mervyn King, has argued that staff quality is not necessarily dependent on levels of pay:

> People often say that you will have to pay vast sums of money to get people to come and be regulators. I do not believe that is true, and if you do pay vast sums of money you get the wrong people.[94]

60. Mr Sants did, however, make a point of notifying the Committee that the many supervisory staff, in place at the time of the crisis, were no longer at the FSA. He stated: "Of the supervisors intended to transfer to the Bank of England, [...] three-quarters of them did not hold relevant supervisory posts at the time back in the summer [of 2007]".[95]

61. Sir David commented that with respect to the quality of resource at the FSA:

> I think it is better now, but the jury is out on whether it is yet good enough, and we shan't know for some time. It is not enough in these supervisory roles just to throw more accountants or lawyers or former investment bankers and whatever it is into teams. They may have an important role to play, but I think that there is a need for experience and quality of judgment, which in part comes from experience in this area. I think the FSA still have some way to go, as do most regulators on the planet, in getting enough high quality experience into the supervisory process.[96]

62. Many of the supervisory members of staff have left the FSA since the crisis. It is possible that they have taken with them valuable experiences learnt in the heat of the crisis that would have proved useful to the FSA now, and the PRA in the future. Sir David Walker referred to the words of a former Bank of England Governor, who argued that "good

91 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 244

92 Q 126

93 Q 143

94 Oral evidence taken before the Joint Committee for the Draft Financial Services Bill on 3 November 2011, Q 846

95 Q 104

96 Q 36

judgement in banking comes from experience. The trouble in banking is that most experience comes from earlier bad judgement."[97] Mr Sants himself described the crisis as a "searing learning experience."[98]

63. Sir Mervyn King, Governor of the Bank of England, in evidence to the Joint Committee on the Financial Services Bill, also argued in favour of the career regulator model, rather than a model based on secondments from the private sector:

> We want to demonstrate that in the Bank of England it is possible to have a public service career where you specialise in being an effective regulator. [...] It is very striking that in other industries the regulators are not people who take secondments from the industry or have had a career working in the industry; they have expertise as regulators. That is the kind of people we need in the Bank of England.[99]

64. **Even with an FSA budget of around £300 million and around 2,500 staff, Mr Sants told us that the quality and quantity of supervisory staff he inherited in 2007 was inadequate. This state of affairs turned out to be calamitous and points to a further prior failure of management and leadership. High quality supervision is dependent on regulatory staff of sufficient quality and experience. We note the Governor's comments about the desirability of cultivating career regulators. We nonetheless recommend that the PRA ensures that career regulators continue to be supplemented with people that have current or very recent commercial experience. These may be secondees, advisers or permanent employees.**

97 Q 37

98 Q 181

99 Oral evidence taken before the Joint Committee for the Draft Financial Services Bill on 3 November 2011, Q 846

3 Lessons for legislation and regulation

The timing of legislation

65. In the wake of the financial crisis, a considerable amount of activity is taking place at the international level to improve capital and liquidity regulation. The Basel III rules, published in December 2010 and revised in July 2011 will, once implemented, considerably strengthen the global capital framework and introduce a new global liquidity standard.[100] It is worth noting that RBS prior to its failure would not have met either the capital or liquidity standards under the proposed Basel III framework.[101]

66. In the UK, with the Financial Services Bill passing through Parliament, and the prospect of further legislation in the form of the draft Banking Reform Bill to embed the proposals put forward by the Independent Commission on Banking (ICB), the UK authorities are now at a pivotal juncture for ensuring that appropriate lessons have been learnt from the crisis and are being incorporated into the new regulatory framework.

67. **While a swift passage of the Bills would reduce regulatory uncertainty for financial firms, we highlighted the danger of rushing the regulatory reform proposals in our report *Financial Regulation: a preliminary consideration of the Government's proposals in February 2011*. We reiterate here our concerns that the legislation would benefit from more careful Parliamentary scrutiny, especially as paucity of time meant that important parts of the Bill were only discussed in short 'stand part' debates in the Commons Public Bill Committee.**

Enforcement

68. As Lord Turner notes in the foreword to the FSA Report, bank directors bear responsibilities to the public that go beyond those of other private sector directors:

> Banks are different because excessive risk-taking by banks (for instance through an aggressive acquisition) can result in bank failure, taxpayer losses, and wider economic harm. Their failure is of public concern, not just concern for shareholders.
>
> There is therefore a strong public interest in ensuring that bank executives and Boards strike a different balance between risk and return than is acceptable in non-bank companies.[102]

69. We did not take evidence, other than from the FSA, on whether an enforcement action could have taken place; our specialist advisers were specifically excluded from stating a

100 Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011)

101 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, pp 22-23

102 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 9

legal opinion on the FSA's decisions as to whether to bring enforcement actions.[103] The FSA Report states that:

> For legal sanction to be appropriate, it has to be clear that there was strong evidence that individuals broke specific rules, and/or that decisions were made which were not only mistaken in retrospect but were outside the bounds of reasonableness at the time they were taken.[104]

70. The FSA's enforcement investigations concluded that in the case of RBS, these conditions were not met. The report later notes that:

> Enforcement Division does not have the power to take action simply because a failure occurs in an area for which an individual is responsible (i.e. there is no requirement of strict liability). It cannot, therefore, take action against the CEO of a firm simply on the grounds that there were a number of failures at the firm, even though the CEO is ultimately responsible for the actions of the firm.[105]

71. It is clearly not the case, however, that the criteria for enforcement are so stringent that the FSA is unable to successfully pursue enforcement actions at all. The following table illustrates statistics for the FSA's enforcement activity since 2009.[106]

Reporting year (April 1 to March 31)	**2009/10**	**2010/11**	**2011 (as at 31 December 2011)**
Number of fines	186	215	94
Total of fines (£mn)	34.36	86.50	57.88
Public censure only	6	9	9
Criminal outcome	3	6	5
Prohibition	63	62	35
Final notices against individuals	114	121	56

72. Lord Turner, in his foreword to the Report, noted that:

> Starting four years ago, the FSA's Enforcement Division has transformed its approach to enforcement, pursuing cases far more aggressively. The number of

103 Treasury Committee, Independent Review of Financial Services Authority's report on The Royal Bank of Scotland – Terms of Reference

104 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 17

105 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 353

106 Freshfields Bruckhaus Deringer LLP, *Bank of the future: FSA enforcement review*, February 2012

major cases brought has significantly increased: the level of fines has more than trebled in the last three years.[107]

73. In evidence given to this Committee Lord Turner also noted that the current enforcement rules "may bias our enforcement activity to zero in on very specific things that we can prove, even if, seen widely by most reasonable people, they may not be the most important things".[108]

74. The FSA Report describes a series of judgements made by senior executives and the Board at RBS that brought the bank to its knees and ultimately cost the taxpayer a huge amount. It also highlights a profoundly inappropriate regulatory framework that allowed the RBS Board and executives to implement these decisions. **It is a matter of considerable surprise to this Committee that nobody (with the partial exception of Mr Jonny Cameron, RBS Executive Director and Chairman of RBS's Global Banking and Markets Division) has been held meaningfully accountable for the failure of RBS.**[109]

75. **It is deeply regrettable that the current rules bias enforcement activity towards technical breaches to the detriment of attention to the most important regulatory failures. We request that the regulators report to the Treasury Committee on what amendments to the statutory rules and to the general law they believe are desirable in order to improve the effectiveness of the enforcement regime. We also call on the Parliamentary Commission on Banking Standards to examine this issue.**

The SIF screening process

76. Despite the failure of enforcement action in the RBS case, there was considerable optimism amongst our witnesses that the Significant Influence Function (SIF) process for screening candidates for the most senior controlled functions within FSA authorised firms was working well, and provided the FSA with a mechanism to ensure that directors of failed banks could be held accountable for those failures, at least to the extent that they should be unable to work in other regulated firms.[110]

77. In the example of RBS, Hector Sants stated to us: "as far as I am concerned, if any of those individuals applied, I would not consider them to be competent on the basis of the track record demonstrated."[111] Sir David Walker was supportive of the use of the SIF

107 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 8

108 Q 97

109 The settlement with Mr Cameron entailed that he "committed not to perform any significant influence function in relation to any regulated activity or to undertake any further full-time employment in the financial services industry. As part of this settlement, the FSA agreed it would not take any disciplinary action against Mr Cameron. The FSA did not make any findings of regulatory breach against Mr Cameron and he did not make any admissions." The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 33

110 More detail on the FSA's improved SIF screening process can be found in the FSA's Consultation Paper 10/3, *Effective corporate governance* (*Significant influence controlled functions and the Walker review*), January 2010

111 Q 96

process, stating: "I am much in favour of beefing up the SIF process. Maybe the FSA should have even more rigorous interviews of proposed significant influence functions people."[112]

78. Although the current SIF process seems likely to be sufficient to ensure that any director of a failed bank is unable to work at another bank, Hector Sants nonetheless supported the idea of legislative change to make this cast-iron. He stated:

> We should change the regulatory regime to [...] ensure that people who have shown [...] serial misjudgment are not allowed to run financial institutions again. That is absolutely my view, so I entirely support Parliament making changes to the regulatory framework so that we can stop people like this working again, without any confusion or any risk that that would not be the case.[113]

79. Mr Knight was also broadly supportive of the use of the SIF process, though he sounded a note of caution about the need for the process to be used with discretion:

> You can't become a director of a bank without FSA approval. I think that that is the mechanism to use, and if people are involved with failed institutions then the next time that they, as it were, apply for a job I think that has to be taken thoroughly into account and I think the circumstances have to be gone into. After all, they might have fought tooth and nail to do the right thing at that previous institution. I do not think you can just legislate across the board. You have to look at what the individual actually did.[114]

80. As well as ensuring that directors of failed banks cannot be appointed to other roles within the financial sector, the SIF screening process also has the potential to be used to ensure the performance of directors of banks while they are in situ. One recommendation of the FSA Report is that "where concerns arise, the FSA should make greater use of formal Significant Influence Function (SIF) interviews to assess the competence of senior managers already in post."[115]

81. Mr Knight and Sir David in their written evidence to the Committee noted the particular importance of the responsibilities that a bank CEO delegates to other senior executives and recommended that:

> The FSA (and in future PRA) SIF screening process ahead of initial appointment should be complemented by the placing of an explicit obligation on the CEO to attest that he or she is satisfied, on the basis of appropriate and regular performance assessments, that those to whom key responsibilities have been delegated continue to be able to fully discharge them appropriately.[116]

112 Q 54

113 Q 94

114 Q 55

115 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 251

116 'Evidence to the Treasury Select Committee by Bill Knight and Sir David Walker, specialist advisers to the Committee in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland', p 3

82. **For the most senior positions within banks a rigorous approach to SIF screening is appropriate and we commend the FSA's more stringent application of standards relating to SIF screening since the crisis. We recommend that the Government consult on whether additional legislation is required to ensure that directors or other senior executives of failed banks cannot work in other regulated institutions in future, or to make the system more certain. We support the FSA's recommendation that the SIF process be used more vigorously to screen not just applicants for new roles, but also the performance of those already in post.**

83. **We support the emphasis placed by our specialist advisers on the importance of the authority delegated by a bank CEO. Mechanisms are needed to ensure that the CEO of a failed bank can ultimately be held responsible for failures that occur within their organisation. We recommend that the FSA (and future PRA) examine the introduction of additions to the SIF screening process to ensure that a bank CEO is obliged to attest that he or she is satisfied with the performance of the executive team to which he or she has delegated authority.**

Future regulation on sanctions against directors

84. In the foreword to the FSA Report, with reference to the inability of the FSA to bring an enforcement action against individuals at RBS, Lord Turner raised the question: "If harm has been imposed on society, surely someone can and should be held responsible?"[117] If we accept that the FSA, under existing rules, was not able to bring any sanctions against the former employees of RBS, the question, as raised by Lord Turner is: "whether the rules are appropriate: whether the decisions and actions which led to failure should ideally have been sanctionable, and whether we should put in place different rules and standards for the future."[118]

85. While, as noted above, the SIF screening process appears likely to be able to ensure that directors of failed banks are unable to take senior positions in other financial institutions, it is evidently much more difficult to apply punitive sanctions to those directors. Mr Sants highlighted a distinction within the current system about the level of evidence that was needed to bar someone from taking a position in a financial institution versus that needed for the FSA to undertake an enforcement action. He noted:

> The threshold for barring somebody's authorisation is lower, is less demanding, than the threshold for enforcement action. While I can say with confidence that, in my opinion, these people will not work again in the regulated sector in an executive role, it does not automatically follow from that that it means we should have been able to take enforcement action. I am entirely in agreement with you: in order to get the type

117 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 7

118 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 8

> of result that you would like to have, and I think we should have, we need changes to the framework under which we operate.[119]

He noted: "I would like to see the framework under which regulators operate changed so that in future if people demonstrate that type of serial misjudgement, which demonstrates they are not competent, we are able to take action against them."[120]

86. In his foreword Lord Turner suggested that existing laws could be changed to allow sanctions of some sort against directors of failed banks. He proposed the following two possible mechanisms through which this might be achieved:

- A legal sanction based approach, introducing a currently absent 'strict liability' of executives and Board members for the adverse consequences of poor decisions, and making it more likely that a bank failure like RBS would be followed by successful enforcement actions, including fines and bans.

- An automatic incentives based approach. This would not rely on bringing enforcement cases which proved personal culpability, but would rather seek to ensure that executives and Boards automatically faced downside consequences from bank failure. Options here could include:

  - Establishing rules which would automatically ban senior executives and directors of failing banks from future positions of responsibility in financial services unless they could positively demonstrate that they were active in identifying, arguing against and seeking to rectify the causes of failure.

  - Regulating remuneration arrangements of executives and non-executive directors so that a significant proportion of remuneration is deferred and forfeited in the event of failure. Regulations of this form have already been introduced for executive directors: they could be strengthened by increasing both the proportion of pay deferred and the period of deferral.[121]

He went on to note some of the pros and cons of these proposals:

> A 'strict liability' legal sanction based approach raises complex legal issues relating to burden of proof and human rights. It might in particular cases result in injustice, and might discourage some high quality and high integrity people from being willing to work in banks, given the large personal liability involved.

119 Q 96

120 Q 95

121 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 8-9

> Automatic sanctions have the advantage of not requiring expensive and contentious legal processes, but may be insufficient to produce a major shift in personal incentives.[122]

87. Sir David also raised some potential problems with the notion of strict liability:

> The specific question [...] is the proposition, which would be very serious if implemented, to introduce the concept of strict liability. That is to say that directors would be personally liable where things go wrong. It is a large question for debate. I would have a lot of reservations about that [...] I think there would be a question whether you would get directors ready to serve in those circumstances if their personal vulnerability was so great. [123]

He later noted that strict liability might have the effect of concentrating the mind of bank directors, but that:

> You would be concentrating the mind of directors in this country in the way that no other democracy does. This does not exist in the States, in Europe, in Australia, New Zealand or Canada. So it would be a bold departure, which is not a reason for not doing it but it would be very novel.[124]

88. Sir David said that he was more in favour of remuneration measures as a curb on risk taking and on the ability of directors to avoid downside risk:

> I am also much in favour of a thing that is currently being discussed in another context, which is in relation to remuneration. We will leave aside all the debate about say on pay and all that, but I do think there is a strong case for more substantial deferment of pay. I would include in that non-executive directors, so that related to some performance measure their fee for 2012 is not available to them, or in some part not available to them, for three or four years, by which time the company will have demonstrated success or not failure. So I think there are things that could be done that would materially help, which are not strict liability.[125]

89. The FSA Report argues that:

> The FSA's Remuneration Code now requires firms to ensure that their remuneration policies are consistent with sound and effective risk management, do not encourage risk-taking that exceeds the firm's level of tolerated risk, and are in line with the firm's long-term interests. The Remuneration Code includes guidance that, in designing their long-term incentive plans, firms should take account of the potential

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122 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 9

123 Q 54

124 Q 61

125 Q 54

for any links to earnings per share to create an incentive to increase leverage to the detriment of the longer-term health of the firm.[126]

90. While the Remuneration Code represents a step forward in thinking about linking remuneration to incentives for appropriate risk-taking, it is open to question whether it goes far enough. There is also a question about how effective the FSA's monitoring of compliance with the Code can be.

91. In relation to the question of whether non-executive directors should be better incentivised to fulfil their responsibilities and be more accountable for failures on their watch, Sir David noted that "if non-executive directors were required to have skin in the game, in the sense of stockholding in any material way, that might be an interesting departure, but if it were the departure I think they would require higher fees."[127]

92. The Treasury published a consultation paper on possible sanctions for directors of failed banks on 3 July 2012, seeking views by the end of September. This sought views on a proposal to introduce a "rebuttable presumption" that the director of a failed bank was not suitable to be approved by the regulator to hold a position as a senior executive in a bank, and on the possibility of introducing criminal sanctions for serious misconduct in the management of a bank.[128] We expect to examine the Treasury's proposals when they are published, and the Parliamentary Commission on Banking Standards may also wish to do so.

93. **In financial institutions senior executives reaped large rewards, much of it paid as bonuses inflated by taking on what proved to be unsustainable risks. Yet when the crash came, they proved to be insulated from many of the risks on the downside. A great deal has been written about the misalignment of incentives embedded within the financial services framework. We support attempts to remedy this. Proposals include the introduction of strict liability of senior executives and Board members for the adverse consequences of poor decisions and an automatic sanctions-based approach. The introduction of strict liability, however, would be a major change to the existing legal framework and would require full public debate. The Parliamentary Commission on Banking Standards should examine the various options, including strict liability.**

126 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 287, p 291

127 Q 60

128 See http://www.hm-treasury.gov.uk/consult_sanctions_directors_banks.htm

4 Report approach and value

The need for transparency and accountability

94. The financial crisis that began in 2007 had a very serious impact on both the financial system and economy of the United Kingdom. In order to maintain financial stability the Government of the day took unprecedented action: it took ownership of Northern Rock and of part of Bradford & Bingley, and bought large stakes in Lloyds Banking Group and the Royal Bank of Scotland (RBS). These interventions are still weighing on the Government's finances. According to the National Audit Office:

> The total outstanding support explicitly pledged to the banks as at 31 March 2011 is £456.33 billion, down from £612.58 billion as at 31 March 2010, and from a peak of some £1.162 trillion. The total outstanding support is 31 per cent of Gross Domestic Product as at March 2011. Of the total support, £123.93 billion was provided in the form of loans or share purchases, which required a transfer of cash from the Government to the banks. A further £332.40 billion relates to guarantees and other forms of contingent liability where the Government will only provide cash if certain events arise.[129]

95. The sheer scale of the Government intervention as a result of the financial crisis underlines the necessity of properly understanding the causes of the crisis, and the causes of individual bank failures.

96. By far the largest recipient of capital from the Government was RBS, who received a total of £45.8 billion in cash injections during and after October 2008.[130]

97. **In putting out a one-page, 298-word summary of their decision not to take enforcement action against the bank or any individuals after their investigation into RBS, the FSA showed an astonishing lack of appreciation of the understandable public interest in the failure of RBS.** At the time, Lord Turner argued in an opinion piece in the *Financial Times* that:

> The causes of the crisis and the role of ill-designed international regulations, poor supervisory practices and bank risk-taking are well understood. In April 2008 the FSA published a report into the Northern Rock failure and set out, more openly than any other financial authority, the inadequacies of our approach. A complete reform of FSA supervisory approaches followed. Then in March 2009 we published my own Turner Review, which detailed how globally agreed capital adequacy and liquidity

129 HM Treasury, *HM Treasury Annual Report and Accounts, 2010-11*, Certificate and Report of the Comptroller and Auditor General, HC 984, July 2011, p89. The peak figure of £1.162 trillion is the sum of the cash outlay (e.g. for purchasing shares in RBS and Lloyds) and the maximum support pledged (e.g. through schemes such as the Credit Guarantee Scheme and the Asset Protection Scheme) by the Government during the crisis, including amounts that were not used. Schemes under which support was pledged were not necessarily available at the same time, so the peak figure of £1.162 trillion was not available at a single point in time.

130 HM Treasury, *HM Treasury Annual Report and Accounts, 2010-11*, Certificate and Report of the Comptroller and Auditor General, HC 984, July 2011, p93

> rules were woefully deficient pre-crisis, allowing banks to take dangerous risks. The international community is midway through radical reforms to put this right too.
>
> It would be possible to add a report looking just at the RBS story. Such a report would be more comprehensive than the FSA's internal investigation, which focused solely on whether individuals broke FSA rules. But it would add little, if anything, to our understanding of what went wrong.[131]

98. The assessment of Sir David Walker was that putting out a one-page statement was both "unreasonable" and "a mistake".[132] In a letter to the Chairman of this Committee on 11 December 2011 Lord Turner acknowledged the "legitimate public interest in receiving a detailed account of this very major bank failure",[133] and at the time of his appearance before the Treasury Committee on 30 January 2012 he admitted that he had underestimated the strength of public feeling in relation to the RBS failure:

> I entirely accept that what we, and I personally, failed to focus on at the time was that it is important when something has gone wrong that there is a public account of it. We stuck too narrowly to our existing procedures. [...] I wish that back in 2009 I—or other people might have suggested it—had realised that the failure of RBS was such a big thing that we should have a public accountability report. That is what I now believe.[134]

He also agreed with Sir David's assessment that the FSA had made an error, saying that they were "not being imaginative enough in realising that this would require a wider accountability. That was a mistake."[135]

99. The public interest in the failure of RBS in part reflects a desire simply to understand what went wrong. Transparency is also necessary to ensure that Parliament is equipped with the information it needs to ensure that the raft of financial services regulation being proposed at the moment reflects the lessons learnt from mistakes made in the run-up to the crisis. Transparency is, moreover, crucial to our ability as a Committee publicly to hold regulators to account. Hector Sants acknowledged the necessity of this when he appeared before the Committee, stating, "I also strongly believe—and this report and this process is part of it—that the regulators should be accountable for what they have done and the actions they have taken."[136]

100. **There is a clear need in cases of bank failure of the magnitude of RBS for public accountability about how and why that failure has occurred. Where public—that is ultimately taxpayers'—money is used to support a business in the private sector there is a need for a full public explanation. In December 2010 the FSA initially felt that a 298-**

131 Opinion, *Financial Times*, 7 December 2010

132 Q 1

133 Letter from Chairman of the FSA to Chairman of the Treasury Committee, 11 December 2011

134 Q 88

135 Q 90

136 Q 189

word statement about RBS's failure was explanation enough. This reflects serious flaws in the culture and governance of the regulator. It also reflects a fundamental misunderstanding of its duty to account for its actions to the public and Parliament. In view of the vast amounts of public money committed to propping up RBS, Lord Turner's comment that a Report into the demise of RBS "would add little, if anything, to our understanding of what went wrong" was inadequate. He should have grasped the need for a public explanation of how that situation had arisen, something which he has subsequently acknowledged. We would not expect the new chairmen of the regulators to repeat the error.

The review process: efficiency, value for money and objectivity

Value for money and efficiency

101. The FSA Report into the failure of RBS took the form of an internal review (that is, the bulk of the review was conducted by FSA staff), supplemented by the oversight and observations of independent reviewers appointed by the Treasury Committee. The Report therefore not only answers the need for public accountability about the failure of RBS, but also acts as a test-case for this approach.

102. Evidence we received on the approach focussed on two main areas: efficiency and value for money, and objectivity. In his evidence to us, Sir David highlighted one considerable advantage of this approach:

> In relation to the efficiency of the process, my expectation would be that if as an alternative route this Committee or whoever engaged lawyers and accountants to do a full investigation [...] it would have taken a much longer time, perhaps two or three years, not 12 months, and would have been hugely more expensive. It is quite interesting that the FSA review team was a bit more than 10 man-year full-time equivalent and the total cost of that was between £2 million and £3 million. The PwC investigation [which supported the enforcement case] cost very significantly more than that, and that was focused exclusively on the enforcement part of the exercise, not on the history, which probably is of larger interest certainly in bringing the facts to light. So, the cost consideration is also relevant.[137]

103. The original investigation undertaken by PwC to support the possible enforcement action was reported to have taken 19 months and cost £7.7 million.[138] Mr Knight agreed with this assessment. He said that an advantage of this approach was "speed and cost and getting the facts out."[139] He also noted that "experience shows, certainly in the case of

137 Q 16

138 "Royal Bank of Scotland investigation: the full story of how the world's biggest bank' went bust", *The Telegraph*, 6 May 2011

139 Q 22

Companies Act inspections, that such inquiries take a very long time, cost a great deal of money and often are quite noncommittal."[140]

104. The internal review approach may have time-and cost-saving benefits, but Lord Turner did highlight in his evidence to us that it was still a resource-intensive process for the FSA. He noted:

> One of the problems on the whole—although I think this process has been incredibly successful, the combination of an internal process with external reviewers has produced a high-quality report—it is very time consuming for a lot of our best people. It is time consuming at a senior level. It has been very time consuming for myself. So a bit of me thinks that the best thing would be simply to pay somebody else to do it at that stage.[141]

Objectivity and the role of specialist advisers

105. Cost and efficiency are clearly important issues, and there is likely to be a benefit to the report authors having existing institutional knowledge when examining failures in their own organisation. The most difficult question thrown up by having a largely internally written report is whether an organisation is able to be sufficiently self-critical for the report to be meaningful. The Governor of the Bank of England highlighted this issue, saying:

> With respect, one of the great weaknesses of the FSA report was that it was the FSA writing a report on the FSA. I do not think that that is a model for the future, and nor does Lord Turner. In future, if you are going to have reports or oversight, it is rather important that the people whose behaviour you are overseeing are not actually members of the board responsible for that.[142]

106. The Governor's comments go to the heart of the question of whether an internal review can be sufficiently objective to add value. An additional question is whether, even if an internal review is objective, it will be perceived to be so. Despite the Governor's claim that Lord Turner did not think the FSA's Report into the failure of RBS provided a model for the future, Lord Turner's own words seem to suggest otherwise. In a letter to the Chairman of this Committee Lord Turner noted that he believed the FSA's Report "should stand as an exemplar of high quality, dispassionate and, when necessary, self-critical analysis".[143]

107. Our specialist advisers agreed with Lord Turner's assessment of the objectivity of the Report. Sir David noted that he believed the Report was "adequately critical"[144] and summarised his view of the fairness of the FSA Report as follows:

140 Q 22

141 Q 190

142 Oral evidence taken before the Treasury Committee on 17 January 2012, HC 1753, Q 21

143 Letter from Chairman of the FSA to Chairman of the Treasury Committee, 11 December 2011

144 Q 53

> There is nothing [...] that has not been published that in our view has any materiality or which if you had it would lead you or us to reach a different view of the story, the narrative, the account.[145]

Mr Knight acknowledged that "where an institution reports into itself they do have the advantage of being able to put their own point of view"[146] but he felt that despite this the FSA Report "does state the facts" [147] and that the Report "is a good, fair and balanced summary that hides nothing".[148]

108. Nonetheless, the FSA's work in this area was improved by external oversight. In particular, a much greater degree of objectivity in the Report appears to have been secured by the work of the independent specialist advisers appointed by the Treasury Committee. In a letter to the Chair of this Committee Lord Turner highlighted the importance of the external reviewers as follows:

> The role of the external reviewers has been extremely valuable ... if in future there are reports into major financial failure which are produced by the regulator itself, I believe that the device of external reviewers should be used to provide challenge, variety of external perspective, and external assurance that there has been an appropriately self-critical approach.[149]

109. Major changes were made to the report as a result of the specialist advisers' intervention. They highlighted five material areas in which they had suggested alterations to initial drafts of the Report, largely aimed at getting fuller and more detailed explanations of areas they felt were particularly important. The five areas were:

- a fuller explanation of the reasons for selecting the three areas for enforcement investigation;
- greater emphasis on the delegation responsibilities of the RBS CEO and the adequacy of their discharge, in particular in respect of the credit, sales and trading business;
- a fuller description of the nature and degree of involvement of the FSA Board in setting or endorsing the relevant policy approaches of the FSA executive during the review period;
- more detailed review and conclusions on the FSA's response, even within the policy approach and framework at the time, to the exceptional complexity, method of execution and risks inherent in the ABN AMRO acquisition, given the seriously constrained due diligence process that was undertaken; and

145 Q 11

146 Q 16

147 Q 16

148 Q 52

149 Letter from Chairman of the FSA to Chairman of the Treasury Committee, 11 December 2011

- a clearer assessment of the substantive functioning as distinct from the formal process of the RBS Board, in particular in relation to oversight of the very rapid balance sheet expansion in the review period and the ABN AMRO acquisition.[150]

Both our specialist advisers were satisfied that the FSA had adequately addressed the issues they raised in the final Report. They noted that "while the structure, content, editing and conclusions of the FSA Report are the responsibility of the FSA, we were able to comment freely on all aspects of the FSA's review and there are no material points on which our work has led us to disagree with the FSA."[151]

110. The role of the external reviewers was important because of the function they performed in commenting on the various iterations of the FSA's Report during the drafting process. Their role was also significant, however, because the very existence of external reviewers and the knowledge of external oversight is likely to have had implications for the behaviour of the FSA reviewers, encouraging them to be more conscientious in ensuring that the Report was a full and frank examination of the issues relating to RBS's failure.

111. Objectivity of an internally authored report can also be secured by ensuring that it is endorsed by the board of the institution involved, thereby making board members individually and collectively responsible for its content. This point was made by Mr Knight:

> I think it is absolutely vital if you go for this model that the board or the governance of the organisation concerned accepts, individually and collectively, responsibility for ensuring that the report is fair. I think that is absolutely vital. That is what they have done here. The board of the FSA have given us an assurance that in their view this is a fair and balanced account.[152]

112. The FSA Report was reviewed in detail by four of the FSA's Non-executive Directors, who were tasked with "providing direct Board-level scrutiny of the Report and of the independence and objectivity of the processes by which it had been produced."[153] Beyond that, the FSA confirmed in its Report that:

> The Report as a whole, and the judgements made within it, had been reviewed by the full Board.
>
> On the basis of the quality assurance processes described above and its own discussion of key conclusions and judgements, the Board agreed to confirm to the specialist advisers that, in its opinion, the Report represents a fair and balanced summary of the evidence gathered by the FSA and by PwC during their review of the

150 Evidence to the Treasury Select Committee by Bill Knight and Sir David Walker, specialist advisers to the Committee in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland', p 2

151 'Evidence to the Treasury Select Committee by Bill Knight and Sir David Walker, specialist advisers to the Committee in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland', p 2

152 Q 21

153 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 18

> failure of RBS, that it fairly reflects the finding of the FSA's investigation and that it is a fair and balanced summary of the FSA's analysis of its regulatory and supervisory activities in the run-up to the failure of RBS.[154]

113. **The FSA's Report into the failure of RBS was largely written by FSA staff, with additional scrutiny being provided by the Treasury Committee's specialist advisers Sir David Walker and Bill Knight. We believe that this model has proved successful in giving our Committee and the public a reasonable degree of confidence that we now have a true and fair picture of what went wrong at RBS. We also have a better grasp of the failings of the FSA.**

114. **A report produced by an organisation into itself will not be completely free from subjectivity. However, the appointment of external reviewers in this case appears to have improved the report and greatly improved its objectivity.**

115. **The work of the independent external reviewers appointed by the Treasury Committee enabled Parliament to scrutinise a powerful regulator in a new way. The approach sets a precedent for the Treasury Committee in the future, and it may also be of use to other select committees.**

116. **Although the FSA board endorsed the Report, non-executive directors of the FSA should have held the FSA's executive to account and themselves commissioned a review of the Authority's performance, as routinely happens within the private sector. The collapse of RBS should have been a prime candidate for such retrospective internal review. We have recommended in our Report on the Financial Conduct Authority that legislation provide for the Treasury Committee to request retrospective reviews of the future FCA's work. We would not, however, expect a properly functioning board to need such prompting from Parliament to conduct such reviews. We will expect non-executive directors of the future PRA and FCA to ensure that regular reviews of performance are undertaken and that appropriate governance structures are in place to support them in this task.**

The value of further reports from the FSA into the crisis

117. As noted above, the FSA's report into the failure of RBS has value in that it meets the need for public accountability. When questioned about the value of the Report to the FSA in terms of learning lessons, Lord Turner said:

> If we go back to what the lessons learned from this report are, many of them we knew already. The basic fact that the capital and liquidity regimes were, to be blunt, rubbish, we knew already, and we were putting them right. The supervisory approach was wrong and we were putting that right.

154 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p 19

> When we produced this, I strongly urged all staff members to read it, particularly those going to the PRA. We have something here that all prudential supervisors, at least for the next 10 years, ought to read as part of their training programme. Indeed, all non-executive directors of banks ought to read it, because I think, when you have a lengthy and, I believe, high-quality report of what went wrong, there are a lot of lessons that you can get out of it, and they just tell you the story of a bank that made a collection of mistakes that reached a failure. That is very important for people to read.[155]

118. Sir David supported this opinion, stating that "having done this exercise, there emerged matters of understanding that have been hugely beneficial for the regulator [...] I would think the regulator has learned a huge amount from this process."[156]

119. In acknowledging that there are "a lot of lessons that you can get out of" the FSA's Report,[157] Lord Turner seems to have had a welcome change of mind from his earlier assertion that a report into the failure of RBS would "add little, if anything, to our understanding of what went wrong."[158] Recommendations for further change to the supervisory structure, in addition to proposals for change identified through earlier work, such as the FSA's internal audit report on the failure of Northern Rock and the Turner Review[159], are identified at the end of each section of Part 2 of the FSA's Report and summarised in Appendix 2A, Table 2.[160]

120. HBOS was another major bank which failed during the financial crisis. Lord Turner committed the FSA to the production of a report once its enforcement action had been completed, stating that the FSA had:

> Put in place a small data gathering team. They will not write down anything that is a judgment, because we cannot do that without potentially prejudicing the enforcement process, but we are going through the process of gathering together the files, doing some of the straightforward calculation analysis that we did with RBS on capital and liquidity, having done it before, so that as and when we get beyond the enforcement case—but I do stress we have no control over the overall timescale of that—we will be in a position to launch it.[161]

121. On 9 March 2012, the FSA announced that its investigation of the firm itself had been completed and that the FSA judged that HBOS had been guilty of very serious misconduct. Given the exceptional circumstances of the firm being part-owned by the taxpayer, the FSA

155 Q 189

156 Q 49

157 Q 189

158 Opinion, *Financial Times*, 7 December 2010

159 The Financial Services Authority, *Internal Audit Division, The supervision of Northern Rock: A lessons learned review*, March 2008; The Financial Services Authority, *The Turner Review: A regulatory response to the global banking crisis*, March 2009

160 The Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, Part 2, and Appendix 2A, Table 2 pp 300-302

161 Q 190

decided not to levy a fine, but instead issued a public censure.[162] On 12 September 2012 the FSA concluded its remaining enforcement action in relation to HBOS when it fined Peter Cummings, former executive director of HBOS plc and chief executive of its Corporate Division, £500,000 and banned him from holding any senior position in a UK bank, building society, investment or insurance firm.[163] Following that announcement the Treasury Committee wrote to Lord Turner as follows:

> We will require of the FSA the same comprehensive assessment of the reasons for the bank's failure, and of the FSA's conduct, as was case with RBS. External advisers, appointed by the Committee, should again be employed during the drafting process to provide assurance that the report is a fair and balanced reflection of the evidence. We will need to discuss whom to appoint. The report should cover the reasons for, and the consequences of, both the Lloyds/HBOS merger and the earlier Bank of Scotland/Halifax merger.[164]

On 28 September 2012 Lord Turner replied to the Committee that:

> On the report, the most important next step will be to agree the Terms of Reference and governance arrangements. The FSA Board has created a sub-committee to overview the development of the report: this Committee will be chaired by Sir Brian Pomeroy who also chaired the sub-committee which oversaw the production of the RBS report, and who in the course of that liaised extensively with Sir David Walker and Bill Knight. [...]
>
> Your letter set out the Committee's desire to appoint external reviewers, as with the RBS report. As you know, my letter to you of 11 July 2011, which said that we believed we should produce an HBOS review once we had completed the legal enforcement [process], also stated that the external reviewers had played an extremely useful role on the RBS report, and that we should use this device again on the HBOS report. [...][165]

The Committee and the FSA will discuss further the details of how the report on the failure of HBOS will be undertaken.

122. **The FSA Report into the failure of RBS, alongside previous reports on other aspects of the financial crisis and pre-crisis regulation, highlights the respects in which pre-crisis regulation was misguided. The document will be of long-term value for those involved in the regulation and corporate governance of banks. A similar exercise in relation to the failure of HBOS will now be undertaken.**

162 "FSA publishes censure against Bank of Scotland plc in respect of failings within its Corporate Division between January 2006 and December 2008", FSA Press Notice, 9 March 2012

163 See http://www.fsa.gov.uk/library/communication/pr/2012/087.shtml

164 Letter from Chairman of the Treasury Committee to Chairman of the FSA, 13 September 2012

165 Letter from the Chairman of the FSA to the Chairman of the Treasury Committee, 28 September 2012

Reports from other bodies

123. In the absence of pressure from the Treasury Committee the FSA Report into the failure of RBS would never have been produced. Lord Turner asserted, however, that the FSA has set out "more openly than any other financial authority" the inadequacies of their approach prior to the financial crisis.[166]

124. HM Treasury has gone some way to addressing this with the publication of an internal report on their performance during the crisis entitled *Review of HM Treasury's management response to the financial crisis*[167], which this Committee will examine in due course.

125. The Bank of England has been much more reluctant to undertake a similar 'lessons learned' review, despite multiple requests from the Treasury Committee for them to do so. In a letter to the Chairman of this Committee the Governor of the Bank of England argued that "the way the Bank used the tools available to it in the first phase of the crisis has been thoroughly reviewed and that far-reaching reforms have been made."[168] He noted that the only tool available to the Bank in dealing with the crisis was its balance sheet and that:

> The Bank's balance sheet, was, and is, used to achieve two objectives: the implementation of monetary policy decisions taken by the Monetary Policy Committee, and to provide liquidity insurance to commercial banks. It proved challenging in the very first phase of the crisis to meet either of these obligations.
>
> In response, the Bank conducted a major review of, and consultation on, the use of its balance sheet.[169]

126. The consultation to which the Governor referred set out proposals for the development of the Bank of England's market operations.[170] It suggested improvements to existing operations which were designed to respond better to the stressed market conditions prevailing at the time. Following the publication of this document the Bank implemented a number of changes to its operations. In addition, a number of the extraordinary operations that were put in place by the Bank, such as the Special Liquidity Scheme, were significant in preventing further failures in the financial sector. The Governor noted in his letter of 31 January 2012 to the Chairman of this Committee that all of the actions taken by the Bank to revise its operations since the crisis had been set out in published documents.[171] While this is the case, these documents do not constitute a thorough review of the Bank's response to the crisis. This remains to be done.

166 Opinion, *Financial Times*, 7 December 2010

167 HM Treasury, *Review of HM Treasury's management response to the financial crisis*, March 2012

168 Letter from Governor of the Bank of England to Chairman of the Treasury Committee, 31 January 2012

169 Letter from Governor of the Bank of England to Chairman of the Treasury Committee, 31 January 2012

170 Bank of England, *The Development of the Bank of England's Market Operations : A consultative paper by the Bank of England*, October 2008

171 Letter from Governor of the Bank of England to Chairman of the Treasury Committee, 31 January 2012

127. In the same letter the Governor hinted at the two other arguments previously deployed by the Bank to suggest that it should not be obliged to undertake a comprehensive review. First, that many of the actions undertaken by the Bank during the crisis were in fact decided upon and implemented by the Bank, FSA and HMT so any review should not be done by the Bank but by an external body examining all three members of the tripartite.[172] Secondly, that while there was still a crisis continuing, it was not appropriate to devote the time or resources to undertaking an internal review.[173]

128. These arguments, particularly the latter, may have merit, but they were significantly undermined when, on 21 May 2012, the Bank of England announced that its Court had commissioned three reviews into areas of the Bank's performance during the financial crisis. The reviews are being led by independent external experts, supported by Bank staff, and cover the following areas: the provision of Emergency Liquidity Assistance in 2008/9; the Bank's framework for providing liquidity to the banking system as a whole; and the Monetary Policy Committee's forecasting capability.[174] They are expected to conclude in October 2012 and the Committee will examine these reviews in due course.

129. **HM Treasury has published a review of its performance during the crisis, which the Treasury Committee will review in due course. The Bank of England has also belatedly announced a number of reviews examining aspects of its own performance in this period. While this represents some progress, it falls well short of what is required. A comprehensive review of the Bank's role in, and response to, the crisis is needed and we will return to this issue after publication of the three reviews commissioned by the Court of the Bank of England. Moreover, by waiting so long before conducting any review, the Bank of England has diminished its value as a guide to better regulation for the future. Any lessons learned as a result of even these limited reviews will also only be available in a very late stage in Parliament's consideration of the Financial Services Bill. Incorporation of them into legislation may therefore be more difficult and this is regrettable.**

172 "Sir Mervyn King scrutinised as Bank of England orders review," *The Telegraph*, 21 May 2012

173 Letter from Governor of the Bank of England to Chairman of the Treasury Committee, 31 January 2012

174 "Court of the Bank of England commissions a set of reviews to learn lessons", Bank of England Press Notice, 21 May 2012

Conclusions and recommendations

The future of prudential regulation

1. The FSA Report paints a picture of a regulator that was severely unbalanced and with an insufficient focus on prudential issues. The prevailing assumptions about decreased risk in the financial markets, and political pressure, have been cited in mitigation of the regulatory and supervisory failures of the FSA. However, statutory independence was accorded to the FSA to enable it both to offer constructive challenge to established dogma and to resist political pressure. The FSA Report describes failures and inadequacies in the regulation and supervision of capital, liquidity, asset quality and a failure appropriately to analyse the risks relating to the ABN AMRO acquisition. This is a serious indictment of both the senior management and leadership, and in particular the Chairman and Chief Executive, in place at the time, and their predecessors, regardless of the prevailing assumptions and political pressures. (Paragraph 22)

2. Mr Sants has maintained that for the FSA to have interfered with the running of banks would have risked acting as a shadow director. We agree that were this to transpire, boards of banks would be less accountable. Boards might attempt to deploy the argument that the regulator had become a shadow director as a defence in any subsequent enforcement action against them. The PRA's use of judgement-based regulation in the future may, at times, also lead to the appearance that the PRA is acting as a shadow director. A similar risk is run by the FCA in undertaking product intervention. We expect both the PRA and the FCA to examine how they will minimise the risk of appearing to act as shadow directors under their new approaches to regulation, and publish their findings. (Paragraph 26)

3. This reflects a grave weakness in the corporate governance of the FSA. (Paragraph 30)

4. The argument put forward in the FSA's Report, that the absence of a formal statutory basis to intervene was sufficient justification for regulatory inaction, was contradicted by the evidence, both of our advisers and of Mr Sants. We support Sir David Walker's conclusion that the FSA should have done more to examine the risks of the deal. It should have intervened at an early stage. It should and could have intervened at a late stage, albeit with more difficulty. Early regulatory examination of such deals now takes place, in the absence of further statutory support. The FSA's failure to assess the risks of the deal represents a serious misjudgement on the part of the supervisory team and the senior management. We need a regulator with the self-confidence to intervene, even if it might cause some destabilisation in the short-term. We recommend that Government include an explicit requirement for the PRA to approve major bank acquisitions and mergers in forthcoming legislation. This should be considered in the context of the Treasury Committee's previous recommendation that the House of Lords consider amending the Bill to make competition an objective of the PRA. (Paragraph 43)

5. We note the FSA's and our specialist advisers' recommendation with respect to independent advice being sought in cases of major acquisition, and recommend that this matter be consulted on, and if necessary, included in legislation. Sir David Walker questioned whether contested takeovers are appropriate in the banking sector at all. In such cases, because only limited information on the takeover target may be available, management and the regulator both face difficulties in being able properly to understand, plan and manage capital and liquidity. We recommend that HM Treasury, working with the relevant public bodies, report on the legislative or other changes it proposes to make to the current regime regulating acquisitions in the banking sector. (Paragraph 44)

6. While there is a good deal of agreement that the FSA's approach was flawed, there is less agreement about what should replace it, with criticism of some aspects of the new regulatory arrangements proposed by HM Treasury. With the Turner review in 2009, the FSA began adopting several reforms to its supervisory approach, including a move to intensive supervision. However, the new statutory structure proposed in the Financial Services Bill places considerable discretion in the hands of the Bank of England for the conduct of prudential supervision. It appears from the remarks of senior Bank of England executives, that a fundamentally different approach to the task is being developed by the PRA. Outcomes are however what count. The Committee welcomes the emphasis on the exercise of judgement before process. (Paragraph 50)

7. The Parliamentary Commission on Banking Standards should examine The PRA's approach to banking supervision in the light of our recommendations. (Paragraph 50)

8. We agree with the suggestion of our specialist advisers that the PRA Board should have independent members with extensive current or very recent market experience. We recognise the potential for conflicts of interest. As we concluded in our Report on the Accountability of the Bank of England, the interpretation of what constitutes a conflict needs to be assessed on a case-by-case basis at the time of appointment, and particular conflicts should be dealt with by committees as they arise. When a potential conflict arises in relation to a member of the Board of the PRA, the rest of the Board, led by the Chairman, should therefore exercise its judgement as to how to deal with it, as is standard practice on the boards of major public companies. The exercise of that judgement needs to be supported by a set of rules to which all members of the Board would be required to agree, and which should be published. In response to the Treasury Committee's request in June 2011, the Bank disclosed its code of conduct for members of the Financial Policy Committee. (Paragraph 57)

9. Even with an FSA budget of around £300 million and around 2,500 staff, Mr Sants told us that the quality and quantity of supervisory staff he inherited in 2007 was inadequate. This state of affairs turned out to be calamitous and points to a further prior failure of management and leadership. High quality supervision is dependent on regulatory staff of sufficient quality and experience. We note the Governor's comments about the desirability of cultivating career regulators. We nonetheless recommend that the PRA ensures that career regulators continue to be supplemented with people that have current or very recent commercial experience. These may be secondees, advisers or permanent employees. (Paragraph 64)

Lessons for legislation and regulation

10. While a swift passage of the Bills would reduce regulatory uncertainty for financial firms, we highlighted the danger of rushing the regulatory reform proposals in our report Financial Regulation: a preliminary consideration of the Government's proposals in February 2011. We reiterate here our concerns that the legislation would benefit from more careful Parliamentary scrutiny, especially as paucity of time meant that important parts of the Bill were only discussed in short 'stand part' debates in the Commons Public Bill Committee. (Paragraph 67)

11. It is a matter of considerable surprise to this Committee that nobody (with the partial exception of Mr Jonny Cameron, RBS Executive Director and Chairman of RBS's Global Banking and Markets Division) has been held meaningfully accountable for the failure of RBS. (Paragraph 74)

12. It is deeply regrettable that the current rules bias enforcement activity towards technical breaches to the detriment of attention to the most important regulatory failures. We request that the regulators report to the Treasury Committee on what amendments to the statutory rules and to the general law they believe are desirable in order to improve the effectiveness of the enforcement regime. We also call on the Parliamentary Commission on Banking Standards to examine this issue. (Paragraph 75)

13. For the most senior positions within banks a rigorous approach to SIF screening is appropriate and we commend the FSA's more stringent application of standards relating to SIF screening since the crisis. We recommend that the Government consult on whether additional legislation is required to ensure that directors or other senior executives of failed banks cannot work in other regulated institutions in future, or to make the system more certain. We support the FSA's recommendation that the SIF process be used more vigorously to screen not just applicants for new roles, but also the performance of those already in post. (Paragraph 82)

14. We support the emphasis placed by our specialist advisers on the importance of the authority delegated by a bank CEO. Mechanisms are needed to ensure that the CEO of a failed bank can ultimately be held responsible for failures that occur within their organisation. We recommend that the FSA (and future PRA) examine the introduction of additions to the SIF screening process to ensure that a bank CEO is obliged to attest that he or she is satisfied with the performance of the executive team to which he or she has delegated authority. (Paragraph 83)

15. In financial institutions senior executives reaped large rewards, much of it paid as bonuses inflated by taking on what proved to be unsustainable risks. Yet when the crash came, they proved to be insulated from many of the risks on the downside. A great deal has been written about the misalignment of incentives embedded within the financial services framework. We support attempts to remedy this. Proposals include the introduction of strict liability of senior executives and Board members for the adverse consequences of poor decisions and an automatic sanctions-based approach. The introduction of strict liability, however, would be a major change to the existing legal framework and would require full public debate. The Parliamentary Commission on Banking Standards should examine the various options, including strict liability. (Paragraph 93)

Report approach and value

16. In putting out a one-page, 298-word summary of their decision not to take enforcement action against the bank or any individuals after their investigation into RBS, the FSA showed an astonishing lack of appreciation of the understandable public interest in the failure of RBS. (Paragraph 97)

17. There is a clear need in cases of bank failure of the magnitude of RBS for public accountability about how and why that failure has occurred. Where public—that is ultimately taxpayers'—money is used to support a business in the private sector there is a need for a full public explanation. In December 2010 the FSA initially felt that a 298-word statement about RBS's failure was explanation enough. This reflects serious flaws in the culture and governance of the regulator. It also reflects a fundamental misunderstanding of its duty to account for its actions to the public and Parliament. In view of the vast amounts of public money committed to propping up RBS, Lord Turner's comment that a Report into the demise of RBS "would add little, if anything, to our understanding of what went wrong" was inadequate. He should have grasped the need for a public explanation of how that situation had arisen, something which he has subsequently acknowledged. We would not expect the new chairmen of the regulators to repeat the error. (Paragraph 100)

18. The FSA's Report into the failure of RBS was largely written by FSA staff, with additional scrutiny being provided by the Treasury Committee's specialist advisers Sir David Walker and Bill Knight. We believe that this model has proved successful in giving our Committee and the public a reasonable degree of confidence that we now have a true and fair picture of what went wrong at RBS. We also have a better grasp of the failings of the FSA. (Paragraph 113)

19. A report produced by an organisation into itself will not be completely free from subjectivity. However, the appointment of external reviewers in this case appears to have improved the report and greatly improved its objectivity. (Paragraph 114)

20. The work of the independent external reviewers appointed by the Treasury Committee enabled Parliament to scrutinise a powerful regulator in a new way. The approach sets a precedent for the Treasury Committee in the future, and it may also be of use to other select committees. (Paragraph 115)

21. Although the FSA board endorsed the Report, non-executive directors of the FSA should have held the FSA's executive to account and themselves commissioned a review of the Authority's performance, as routinely happens within the private sector. The collapse of RBS should have been a prime candidate for such retrospective internal review. We have recommended in our Report on the Financial Conduct Authority that legislation provide for the Treasury Committee to request retrospective reviews of the future FCA's work. We would not, however, expect a properly functioning board to need such prompting from Parliament to conduct such reviews. We will expect non-executive directors of the future PRA and FCA to ensure that regular reviews of performance are undertaken and that appropriate governance structures are in place to support them in this task. (Paragraph 116)

22. The FSA Report into the failure of RBS, alongside previous reports on other aspects of the financial crisis and pre-crisis regulation, highlights the respects in which pre-crisis regulation was misguided. The document will be of long-term value for those involved in the regulation and corporate governance of banks. A similar exercise in relation to the failure of HBOS will now be undertaken. (Paragraph 122)

23. HM Treasury has published a review of its performance during the crisis, which the Treasury Committee will review in due course. The Bank of England has also belatedly announced a number of reviews examining aspects of its own performance in this period. While this represents some progress, it falls well short of what is required. A comprehensive review of the Bank's role in, and response to, the crisis is needed and we will return to this issue after publication of the three reviews commissioned by the Court of the Bank of England. Moreover, by waiting so long before conducting any review, the Bank of England has diminished its value as a guide to better regulation for the future. Any lessons learned as a result of even these limited reviews will also only be available in a very late stage in Parliament's consideration of the Financial Services Bill. Incorporation of them into legislation may therefore be more difficult and this is regrettable. (Paragraph 129)

Formal Minutes

Tuesday 16 October 2012

Members present:

Mr Andrew Tyrie, in the Chair

Mark Garnier	Mr Pat McFadden
Stewart Hosie	Mr George Mudie
Andrea Leadsom	Jesse Norman
Mr Andrew Love	David Ruffley
John Mann	John Thurso

Draft Report (*The FSA's report on the failure of RBS*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 129 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Fifth 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.

[Adjourned till Tuesday 23 October at 9.45 am

Witnesses

List of printed written evidence

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 475
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and FSA Responses	HC 1533
Twenty-first Report	Accountability of the Bank of England	HC 874
Twenty-second Report	Appointment of Robert Jenkins to the interim Financial Policy Committee	HC 1575
Twenty-third Report	The future of cheques: Government and Payments Council Responses	HC 1645
Twenty-fourth Report	Appointments to the Office of Tax Simplification	HC 1637
Twenty-fifth Report	Private Finance Initiative: Government, OBR and NAO Responses	HC 1725
Twenty-sixth Report	Financial Conduct Authority	HC 1574
Twenty-seventh Report	Accountability of the Bank of England: Response from the Court of the Bank	HC 1769
Twenty-eighth Report	Financial Conduct Authority: Report on the Governments Response	HC 1857
Twenty-ninth Report	Closing the tax gap: HMRC's record at ensuring tax compliance	HC 1371
Thirtieth Report	Budget 2012	HC 1910

Session 2012–13

First Report	Financial Services Bill	HC 161
Second Report	Fixing LIBOR: some preliminary findings	HC 481
Third Report	Access to cash machines for basic bank account holders	HC 544
Fourth Report	Appointment of Mr Ian McCafferty to the Monetary Policy Committee	HC 590

Monday 30 January 2012

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Andrea Leadsom
Mr Andrew Love
Mr Pat McFadden
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Lord Turner**, Chairman, **Hector Sants**, then Chief Executive Officer, and **Margaret Cole**, then Managing Director, Enforcement, Financial Crime and Markets, Financial Services Authority, gave evidence.

Q88 Chair: Thank you very much for coming before us this afternoon and producing a voluminous report. We have quite a bit to get through, as you would expect with a 500-page report. I would like to begin by asking you, Lord Turner, a question. You saw that Sir David Walker said your original decision to publish a one-page document was driven by a desire to say no more than you absolutely had to. Isn't that a reflection of just how cut off the FSA had become, and indeed has become?
Lord Turner: I entirely accept that what we, and I personally, failed to focus on at the time was that it is important when something has gone wrong that there is a public account of it. We stuck too narrowly to our existing procedures. In fact, we went a little bit beyond them, because our normal procedure, when we decide not to bring an enforcement action, is that we don't actually say anything. Even putting out a one-pager was a deliberate decision that this was sufficiently important that we ought to say something, but I wish that back in 2009 I—or other people might have suggested it—had realised that the failure of RBS was such a big thing that we should have a public accountability report. That is what I now believe.

Q89 Chair: Why did you put out a one-page note?
Lord Turner: As I say, our normal procedure, when the enforcement division decide not to bring an enforcement action, is not to put out anything. Obviously, at any one time, month by month, there may be many situations—

Q90 Chair: You scarcely could have thought that a one-page note was much of an improvement, Lord Turner.
Lord Turner: We felt that we had to comment on the fact. Given that people had speculated that there was almost certainly something going on in an enforcement investigation into RBS, we felt that we had to say that it had reached conclusions. But I entirely accept that we were sticking to the existing procedures and not being imaginative enough in realising that this would require a wider accountability. That was a mistake.

Q91 Mr Ruffley: Mr Sants, the criteria for assessing whether individuals had acted in a way that could lead to formal disciplinary action rested on whether it could be demonstrated that they had acted in a dishonest, reckless or incompetent way. Can you point to the page in the report where incompetence is defined?
Hector Sants: The decision as to whether we should take enforcement action rests on the recommendation of the enforcement department, which in itself is a separate process accountable through the RDC to the board. If you don't mind, I think it would actually be better if Margaret could answer the question.

Q92 Mr Ruffley: No, I would not be happy with that, because you are going to be taking a job as chief executive in the Prudential Regulation Authority, which is going to be the premier authority for supervising banking. The report says there were a series of bad decisions in the years immediately before the crisis, and I want to get to the bottom of this. I want to hear your view on how incompetence is defined in this report.
Hector Sants: Well, as—
Mr Ruffley: It's not, is it?
Hector Sants: Incompetence, per se, is not defined in the report. What we would have to demonstrate is a breach of our regulatory rules and, as the enforcement section of the report lays out, the enforcement department found that there was no basis to proceed against that framework. The executive committee personally listened to, challenged and engaged with the enforcement department to satisfy itself that that conclusion was thoughtfully reached, and I believe it to be. But to your point, absolutely, there is not. We would have had to demonstrate a failure to comply with the FSA's procedures, rules and framework in order to have taken an action.

Q93 Mr Ruffley: What most people are amazed at in this report is that, with the exception of Johnny Cameron, there are no serious sanctions against significant individuals. Fred Goodwin emerges relatively unscathed, and I just want to pursue this question of what you think competence and incompetence is in the case of the RBS debacle. The report says, "The substance of decision-making by the board in relation to ABN Amro was defective at the time, whatever the subsequent deterioration in the market and wider financial environment". Would you not agree that making a decision as significant as the ABN Amro acquisition, even without the benefit of hindsight, was judged to be poor? Does that not imply a very large degree of incompetence? I want to understand—and I think people listening to this will want to understand—why no one has been fingered for that in this report. It is a pretty useless report in that sense, isn't it?

Hector Sants: I entirely agree with you.

Q94 Mr Ruffley: You agree with that?

Hector Sants: The substance of the report is to make clear that we considered the board and the senior executives of RBS, which includes Goodwin, to have made a series—a series; there was more than one—of very poor decisions, which led to the bank failing. I would also agree with you—and Adair has discussed this in his foreword, but I entirely endorse his comments—that, going forward, we should change the regulatory regime to allow the regulator to take those sort of assessments into account, to ensure that people who have shown that sort of serial misjudgment are not allowed to run financial institutions again. That is absolutely my view, so I entirely support Parliament making changes to the regulatory framework so that we can stop people like this working again, without any confusion or any risk that that would not be the case.

Q95 Mr Ruffley: That is a very useful disclosure you have made, Mr Sants. Could I sum up your reply there as saying that the FSA did not have the enforcement powers under the FSA regime to bring Mr Goodwin, in particular, to book in terms of enforcement proceedings? Is that what you are saying? You are blaming the structure of the way the FSA was set up and the powers it was given by Parliament at the end of the 1990s?

Hector Sants: I am absolutely saying that, in my personal judgment, the depth of failings demonstrated over a prolonged period—there was more than one here; I think you have to build a track record, just to be clear—amounted to a clear track record of a series of misjudgments by the executives of RBS, and in my judgment that means they are not fit to run a regulated institution. I would like to see the framework under which regulators operate changed, so that in future if people demonstrate that type of serial misjudgment, which demonstrates they are not competent, we are able to take action against them.

Q96 Mr Ruffley: In the announcement of the outcome of the enforcement regulation, the FSA said, "the competence of RBS individuals can, and will, be taken into account in any future applications made by them to work at FSA regulated firms." Is the implication of that that you would deem some of them to be incompetent, and if some of them were incompetent why could you not have taken enforcement action against them?

Hector Sants: Yes, to your first question—absolutely. I should make it clear, by the way, that I am giving my personal opinions.

Mr Ruffley: No, they are very interesting.

Hector Sants: Strictly speaking, we are not allowed by the rules under which we operate to make a judgment unless somebody reapplies. I should be quite clear that I am speaking to the Committee in a personal capacity because, as the FSA, we are not allowed by the rules under which we are set up to say upfront what would happen if somebody applied.

Chair: You are speaking under parliamentary privilege.

Hector Sants: I am making clear that, as far as I am concerned, if any of those individuals applied, I would not consider them to be competent on the basis of the track record demonstrated. If I could draw a distinction, which again is an issue around the regulations. I would though be keen to allow Margaret to contribute to this discussion, as I know she feels also strongly about this. The threshold for barring somebody's authorisation is lower, is less demanding, than the threshold for enforcement action. While I can say with confidence that, in my opinion, these people will not work again in the regulated sector in an executive role, it does not automatically follow from that that it means we should have been able to take enforcement action. I am entirely in agreement with you: in order to get the type of result that you would like to have, and I think we should have, we need changes to the framework under which we operate.

Q97 Mr Ruffley: I know he wants to get in, so can I just put my final question to Lord Turner, Chairman? The report quite clearly says that the FSA cannot, "Take action against the CEO"—in this case, Fred Goodwin—"of a firm simply on the grounds that there were a number of failures at the firm, even though the CEO is ultimately responsible for the actions of the firm." Don't you think that is a grotesquely inadequate system of regulation that a man like Fred Goodwin can pretty much walk away from this mess scot-free?

Lord Turner: That is why in my foreword I deliberately put on the table the fact that we need to explore whether there should be a change in the law. The point I wanted to come in on is this issue of what is competence, and was there not a case for incompetence. I have to assure you that that was something the board sub-committee that oversaw the production of this spent a long time quizzing enforcement about, and it is something I have considered. The way the law works at the moment, in the best judgment of our enforcement lawyers as to what they would be successful in in appeal to the upper tribunal, is that the way it is interpreted at the moment, competence has to relate not to a broad set of decisions. You cannot accumulate lots of decisions and say, "If 10 of them were bad, there must be some incompetence." You have to say, "Look, you didn't follow the procedures here; you did that wrong; you clearly didn't have a technical competence in that very specific effect." That, bluntly—and this is something that has worried me—may bias our enforcement activity to zero in on very specific things that we can prove, even if, seen widely by most reasonable people, they may not be the most important things to what led to a failure.

That is one of the reasons why I raise the question in my foreword as to whether we should have a different structure of law to say that, where something on this scale has gone wrong, there should be some category of automatic sanction that applies to the people who were responsible, whether or not we can prove that in some procedural or specific fashion they did something wrong. That is precisely why I put those issues on the table in my foreword.

Q98 Mr Ruffley: One final one-line question and one-line answer, if you would, Lord Turner. In your judgment, in its new Financial Services Bill, has the Government addressed the problem you have just explained and which is in your foreword to this report?
Lord Turner: Not yet. At the end of March, the FSA and the Treasury will produce a joint discussion paper on this issue putting forward options, which is intended to be consulted on, so that the Government could then put it in—as my understanding of their intention is—as part of the legislation that will also implement the Vickers recommendations, on which I believe a White Paper may be forthcoming before the summer.

Q99 Chair: Isn't this a huge mess? We have a piece of legislation that is amending another hugely complicated piece of legislation, and now you are telling us that, with the Bill now published already, that is effectively redundant, at least on this point, because that is going to be further amended, even before we have had a chance to read the document.
Lord Turner: Given that in any case, because of Vickers, we are going to have two Financial Services Bills, I don't think there is a huge disadvantage in that, as long as at the end of the day we have an effective way forward.

Q100 Chair: The measures that we are discussing here are pertinent to the legislation—
Lord Turner: They are clearly pertinent.
Chair:—and are nothing to do with or secondary to Vickers.
Lord Turner: No, they are clearly pertinent to it. If we had started on this debate a year ago it might have been part of pre-legislative scrutiny and gone into this Bill.
Chair: They should have been subject to pre-legislative scrutiny.
Lord Turner: I think it would be unfortunate now to rush this.
Chair: Absolutely.
Lord Turner: There are a set of very complicated pros and cons of the different approaches that I have put on the table, which—

Q101 Chair: This Committee has been arguing that this legislation is being rushed for many months and has already published that view, as you know. You are saying you support that and if we leave this open for a few more months we might get to a better place, is what you are saying?
Lord Turner: We have a procedure now to put all the issues on the table. They are very important ones. The pros and cons of the different approaches need to be carefully analysed and the next step will be this joint FSA/HMT discussion paper to actually widen the debate.
Chair: All that is going to have to go on while the Bill is actually in the Committee.
Lord Turner: That is true. That is true, but we—

Q102 Chair: Do you think that is a good way to legislate, having just got it manifestly seriously wrong, and you are saying we did, 10 years ago where we rushed it then?
Lord Turner: I don't think it is for us to comment on the parliamentary timetable and the management of the legislative process.
Chair: All right, you have gone as close as you can to commenting on it.

Q103 Jesse Norman: Mr Sants, you have spoken about the serial incompetence of members of the RBS management. Let us not forget this was a contested, mainly cash takeover for another institution with a value of €71 billion, shortly after which the Royal Bank raised its dividends before throwing up its hands with the loss of £40 billion. Last week when we saw them, the reviewers said that the due diligence done by Merrill Lynch in advance of the transaction, who were the advisers to the Royal Bank of Scotland, consisted of two lever-arch files and a CD. When you were in your position as managing director of wholesale institutional markets in April 2007, can you take us through the kind of deliberations inside the FSA at that time as to whether or not you should have intervened? What were the kinds of things that you were talking about and thinking about?
Hector Sants: May I first make a general introductory comment. I will answer your specific question, but just as a general point I would like to say something upfront on this. I can see a number of questions in this space, so I would like to make clear that I agree that the general approach to supervision, and the policy framework that accompanied it that was in place in the FSA before the crisis, before the summer of 2007, in relation to overseeing UK institutions, UK banks, was inadequate. As soon as I could, once I took over as chief executive, I changed that.

Q104 Jesse Norman: Would it not be fair to say grossly inadequate?
Hector Sants: Grossly inadequate; totally unacceptable to me. That is why, as soon as I could, I introduced changes. I waited for the Northern Rock report, which I think was right and proper, but I would have effectively made many of those changes anyway. From March 2008, as you know, we embarked on a radical change to the entire approach to supervision and a wholesale change to the people involved. I might point out in passing that, of the supervisors intended to transfer to the Bank of England, at whatever date that is in the future, three-quarters of them did not hold relevant supervisory posts in the summer of 2007. That is, we have changed three-quarters of the supervisory staff. I am not in any way trying to defend the approach taken to supervision in that period.
To your specific question, I have to say—and I am sure you will find it somewhat strange to hear, but it is true—that the FSA under the previous executive management operated in a very silo manner and we did not discuss specific major supervisory issues in our executive committee. We were not encouraged to question or debate the management approach across the silos, across the areas. To answer your specific

question, there was no discussion, and the then chief executive did not convene any discussion, on the merits of the deal.

Jesse Norman: I must say I find that absolutely astounding.

Hector Sants: I agree with you.

Q105 Jesse Norman: I am grateful for your frankness on this issue. As far as you are aware, was there any discussion among the members of the board of the FSA?

Hector Sants: To the best of my knowledge there was not. I think the existence of the takeover was reported by the then managing director responsible for it, but you would not describe there being any substantive discussion at the board level. I should perhaps, in fairness to the people involved, indicate that, although there was no discussion in the executive committee, I understand from those who prepared the report that there were some bilateral conversations between the chief executive and the relevant managing director that I was not party to. I should be a little careful as to the degree of discussion, but there was no formal consideration of it in the executive committee or the board.

Q106 Jesse Norman: A very large chunk of the Royal Bank's business fell under your remit as managing director of—

Hector Sants: If I may interrupt, that is completely untrue.

Q107 Jesse Norman: Could you tell me how much did?

Hector Sants: None.

Jesse Norman: None at all?

Hector Sants: None at all.

Jesse Norman: No part of the RBS at all?

Hector Sants: No part. I had no involvement in any way whatsoever in the supervision of RBS. The way that the then chief executive had organised the FSA was to place those institutions that were domestically located in the United Kingdom inside one division, and in the other we placed the markets activities, i.e. overseeing stock exchanges and so forth, and overseeing wholesale foreign institutions. It was an integrated, holistic approach, so the investment banking division of RBS was regulated and overseen by those people who looked at the rest of RBS, all of which sat within the responsibility of the managing director, retail. I had no involvement whatsoever. I had no knowledge of what those supervisors were doing. There was no cross-discussion in the FSA. At no point in my tenure did I ever discuss RBS.

Q108 Jesse Norman: You are painting a picture of a wildly dysfunctional organisation. Can I just ask you then, as I understand it, therefore, the investment banking part of the business was treated under the retail side and, therefore, you had no visibility to that?

Hector Sants: Correct.

Q109 Jesse Norman: Was this the position that you complained about?

Hector Sants: Yes.

Q110 Jesse Norman: Did you push for some ability to have oversight into the RBS at that time?

Hector Sants: I did, but the offer was not taken up. It probably does fall into the category of the things where, if you look back on it, maybe I should have shouted louder, but I did raise the question with the then chief executive.

Q111 Jesse Norman: You sound like the Governor of the Bank of England—sounds like everyone should have shouted louder.

Hector Sants: I cannot speak too loud when I say that. I am sure you appreciate that I have gone back over these events many times in my mind to see if they could have been done differently. Given what happened, it would be nice if I could point to some document where I laid out all the risks of that. I cannot, but I can tell you in all honesty I did raise the issue.

Q112 Jesse Norman: This really, then, is a question for Lord Turner. Obviously, you were on the board of the FSA at the time—am I right about that?

Lord Turner: No, I joined the board of the FSA on 20 September 2008.

Q113 Jesse Norman: When you came in, this was already an organisation that had been in some transition?

Lord Turner: Yes.

Q114 Jesse Norman: You have made certain further proposals to this Committee for the board of the FSA to be improved in various different ways or, as it were, scouted them. Do you think similar concerns could be expressed and addressed through improvements to the Court of the Bank of England, in terms of its own supervisory arrangements since, as you may know, we have been very critical of its inability to act as a genuine board of supervision?

Lord Turner: Can I start, as a background, by saying that the FSA board, like the FSA, does a very wide span of things—too many? One of the things that has made me a strong supporter of what is now intended is a realisation that just the sheer span, from the prudential regulation of major banks to the conduct regulation of IFAs, is just too much to do and produces a diversion of approach.

Secondly, in terms of the way that the FSA board operates and reports, in the future we will be heading in three different directions, one of which is the FCA board, which I think should probably be more open about the debates it has on things, like the RDR and the mortgage market review, illustrating to a greater extent than we do at the moment the arguments put for and against because, often there, there is not sensitive supervisory information. There are public policy debates. There is another bit that will head to the PRA, which is the supervisory side. It is always quite difficult to be open and accountable on any current basis about the discussion on actual prudential supervisory cases because they are of their nature highly confidential. We are now having detailed conversations, as you would understand, about the eurozone, which it would not be reasonable to put into the public domain.

The third category, which we should have been doing but were not doing much at all, was the macro-prudential, "How is the whole of the system operating?" That in future will be the responsibility of the Financial Policy Committee, and there I think the shadow Financial Policy Committee has already started with a high degree of openness as to the debates that are going on there. There is an ability looking there—

Q115 Jesse Norman: Yes. I will make another point, which is what we are seeing today is a description of an utterly dysfunctional board of the FSA. The board is allowing this institution to do these things that Mr Sants has described so eloquently, failing to intervene and failing to organise, and the result in part is a catastrophe. The question is, being that dysfunctional, is there a danger of replicating this absence of proper scrutiny in institutions such as the Bank of England?

Lord Turner: I don't think so. Because I am on the Court of the Bank of England, I was a party to the document on bank accountability, which I know this Committee had some concerns about, but I think it was a reasonable set of suggestions. I felt, if I may, that you may have not appreciated the way that that could develop. What that document was saying was that an oversight committee could exist that would produce an annual report on process. We have in the Monetary Policy Committee and the Financial Policy Committee—

Q116 Chair: We are not here to discuss this. I know the question was asked—

Lord Turner: The question was asked. I am very happy to—

Chair:—so let us have a quick go and get back to the report we are discussing.

Lord Turner: The question is on the Court of the Bank of England.

Chair: Let us have a quick go on it and then—

Lord Turner: Oh, you want a quick go? Okay.

In the substance of its activity, there is a high degree of openness of its nature within the Bank of England on the Monetary Policy Committee, and we can see the debates going on there. There is a high degree of openness now on the Financial Policy Committee, and that is appropriate. What is proposed is an oversight committee that would produce an annual report, and to my mind this is not simply two paragraphs in the general annual report—it would be a serious annual report of the oversight committee, which would be seeking to ensure, and to ensure that you were satisfied, that there was no groupthink going on, that the individuals who had counterpoints of view were able to put them forward, and that the processes of analysis had been driven by the external members as much as the internal members. That would help ensure process.

Then there is also a proposal in there that, where there has been a set of developments that are controversial, a trusted external body, such as the IMF, would be asked to give a report on substance. So, for instance, if one went through a period—

Chair: We have read the report, so let—

Lord Turner: My point of view is that it could be made to work. It depends on the details.

Chair: We may take further evidence on that in due course.

Q117 Mr McFadden: Mr Sants, can I take you back to the judgment the FSA made about the ABN Amro takeover? In autumn 2007, you considered the question of whether the FSA should intervene in the takeover, and you concluded that, from a capital perspective, RBS would be able to deal with it. Given that this was the view that ended up sinking the bank, was that not a disastrous misjudgment?

Hector Sants: First of all, can I make clear that I do think when you read the press there can be some misunderstandings on this point? At no point in the process at all was the FSA required to approve the acquisition. There was no formal requirement—

Mr McFadden: No, but you did have the power to intervene.

Hector Sants: Not to sign off or to approve it in any way. There was no—

Q118 Mr McFadden: But you did have the power to intervene, didn't you?

Hector Sants: There was no specific decision point. I decided—and I might point out that the previous chief executive had not—that it would be a good and proper idea to assess the risks in the transaction, which I and the Chairman did do a number of times in late September, early October. But you need to be quite clear that at that point, once the offer document was published, which it was on 20 July, the only basis under which we could have intervened would be if we had concluded that the bank, on completion of the transaction, would not meet threshold conditions.

I am absolutely clear—and again, I have been over this in my mind a number of times, and I remain completely clear—that there was no regulatory basis for an intervention. So no, on the information available at that time, it was not possible to intervene at that point after the offer document was published. I did not have the power to intervene.

Q119 Mr McFadden: Do you regret the judgment that you made about the capital strength of RBS being able to handle that deal?

Hector Sants: I think you misunderstand what we were doing. We were not making a judgment. We were assessing whether the bank met threshold conditions. That is a very specific test that requires us to conclude that the bank will imminently fail; will fail, with near complete certainty. The bank did not fail for over a year. It did not fail until there was a significant deterioration in market conditions, which occurred from the summer of 2008 onwards, and until after Lehman Brothers collapsed, which dramatically changed the liquidity framework for the marketplace as a whole. You could not have concluded it did not meet threshold conditions in September 2007. You can go back over that judgment. I have been back over that decision many, many times, but the facts remain the facts: there was no basis to intervene.

Q120 Mr McFadden: Are you not saying you were guilty of the same misjudgment as the RBS board, in that you thought that they would be able to handle this?

Hector Sants: No. It was not a judgment in the way you are describing it. It was not a judgment about the future. It was a decision on whether it met threshold conditions. In order for it not to meet threshold conditions, you would have had to have been able to say it would fail. It did not fail immediately the acquisition took place. Therefore, the event demonstrates that was the only conclusion you could reach. We are talking about the board making judgments about risks, which might or might not have happened, and saying they took an unreasonable degree of risk. That is not the same as assessing the test of threshold conditions. The time for the FSA to have intervened, as the report clearly says, was before the offer document was published. I entirely agree, as to the earlier discussion, that they should have made an assessment of risk at that point, and I would like to think, if we had done so, we would have intervened. I cannot say whether we would or we would not, because that is obviously a hypothetical question, but I would like to think we would have done as the report says.

This is not the same as what the board was doing. This is a regulatory conclusion based on a set of facts. The RBS was meeting its regulatory capital at the time of the deal. It was going to meet its regulatory capital immediately after the deal closed, which it did. It was funding itself in the marketplace. In fact, it was telling us that it was benefiting from a "flight to quality". It had succeeded, despite the fact that it had made essentially a cash offer, in finding funding for its cash offer. A regulator could not have warranted an intervention. If a regulator had intervened at that point, people would have said, "You can't do that; it's totally irresponsible; it's not in any way linked to the powers that you have."

What we would like, which is back to the earlier questioning in terms of different powers, is a different sort of power, a power to actually make the judgment that you are saying I should have made, which is: "There is a reasonable risk that it will fail, therefore it cannot go ahead." That is the power we would like. If we had had that power—back to the earlier question—you could then hold the PRA to account in the future as to whether it successfully makes those sorts of judgments. But the threshold condition test is an entirely different sort of test. I think it is really important you understand that. It is in no way analogous to the judgments the board of the RBS was making, but we would like a power. We are prepared to take on that responsibility, which no doubt will produce some very difficult decisions in the future, which you rightly will then wish to hold us accountable for.

Q121 Mr McFadden: Let me take you through what you did on capital over the next few months, because the FSA started to get much more concerned about capital and liquidity issues at the end of 2007, beginning of 2008. You met with the chief executive of RBS in April 2008 to discuss the bank's capital position. You asked for further work on this to get the definitive position. We understand that work was not done. Why was that?

Hector Sants: You are right. In practice, it did not make any difference to the outcome, because the reason I asked for further work was that they had indicated to us that their capital might have fallen by some 0.1 of a percent below our internal guidelines, which is a very, very small amount, but nevertheless an issue of concern that triggered a debate with us. I had the conversation with the chief executive on 9 April. As related in the report, I specifically required him to have a rights issue, which certainly, as far as I could judge from that meeting, he was not intending to do when he came into the meeting with me. I asked him to raise as much capital as he possibly could. I also asked him at that point to complete that capital calculation and return that information to the supervisors. Unfortunately, RBS's systems did not allow them to do that. I have to say that is a criticism of RBS, but in terms of the outcome, in terms of future events, it did not make any material difference, because we required them to raise as much capital as possible, and to have a rights issue, which I think was one of the largest in European corporate history, and certainly in the UK banking sector, and they did everything they possibly could to bolster their capital position at that point. But of course, in the light of events, it proved not to be enough. So you are absolutely right, they did not comply with our request to give us the detailed information. It does reflect the very poor state of their systems and controls, which was a major issue throughout this period. Their systems and controls were extremely poor, as the report demonstrates.

Q122 Mr McFadden: At the end of 2007, you put them on a watch list for capital risk. You put a danger sign over RBS.

Hector Sants: Yes.

Mr McFadden: They then increased dividend payments two months later by 10%. Can you tell us, did you have any power to press the pause button or stop that increase in dividend payments after putting them on a capital watch list?

Hector Sants: No. In order for us to intervene on the dividend, they would have to be non-compliant with our regulatory rules. When they raised their final dividend—and actually they raised the final dividend by 4%, not 10%;10% was the total dividend for the year, the final was up 4%. We were not required to give approval for that increase, as they were still complying with their capital and liquidity rules at that point. We were not required to give a formal approval to that dividend increase. We were notified the day before but there was no dialogue on that dividend issue.

Q123 Mr McFadden: Can I just ask you one final thing? There were 13 months between the run on Northern Rock and the collapse of RBS, and these issues were at the top of the national agenda. We then find that there was no contingency plan throughout that period for a bank that could not meet its overnight funding, despite the fact that RBS and one or two

others were hugely dependent on that kind of funding. Looking back on that 13-month period, do you not think the FSA was asleep at the wheel?
Hector Sants: There was a contingency plan, so I don't recognise that statement. As the report says, we should recognise that if there is no liquidity in the market a bank is not going to be able to find liquidity in the market. Therefore, for banks of this size, the contingency plan is provided by the central authorities, by the central bank. As the documentation makes clear, from the end of November onwards, which as you rightly point out is when the FSA became concerned about potential capital and liquidity risks for the larger banks, we were pressing—as I think I have mentioned in earlier Treasury Select Committee hearings—for the Bank of England to put in place long-term liquidity facilities, and the chairman of the FSA, Callum McCarthy, was very active in that dialogue. We were seeking to put in place the appropriate contingency plan for a liquidity failure of a bank of the size of RBS. The FSA does not itself have any liquidity that it can provide. When marketplace liquidity disappears, the contingency plan has to be one for the central bank. We were clear about that from the moment that we saw deterioration in the liquidity position of the larger banks, which we saw from the end of November, and we put that in writing to the tripartite authorities repeatedly from then on.

Q124 Mr McFadden: Does your report not say, at paragraph 550, and is this not a quote from it, that there was no FSA "contingency plan in the event that a particular bank can't fund its overnight position"?
Hector Sants: No. What that says is that there was a director in the FSA, who was not party to the tripartite and senior discussions that I referred to, who sent me an email asking whether there was one. That doesn't mean there wasn't one. It just means that he was not party to the tripartite discussions, in particular the discussions between the Chairman, the Governor, the Treasury and the Chancellor.

Q125 Mr McFadden: He was wrong?
Hector Sants: He was asking me a question, to which I answered, "Yes, there is a contingency plan."

Q126 Chair: Mr Sants, can I take you back to this question of what you describe as the poor systems and controls in RBS that prevented them from doing the work on the capital position, which you requested of the chief executive in April 2008? What does it say about the FSA's systems and controls, that you demanded it but did not get it and did not follow up on it?
Hector Sants: I think it says that we were extremely stretched during this period. Maybe I will come back a little bit to the opening discussion we had with Jesse Norman.
Chair: You are all very busy and, therefore—
Hector Sants: No, if I could finish the question. I am entirely agreeing that the quality and quantity of the supervisory staff that I inherited in the summer of 2007, as well as the procedures and philosophy they were operating to, was inadequate, and that is why we—

Q127 Chair: It does sound as though you are dumping on your predecessor.
Hector Sants: We started with, as you know, some seven people on RBS. We currently, as a dedicated supervisory team, have 23. On major issues, such as stress testing, we use between 50 and 100. As you say, we were notified that there was uncertainty over the March year-end return, but first of all, I would like to say, even efficient banks don't necessarily know the absolute final number within a couple of days; secondly, the difference was only between 0.1 of a percent on 9; and thirdly, once we had requested them to have as large a rights issue as possible, our focus was on maximising their capital position. Would it have been better if the supervisory team had followed up to close that out? Yes, although I do know the report finally notes that actually RBS believe they may not have breached the ICG. But it made no substantial difference to the outcome here. As a general point, are you saying, yes, the FSA was understaffed and lacked enough quality staff to address the enormity of the crisis that broke from October onwards? Absolutely, and that is why we have added some 600 more supervisors, changed the way we operate, changed three-quarters of the staff, and adopted an entirely new model—so it was working in a very stretched environment.

Q128 Chair: Mr Sants, I am not asking you whether it made a difference that they did not follow it up. I am asking you what it told us about the FSA at the time that you were managing it, and you—
Hector Sants: It told us that it was very stretched and needed to focus on the essentials, and this was not an essential point. This was not an important point in the context of trying to ensure RBS did not fail.

Q129 Chair: Can I take you back to some questions that you answered about your role as head of wholesale? During your time as head of wholesale, the investment side, the side that plausibly would fall under wholesale, was growing very fast in RBS, was it not?
Hector Sants: The investment bank of RBS? Yes, between 2005 and 2007. There are statistics in the report.

Q130 Chair: Yes, which I have in front of me here. It was growing very fast and was the best part of two-thirds of the bank's capital base by 2007. You have said that you raised it. Have you any evidence at all that you raised it to show us?
Hector Sants: I did not raise the specific issue of the growth on the investment banking side. The concern I raised—
Chair: But you raised your concern about the silos.
Hector Sants: Yes. The concern I raised, which was highlighted to me by my staff on the investment banking side that looked at Morgan Stanley and Goldman Sachs and others, was that they had considerable expertise in investment banking activities and they were not able to share their

expertise easily with the supervisors in the UK Banks Department.

Chair: Yes, but the question is, do you have any—

Hector Sants: I am afraid I don't have anything in writing that can demonstrate that. You have to decide—

Chair: None at all?

Hector Sants: No. I could ask other individuals in the FSA whether they are happy to corroborate that. I can think of one or two who might well be, and if you would like me to do that I can certainly do that.

Q131 Chair: You were on the Executive Committee at the time. An Executive Committee will have minutes. Bearing in mind the gravity of the situation, did it not cross your mind that you should at least get your reservations into those minutes? You said you were very upset about it.

Hector Sants: I think that is a fair point. I did not read it into the Executive Committee minutes. I have to however say that the Executive Committee minutes for the FSA are action point minutes. They are not actually verbatim accounts.

Q132 Chair: Well you wanted some action taken, didn't you?

Hector Sants: Yes, I agree. I acknowledge that point.

Chair: So they were exactly what you would expect.

Hector Sants: I am acknowledging that point. With hindsight, I should have ensured it was fully documented, that I expressed my views. I also expressed my views about the limitations of the management in that area. I think Margaret Cole did the same, so she may wish to corroborate the general concerns we had about the weak management in the retail area of the FSA.

Q133 Chair: This is something that you felt was wrong at the time, raised in the corridors, or privately or informally. Do you remember how you did this?

Hector Sants: I raised it in my regular bilateral meetings with John Tiner. We also raised the question of the general quality of management in that area, informally, in the margins in a number of the executive meetings.

Q134 Chair: What did Mr Tiner do when you mentioned this to him?

Hector Sants: He made it clear that the model he had set up for the FSA was of autonomous business units, and that was how he envisaged it being run. On the question of the individual—

Q135 Chair: He was saying, "It's none of your business, really; let the retail side get on with it"?

Hector Sants: It would be for you to ask him, but I think he took the view that he had set up an autonomous business model arrangement and that was the way he wanted it run. But as I say, I might invite Margaret to join in, because she was part of the executive committee. You are asking for some corroboration, and she could—

Chair: I don't think there is any need, because it is your replies that matter on that point, since it was you who were head of—

Hector Sants: Yes. I should also point out at this point that I did ask for the resignation of the managing director, retail, which I hope demonstrates my views on that subject.

Q136 Chair: When did you do that?

Hector Sants: As soon as I reasonably could, which was after the completion of the Northern Rock report.

Q137 Andrea Leadsom: Ms Cole, I would just like to ask you, as a legal person at the FSA, I certainly recall John Tiner talking very much about principles-based regulation and not about very narrow definitions. Mr Sants says that it would not have been possible, once the offer document had come out, for him to do anything other than to shut it down if the merged bank was absolutely imminently then going to go bankrupt. Would you say that that is true, from a legal perspective, at the time of that report coming out, and bearing in mind the FSA supposedly was working under principles-based regulations?

Margaret Cole: I would say that it was certainly true. The legal advice that was given to Hector on that subject was given by the general counsel's division, so not by me. I do endorse the fact that there were very strict legal requirements for the test of not meeting threshold conditions. I have to say that I don't think the principles—which are a set of principles that govern the behaviour of firms and individuals within firms, which you quite rightly say overarch the detailed rules—were operationally relevant to that particular decision. There was a very strict legal test for that.

Q138 Andrea Leadsom: You agree that it would not have been possible for Mr Sants, coming in as the new CEO, to have been able to stop that deal going ahead at that point on any grounds other than its being imminently about to be bankrupt?

Margaret Cole: I agree with Hector's explanation about how we had to consider whether threshold conditions were met, and that was the pertinent and relevant test at that time, and that principles were not applicable to this.

Q139 Andrea Leadsom: I have to say, it does seem to me astonishing that somebody who is earning more than five times the Prime Minister of Britain can only express a view if it's going to be the imminent collapse of a bank, where clearly you had very grave concerns. Were there no other hook or by crook measures you could have used to make clear your concerns about this merger?

Hector Sants: I would like to say, in passing, I am not earning five times the Prime Minister. I have no final salary pension or defined benefit pension, that is by the by but it is not correct, what you just said.

I would make the point here that we are unelected officials and, as I have said many times before, I believe it is important that we work within the rules set by Parliament, the laws. We should operate within the law. The general principle that still prevails, and was certainly prevailing at that point, was that boards take responsibility for running their own firms, and that ultimately the decision for running the firms well rests with the boards and their executive. For the FSA to act as shadow directors, and second-guess the judgments that executives and boards have made, was absolutely not the philosophy prevailing at the time. To have intervened in a bid that had been nearly unanimously—95%—approved by the shareholders, which would have required the triggering of the MAC clause by the firm to pull out of, unless we had the power to do it, is not something the FSA should be doing. It does not seem to me that I should be seeking to intervene in a way that I was not mandated so to do. I think you would consider that a misuse of my position if I had merely just sought to disrupt the deal in an irresponsible fashion.

Q140 Andrea Leadsom: Yes, but Mr Sants, even the Governor of the Bank of England found a way to talk publicly about the need to sort out our deficit during the period in the run-up to the General Election, and got into trouble for that, but he found a way to get his view known. What we are talking about here is the extent to which you really were genuinely concerned and felt completely unable—and you were legally unable—to act and reflect your concerns, versus you were just going along with it because you were caught up in the herd mentality of the RBS board and the shareholders.

Hector Sants: I certainly was not caught up in the herd mentality. I draw your attention to the point earlier that the previous chief executive had not even thought that he should consider the issue. Surely, the point at which the issue should have been considered was before the offer document. I had the guts to consider the issue, I actually did what nobody else did, including my executive chairman, with whom the final decision ultimately rests, not me, to get out there and take a look at the question.

Q141 Andrea Leadsom: But you did not act in any way other than to say, "It is not going to imminently go bankrupt."

Hector Sants: It is not actually for me to act, I just repeat that. We do have a system here where there is an executive chairman in the FSA. If I had sought to act capriciously or unreasonably, I am absolutely sure the board and the chairman would have told me I could not do that. Your line of questioning is implying this was a decision solely for me. It was not a decision solely for me. There is clearly the fact that there is an executive chairman of the FSA who was party to the deliberations. Nevertheless I would like to restate that, yes, I did look at it responsibly and I concluded within my powers I could not act. I consider that I was doing my utmost to address a very difficult situation.

Q142 Andrea Leadsom: In conclusion, from everything I have heard, you are utterly blameless, innocent, there is nothing you could have done differently or better, and you have no regrets about anything of your part in this whole fiasco? There is nothing that you feel you could have done differently?

Hector Sants: No. Look, I am answering the very specific narrow question of: could we have done something different after the offer document was published in relation to the ABN Amro deal? I am saying I have been over that many, many times in my mind, and the answer is no. Does that mean there are other things I could have done differently? Absolutely; we have referred to a number already.

Q143 Michael Fallon: Let us just have a look at the timeline again. You took over at the end of July 2007. In appendix 2C, the timeline tells us that you had three assessments of the impact of this acquisition: 19 September, 28 September and 4 October. This is two months after you took over. It then took another four and a half months before you even met the Chairman of RBS, which was then by far the biggest bank you were dealing with. Why was there a four-month delay?

Hector Sants: Because in that period, up until the end of November, we were extremely focused on the risk posed to the mortgage banks of the United Kingdom: Northern Rock initially, HBOS, Bradford & Bingley, and Alliance & Leicester. They were clearly the most at-risk institutions. I think the Northern Rock report has already indicated we were aware from the onset of the crisis in August that these four institutions were at risk. We had almost no investment banking expertise in the FSA. We had very limited risk analysis expertise in the FSA. We had a very small number of supervisors; as I say, six or so on RBS and one to two on these other banks. I thought it was the best use of my resources to concentrate on those institutions most at risk. Would it have been ideal if I had also spent some time with RBS in that period? No doubt, but I think you underestimate the stress that was placed on the organisation, and I made the judgment, which I think is a reasonable one, to deploy my resources where we had institutions most at risk.

As we indicated earlier, RBS was complying with its capital and liquidity guidelines throughout September/October. It was actually benefiting on the liquidity side from a "flight to qualify" at the end of September and early October. The risk to the larger banks in the United Kingdom did not become apparent to us until the end of November, early December, which was the time it was placed on the watch list. So the answer to the question is: I cannot be everywhere at once. We had a very, very small number of competent professionals. I think you underestimate the strain and the stress under which the organisation was being put at that time.

Q144 Michael Fallon: Yes, but I am not talking about the organisation or your resources. I am talking here about you—you are in charge.

Hector Sants: Yes, well, I have told you what I was doing.

Michael Fallon: But you were in charge—hang on a minute. Hang on a minute—

Hector Sants: I was addressing the principal risks facing the United Kingdom financial sector at that time, which was the risk to those banks I have outlined. That is where I put my personal effort. We had a supervisory team, and they were on the case of RBS in that period, but they were making the judgment, which they were advising me on, that it was not materially at risk until the November period.

Q145 Michael Fallon: Yes, but it was not until 13 February that you deigned to meet the chairman of your biggest bank, the one they said might be at risk. Why was that delayed? In October/November—
Hector Sants: I have answered the question, because at that time I judged that my time was best used addressing the near and present danger to the other institutions, and that was what I was doing.

Q146 Michael Fallon: Do you now regret not seeing the chairman or chief executive of RBS a little bit earlier?
Hector Sants: I think it would have been better, certainly it would look better for this discussion, if I had done so, and that falls into the category of a number of procedural issues that I think with hindsight I could have done differently. But may I make a general point about all the actions that took place between November 2007 and September/October 2008? At the end of the day, we realised that RBS was short of capital. It was me personally in a meeting with Fred Goodwin that pressed him to have a rights issue. I have no doubt that he would not have had a rights issue of that size without my personal intervention. The firm raised as much capital as it possibly could. There is no evidence that if we had intervened earlier they would have raised any more capital—if they had had the rights issue in November or December. At the end of the day, the largest rights issue in the UK financial sector proved not to be enough; whether that rights issue had occurred in November, or whether it had occurred in April, it would not have made any difference to the bank failing.
Similarly, on the liquidity point, it went into the summer of 2007 structurally deficient on liquidity, as the graphs point out. There was no way that it was going to be able to alter that liquidity profile, given the market conditions from November onwards. So, the nuances of what we did one day, by that day, does not alter the substance of the point that we pushed them throughout to improve their liquidity position. We engaged with the central bank to put in place contingency facilities. We pressed them to raise as much capital as we possibly could. It would not have made any difference when they raised that capital, and the amount of capital they raised was not sufficient to stop them failing.

Q147 Michael Fallon: You still don't think it is odd that there was a four-month delay of you seeing the RBS chairman?
Hector Sants: I am saying, for the purposes of dealing with this discussion, it would have been preferable if I had seen the RBS chairman, but I do remind you again that it was the tradition in the FSA at that time that the chairman of the FSA engaged with the chairmen of banks. I actually was the first chief executive to get interested in having regular dialogues at the senior executive level. I now have regular meetings every month with the chief executives of the major banks. Again, that is a question you could partially address to the former chairman of the FSA.

Q148 Michael Fallon: You keep trying to offload the blame. If you were changing the culture—
Hector Sants: No, I am not offloading. I have taken full—
Michael Fallon:—why did it take six months for you to meet the chairman?
Hector Sants: I have answered the question. With hindsight, it would have been better if I had. I said that once. I said it twice.

Q149 Michael Fallon: Okay. In the report, at 446, it says that once the crisis period started there was limited action that the FSA could take to improve the firm's liquidity position, given market conditions.
Hector Sants: Yes.
Michael Fallon: When, for the purposes of that sentence, did the crisis period start?
Hector Sants: As I have indicated, from November onwards it was apparent that the RBS and the major banks were under some liquidity pressure. I think we have a timeline of in here—bear with me—the liquidity graph on page 197, paragraph 471. It demonstrates that the material deterioration in the liquidity of RBS began to occur in July 2008 and then accelerated, obviously after the Lehman Brothers incident, and as the report makes clear to that effect. There was pressure, as I indicated earlier, on the major banks from November onwards, which is when we were pressing the authorities to put in place their contingency plans.

Q150 Michael Fallon: But there were liquidity issues brought to the fore by the mortgage bank issues back in October/November 2007. Why would it take another year for some action to be taken in respect of RBS?
Hector Sants: No. I am sorry, I said in November 2007 we were pressing the central authorities to put in contingency. The assessment that I received from the supervisors in September/October, on which we based our threshold condition conclusion, made very clear that RBS was not actually suffering liquidity pressure at that time. In fact, quite the contrary, the supervisory group advised me that the firm had made very clear to it that in that period it was benefiting from a flight to quality, and was actually gaining deposits because of the pressure on the smaller banks in the period described. In September/October, there were no signs of increased liquidity pressure on the major banks, as reported to me by the supervisory group, and I think the report found no evidence that that report was inaccurate. From November onwards we did have concerns, and as I said, that was the point at which the chairman of the FSA started pressing the central bank and Treasury to put in place contingency facilities; that is, from the end of November 2007.

Q151 Michael Fallon: It was then still a further year before RBS disintegrated.
Hector Sants: Yes. The point of the paragraph you drew attention to was that we should not think the firm was not aware that it had a wholesale liquidity risk. It was very apparent it had a wholesale liquidity risk. It was seeking to improve its position in the marketplace but was not able to do so, so there is a

difference between conditions under which you can improve your liquidity profile and conditions under which your liquidity profile is deteriorating. I am explaining that under the conditions that prevailed, as that paragraph—I did not write that paragraph, it is an independent report, so again we could check; maybe ask Adair to comment here—in the report is highlighting, the ability of the bank to improve its position was not there. That does not mean that the bank's position was deteriorating and, as that graph shows, it did not markedly deteriorate until July. As I say, I think you should be aware that these are conclusions in the report. I did not write the report.

Q152 Michael Fallon: We are testing this conclusion. The conclusion is that there is limited action that either you or the bank itself could have taken, actually over a year.
Hector Sants: That is not my conclusion. That is the conclusion of the independent report I am presenting to the Chairman.
Michael Fallon: Of course, but what we need to test is whether it is right—
Hector Sants: In my judgment it is.
Michael Fallon:—that there was limited action that you could have taken over a period, as much as a year, to improve the firm's liquidity position.
Hector Sants: Correct. And I believe that judgment of the independent report to be correct.

Q153 Mark Garnier: You are painting a pretty staggering picture of institutional incompetence at the FSA in the run-up to when you took over. You also told us at great length how you were trying to raise the issues, the fact that you thought there were a number of things that were not right about the organisational structure of the FSA. Who were you raising that to?
Hector Sants: I think I covered those points earlier. I acknowledge that we did not raise them formally, and with hindsight I wish I had done.
Mark Garnier: No, I want to know who did not take the action.
Hector Sants: I raised them with the chief executive.

Q154 Mark Garnier: The Chief Executive, and would he have referred that back to the board?
Hector Sants: I cannot tell.
Mark Garnier: Should he have referred it back to the board?
Hector Sants: It is an interesting question that, and again Adair might like to comment. Historically—and I think there is the material there in the report on the board's role—in general, the board primarily restricted itself to its policy role of rule making, and took relatively little interest in the supervisory model. In my view, there was very little challenge by the board of the executive on the way we went about supervision. Clearly, in my view, that was a failing of the board, which has since been rectified, and in bringing in the new supervisory enhancement programme, the board rigorously engaged with the executive team as to the nature of that model and whether that model would address the shortcomings of the past. But traditionally, no, the board did not engage with the executive on these sorts of issues.

Q155 Mark Garnier: In Lord Turner's 2009 review, he identified seven causes of the financial crisis. Were any of those discussed at board level, do you know, prior to the financial crisis? Would you like me to remind you what they are?
Hector Sants: You might be advised to do so. That would be helpful.
Mark Garnier: I will go through them one by one.
***Hector Sants*:** Thank you very much. I am sure Lord Turner can remember them.

Q156 Mark Garnier: "The massive growth and increasing complexity of the securitised credit model", was that discussed?
Hector Sants: Not to my knowledge.

Q157 Mark Garnier: "Extensive commercial bank involvement in trading activities."
Hector Sants: Not in the way that that report describes.

Q158 Mark Garnier: "High leverage in multiple forms."
Hector Sants: No.

Q159 Mark Garnier: "Expanded maturity transformation dependent on the marketability of assets." No? "The complexity and opacity of the structured credit and derivatives system."
Hector Sants: There was some discussion on that, I think. But I have to say we would have to double check the minutes.

Q160 Mark Garnier: Apparently they were not. "Hard-wired procyclicality."
Hector Sants: I know there was some discussion of that, because that would have fallen into the category of discussing rule making, and obviously the board did approve the Basel II rules, and therefore, where you have policy issues, which manifest themselves in regulatory rules, then the board engaged with those topics. To your general point—just to wrap it up as a clean answer, to avoid us having to come back in detail—you are entirely right, that the FSA did not give any consideration to financial stability in any material way, or the risk in the system as a whole. So of course, to be fair to the board, there was no specific and clear mandate so to do, and indeed, the MOU says that is the responsibility of the Bank of England.
Lord Turner: If I can just quote from paragraph 691, because we did look through the board minutes: "It is noticeable that during the period between January 2006 and July 2007, of the major topics discussed at the FSA board only one out of 61 related in some way to bank prudential risks and issues."

Q161 Mark Garnier: One out of 61?
Lord Turner: One out of 61. The focus was very strongly on Equitable Life, split capital trusts, RDR, treating customers fairly, and so on. That was the skew of the focus of the board at that time, against the background of a widely held assumption—but in

retrospect, complete delusion—that the world had become a safer place, precisely because of all these complicated things, which in retrospect we know have made it less safe.

Q162 Mark Garnier: In the report, the FSA puts a great deal of emphasis on the performance of the non-executive directors of RBS, and yet the non-executive directors of the FSA were sorely lacking in scrutinising what was going on. There is a suggestion that there is a conflict of interest between having people with direct industry experience on the board of the FSA, and yet it is absolutely because of the lack of that direct industry experience that you managed to hard-wire procyclicality and other things, if the system had only examined one out of 61 problems that were identified.

Lord Turner: Can I comment—I think it goes back to the comment I made earlier—it is my belief that the FSA was set up as a job to do far too wide a span? I have been continually aware of that at board meetings over the last few years, that we have enormously long agendas, enormously long meetings. We have to go in detail through mortgage market review, retail distribution review. We now go through in great detail what is going on, particularly in the reports from the CEO and from Andrew Bailey now, the director in charge of bank supervision. We go through in very considerable detail the risks and how we are addressing them, but at the time that was squeezed out by other elements of the agenda. I think it reflects the fact that that was not an intelligent way to set the system up, and that in the future we will have dedicated people on the Financial Policy Committee who will simply be focused very extensively on the macroprudential, on the overall systemic risks. We will have people on the Prudential Regulatory Authority, both in respect of its executive and its board, who are simply focused on the supervision of major banks. It is too much to expect somebody to be dealing with these incredibly complicated issues of capital and liquidity, if you also ask of them half of their time to be expressing a point of view on Keydata or Arch cru or retail distribution review or mortgage market review, it is too wide a span of control.

Hector Sants: If I can add briefly, with regard to the PRA and looking forward, there are some recommendations from David Walker, with which I entirely agree, that it is vitally important for the independence that the PRA board do come with current industry experience, and I recognise the point about conflict. We all have to think through: how do we avoid conflict—particularly if we want to involve the independent board members, as we do—in the decision-making, so they would be part of the assessments for these important questions we have been talking about today? Basically, we do have to have independents with current experience on the regulatory boards. But, as Adair said, that is an argument, in particular, for specialisation, because the wide span of the FSA set of responsibilities clearly proved too much for the board to be able to effectively oversee. I agree with the points you are making.

Q163 Mark Garnier: Lord Turner, on a number of occasions you made the point that the board should have quite detailed minutes coming out, in order to make each individual member more accountable and perhaps to air their views a bit more enthusiastically. I have not read it in detail, but I understand that the Financial Regulation Bill does not make any requirement that the FCA publish its minutes, and merely leaves it up to them to decide what they should or should not do. Do you think that is a mistake in the Bill?

Lord Turner: I would not be against it being put into the Bill. I think the FCA board may well—and I will recommend—think very carefully in future about the style of minutes. What has struck me is that, on the Monetary Policy Committee side and the Financial Policy Committee side, we have a style where you see the people who are responsible for making the ultimate decision expressing alternative points of view. You have a minute that says, “Some people said this. Some people said that. They considered this data. At the end of the day they concluded X”. We have not previously provided that openness in relation to, for instance, the debates about the RDR, so we have not been transparent as to whether there was a variety of points of view or what factors were considered. I cannot see a problem with doing that, and indeed I think, as we move to a new structure and think about it, that that would be my recommendation, that we do have that degree of explicitness. It is very important when you look at an issue, like the RDR or the mortgage market review, that people understand that these are not technical decisions where there is necessarily one right answer. They are a balance of different points of view, and those different points of view and how it was resolved should be open.

Indeed, I would also suggest—and I think I recommended this when we talked before you on the issue of the FCA governance—that you have never previously asked non-executive directors of the FSA to come before you, in the way that you ask the external members of the MPC and the FPC to. I think in future, where we have major retail conduct policy issues—like MMR or RDR—that would be a perfectly legitimate thing for you to do.

Q164 Mark Garnier: My very final question. Hector Sants, in the light of everything you said to us a bit earlier about the fact that you were raising these issues, do you feel that, having published minutes of boards would give an opportunity for people such as yourself in your previous position to be able to air those concerns publicly, or at least to get them down on the record? So that the person who is talking about the next crisis—which I hope does not happen under your watch, but should it do—rather than having to rely on good friends to come up and fly your flag, would actually have minutes recording that?

Hector Sants: Yes. I sincerely hope the next crisis is not on my watch. But yes, I am broadly in favour of public minutes and entirely endorse that general sentiment.

Chair: Jesse Norman wants to come back with a point.

Q165 Jesse Norman: A very quick question. Mr Sants, you said that having an early rights issue in November 2007 would have made no difference, versus when it actually took place in 2008. I wonder if that can be true, because of course there was a raised dividend in between, and if RBS had done a rights issue they would hardly have raised their dividend.
Hector Sants: That is possibly true. But the amount of the raised dividend, I think from memory, was about £210 million. It was the difference between the one penny extra; the final went from 22-odd pence to 23 pence. Sadly, I don't think that £210 million would have made any difference to the outcome for RBS.

Q166 Jesse Norman: When Michael Fallon asked you about funding for the building society market, you responded by saying that RBS had benefited by getting deposits. But was it not true that the failure of the building societies was pointing to a drastic shortfall in money market wholesale funding, on which RBS was itself extremely reliant?
Hector Sants: At that stage, on the supervisory information I was given, there was no evidence of that. In fact, my recollection is that the general comment about flight to quality, which the firm made to us, covered both wholesale and retail.

Q167 Chair: Could I just take you to paragraph 433 to clarify one point. This is September and October when you were in charge. It says "While the FSA senior management was concerned by liquidity conditions in the markets at that time, the scenario under which those risks could crystallise for RBS was considered very unlikely". Did you agree with that judgment?
Hector Sants: That was the judgment that the supervisory assessment paper presented to us.

Q168 Chair: Yes, but you were chief executive, so I am asking whether you agreed with it.
Hector Sants: Did I agree with it? Yes. People were asking earlier when I look back on events what do I think about them, and I absolutely acknowledge I did not envisage Lehman Brothers failing in the way that it did and I did not envisage a catastrophic collapse in market conditions and confidence that occurred in late—

Q169 Chair: But the markets were already tightening by that time, were they not?
Hector Sants: I come back to the point earlier, which we have just touched on, that the supervisory team clearly stated, and the firm was clearly stating to them, that they were a beneficiary of these tightened markets, and that did not seem to me to be an unreasonable scenario, whereby major global institutions would be a gainer from pressure primarily on smaller institutions dependent on the securitisation funding model. I entirely agree that the FSA was not envisaging the events that transpired in autumn 2008.

Q170 Chair: Can I just take you further on to paragraph 435 where it seems that adequate attention was not paid to the information that might have been available from the Dutch Central Bank, the DNB. Were you aware of this at the time?
Hector Sants: I was not aware of that detail. That was the responsibility of the supervisory team and the managing director, retail to engage—

Q171 Chair: It is a bit more than the management, isn't it? Just to clarify, Mr Sants, it is far more than detail. This is going to the central bank, and the bank which is about to be taken over in the biggest banking deal in history, to find out whether they have anything to say that you ought to know.
Hector Sants: Yes, absolutely.
Chair: It is not a detail.
Hector Sants: No, obviously. I said I was not in receipt of the detail. I am sorry if I was clumsy in my wording. I was in receipt of the general feedback from the DNB, and I do indeed have memorandums with that material on it, and the DNB were not giving us any material risk warnings at that time, and I believe this paragraph says that—that the DNB did not communicate significant risks to us.

Q172 Chair: What they said was they were relying on you, is it not? The DNB informed the review team it believed the FSA would supplement the answers provided by RBS.
Hector Sants: That was in regard to RBS. I assume what you are discussing was the DNB's information with regard to ABN, and as I am saying they did not highlight to us any major risks in relation to ABN. What they said to us, however, which was perfectly reasonable, is they were relying on us for the analysis to the risk in RBS, which was perfectly reasonable.

Q173 Chair: Could I also take you to paragraph 439, which is, I suppose one could say, the exoneration paragraph, where it says, "In the context of the time, the decision by the FSA CEO and Chairman not to intervene"—that is you—"in the period after the offer had been published, was reasonable". The paragraph then continues, "given the low probability of extreme liquidity stresses emerging". That is the point we have just discussed, and then it says, "and the FSA CEO's and Chairman's judgment that the intervention could itself have destabilised RBS." So you were taking into account the risk that if you intervened, you yourself could create a financial contagion, is that right?
Hector Sants: Not exactly, no. That sentence could run to misinterpretation. I think there are two different issues, and I did try to draw that out in the earlier discussion. Perhaps we can just return to that. There was a clean decision on threshold conditions, which we have covered and, as I say, I have been back over that many times. As Margaret has said, I—we—remain clear there was no regulatory basis for an intervention. So we could not have intervened. But, even if we did not think we had any grounds for intervention, it did cross my mind a little bit in some of the earlier questions that maybe I should just be saying, "This is an irresponsible deal, you should not be doing it," and making some public pronouncements, or maybe even trying to intervene, at which point the firm would have pushed back and said, "You can't do it." But maybe that whole furore

would in itself have been a useful intervention and I concluded—and I think David Walker in his remarks agreed with me on that point—that being just disruptive was irresponsible and could in itself have destabilised RBS. The board might well have responded very negatively to that. So that is certainly a different point to the straight judgment on threshold conditions.

Q174 Chair: Just to get back to clarity on this point, you are saying you could not intervene?
Hector Sants: Correct.
Chair: Whatever happened, you could not intervene?
Hector Sants: On the information available at the time.
Chair: What you could have done is smashed the furniture, but you could not intervene. That is correct?
Hector Sants: Yes.

Q175 Mr Love: Lord Turner, before you published this report it went through the Maxwellisation process. There has been lots of speculation in the newspapers. Indeed Sir David Walker, when he came to speak to us last week in a session, confirmed that there were changes made to the report. Can you detail for us the changes that were made during that process?
Lord Turner: I can absolutely confirm that there were no changes that made a material change to the overall thrust of the report. It is part of the agreed process that reports of this nature should go through a process—to which the name of Mr Maxwell is forever connected, Maxwellisation—where they have the right to look at it and make comments on it. Those comments, as you will probably understand, are voluminous, and they often contest lots of different points, and they contest them as being unreasonable or not supported. We then have to go through and see whether there were any of those that we thought were legitimate. As we went through—and this was a careful process with myself, Sir David Walker and Bill Knight—there were a small number where we said, "Yes, look, on reflection, we don't have a strong support for that point." Indeed, I have to say that one of the things that Bill brought to the process, as a lawyer, was a very strong focus that we should only put into reports things for which we had an evidential basis, that if you did not have an evidential base for it we would be detracting from the quality of the report by putting stuff in that was not there.
In relation to the specific one that Bill Knight mentioned, I draw your attention to paragraph 612 of the report, on page 234, where it sets out four questions. It says that there are four questions about Goodwin's "capability and style". Those are: "Whether his management style may have discouraged robust and effective challenge from the Board and senior management team"; "Whether the levels of remuneration paid to RBS executive directors"—that is, those that report in to him—"may have played any part in discouraging robust and effective challenge of the CEO"; "Whether the CEO was overly focused on revenue and profit" targets himself, because of the way he had been incentivised; and "Whether his response to the emerging losses"—and I consider this a very important one—"in structured credit, monoline insurance" and so on "reflected a bias towards optimism."
In the earlier version of this we had a fifth question, which Bill Knight referred to: whether he had a focus in his own experience towards retail banking rather than to investment banking. That was a fifth question, posed as a question not a fact, which was in an earlier version. When we went through it—and you can take it that every one of these was challenged—we thought that that was the only one where we were not convinced that it was highly material or clearly evidence that that was relevant to the story and therefore we changed that.

Q176 Mr Love: That is a very detailed response, but what I want to focus on is the claim that originally the description was made of the report about the ABN Amro takeover as being "a risky gamble". Can you confirm or deny that those words were used and changed and, if they were changed, what do you think is an adequate description of what went on in terms of a takeover?
Lord Turner: We still have the word "gamble" in there somewhere, if I remember rightly. I am afraid I have not memorised it, but the word "gamble" is in there. If I am honest, telling stories, I think we had a slight difference between our two external reviewers and their appetite for whether the word "gamble" was absolutely the best word to use or not, and we debated it. But the word "gamble" is put in there. I think it was a gamble actually, in the sense of it was a—

Q177 Mr Love: Would you accept a "risky gamble"?
Lord Turner: It was undoubtedly a risky gamble, but I think all gambles are risky—I mean, aren't they?
Chair: Oh, just a—
Lord Turner: Well, the Chairman is not sure, in which case I want him to tell me of these non-risky gambles, because I will start wagering on them.
Chair: Carry on, then.

Q178 Mr Love: What is coming through to me at this stage is that there was an acceptance in the FSA, at the time of this takeover, that, while there were no grounds under current conditions—and we have gone into this in some detail—to intervene, there was a very strong feeling that this was—and I use the words that Mr Sants used earlier on—"an irresponsible deal"—that was the word that you have used, or other similar phrases. In your view, Mr Sants, is that adequately reflected in this report? Again, I want to ask Mr Sants because, as I understand it, he did not have anything to do with this report, but the report is on many things.
Hector Sants: Yes, well I think we used the words "risky" and "a gamble". I apologise, I don't immediately have it to hand, but I think it is in there—but certainly highly risky.
Michael Fallon: Paragraph 415.
Hector Sants: Thank you very much. It is consistent with the wording I have used and, as you rightly say, it is reasonable to conclude that it was a highly risky transaction, and events showed it to be.
Lord Turner: Can I just clarify? What this report shows is that, sadly, prior to the point at which this offer had already gone out and been given a 95% vote

by the shareholders in August 2010, there was not adequate focus within the FSA, that this was a highly risky thing to do. As you go through the months of April, May, June, July 2007 we are not finding evidence of anybody in the FSA at that time saying, "This is a highly risky gamble; we had better try and stop it." That is what the report says, that there was a failure to recognise that the sheer scale and nature of this thing should have provoked a change to the classic non-interventionist way of the FSA dealing with a major acquisition. I think there was a failure to understand, or to focus on or to consider, that it was part of the role of the FSA to focus on the risks involved in this acquisition.

Hector Sants: Certainly, when we have deals now notified to us in advance, we have now demonstrated, we have a visible track record, of intervening at a very early stage before offer documents are published, to minimise the risk or even sometimes to try to dissuade management from acting. In those cases, it won't have been visible to the marketplace at all. That approach is one that we now incorporate in the new proactive supervisory approach. I entirely agree with Adair that was lacking. The report is clear that it was lacking. I entirely agree it was lacking in the FSA's approach in the past.

Q179 Mr Love: Lord Turner, was that highlighted? There is plenty in this report, and I am talking here now about getting the proper balance. There is plenty of criticism in here of RBS and its management. Indeed, there has been even more this afternoon. But did you balance that against the responsibilities of the FSA? I am now highlighting the fact that there were shortcomings, and indeed Mr Sants has gone into this in some detail about the shortcomings. Do you think the report gives a balanced position in relation to responsibilities vis-à-vis RBS management and the FSA executive?

Lord Turner: I think it does, in particular, in relation to this. If you look at paragraph 420 it says, "The FSA's supervisory approach to the acquisition of ABN Amro did not entail adequate assessment of the risks which RBS was taking. This reflected that…approval was not required…Supervision lacked a defined approach…the prevailing FSA philosophy and approach" believed that you should leave these things to senior management. It says clearly—

Q180 Mr Love: Let me ask you a question that is very clear to me. You have to get to page 342 of the report before Mr Sants is mentioned. He was second-in-command, if I can call it that, because I cannot remember offhand his title when he first came to the FSA.

Hector Sants: I was one of three managing directors.

Mr Love: One of three managing directors and, subsequently, chief executive during part of this. I think you would accept that it is not unreasonable for this Committee, recognising that Mr Sants will have a continuing and very important role when the PRA is finally established, to question whether or not this report adequately ventilates the issues for which he was responsible. There are many who have commented that that is not happening. What is your defence of ensuring that there is an adequate reflection of the role of Mr Sants since coming to the FSA?

Lord Turner: I honestly think there is. I am not sure about your reference, do you say page 344?

Mr Love: Yes, page 342.

Lord Turner: There are lots of references. I am just randomly looking on 182 to 183. He is not referred to as "Hector Sants", he is referred to as "the FSA CEO", but in that period the FSA CEO is Hector Sants. So there are lots of references before that where he is named by title and, on the whole—and it was one of these sort of issues of style that we went for—we decided to go more for titles rather than names, that is a stylistic choice you make, but it is clear who it refers to. So we have carefully considered, and the review team considered, and I considered and the external reviewers considered, what exact words we should use, in particular, about the decision not to intervene in relation to ABN Amro, and that is something that we gave very careful consideration to, what should be the exact balance of the words.

My own belief is, and I have to say, that if I had been there as chairman or chief executive at the time, I would have reached the same decision, which, in retrospect, knowing what we know now, we all regret. I feel that, with the information available then and the legal powers available then, I would have ended up making the same decision. What we also describe in this is an organisation that, from autumn 2007 onwards, is beginning to get a grip on the faults that it previously had. It is leading the way with new liquidity standards, leading the way with new capital standards, doing the drains up on Northern Rock and putting in place a supervisory enhancement programme. It is the nature of such things that, if they had been put in place about three years beforehand, they might have helped prevent some aspects of the crisis. They were of the nature that if you start there you cannot prevent the crisis that then occurs. But I do think that Hector led that transformation, and that is the judgment that I have made that he has been the right person to lead the FSA and to stay on and lead the transition to the PRA.

Q181 Mr Love: I understand that, and this Committee has gone through many sessions trying to understand all of the changes that you are talking about, but I think at the time when the new regulatory structure was introduced Mr Sants, along with many other people, commented that it is the quality of the staff that will be the final arbiter of how well you do as a regulator. It is on that that I want to put my final question to Mr Sants. You have gone through a baptism of fire, if I may say so; what do you think you have learned that better equips you now for doing the job as PRA chief than perhaps you did when you first came to the FSA?

Hector Sants: Three points on that, I think. First of all, I should say—and you are asking the question and I will answer it—I do think the right people to ultimately answer that question are the people who make the appointment. But I realise you have asked me, so I will try to answer that. I would like to make a couple of points. I genuinely believe, but I accept it is for others to judge, that in the period after I took

over the FSA, during the crisis, that in the circumstances, given the whole legacy that we took into it, the FSA did its utmost in that period. Of course, I am not saying at the end of the day it is the outcome we would have liked. Obviously it was not what anybody would have liked, and the crisis has been a major, major crisis. But I genuinely believe, in the round, over that period we did our utmost, and I will be more than happy at any time to sit in front of this Committee and go through in detail, in more detail than we have managed to do today, every decision we have made. I would like to think, if you were faced with the information we were faced with at that time, with the resources we had at the time, you would recognise that we have done our utmost.
As to your specific question, it might be worth just reminding ourselves that I was leaving. I was asked to stay on. I decided it was the right thing to do to stay on, on the basis that I accepted the argument made to me that I was the best person to take forward the regulatory reform programme and leave the regulatory regime in a good shape. That is what I think I should be judged on. Talk about judging people, the quality of people, I have been given a specific task that I was persuaded to take on; that is what I will deliver. I would be more than happy to spend more time with this Committee on whether I am delivering against that reform programme. At the moment that reform programme is on track. I think we have learned a lot from the experiences, and we are using all that experience to make a better regime for the future, which will significantly diminish the probability of these types of crises happening again.
The final point is, when I look back over, particularly those early months—and there has been much discussion about it, September/October, and could the judgment have been different, could we have intervened earlier?—when you look around that whole process of decision making I am sure, in the round, the authorities as a whole would have made better judgments if we had more people who had direct and immediate experience of a crisis of that nature, and we did not, for obvious reasons. We are still in one of the most severe financial crises in modern times, and I think a very sensible judgment has been made by those who asked me to stay on, which is that people should have the benefit of my searing learning experience. Let us not underestimate how extremely unpleasant a time that was. I think everybody who knows me, and I have been in front of this Committee many times, will not have doubted that I have always acted with the best of intentions. I have 30 years of experience in investment banking. I have always done my very best, and I think that given what I learned in that period there is value in me imparting that to the system.

Q182 Chair: Mr Sants, you have described several issues with your differences between you and your predecessor prior to taking the post in July. He announced he was going in January, I think. When did you find out that you were going to be taking over from him?
Hector Sants: Again, I have to say, it was not a job I particularly wanted to take on. I was persuaded to apply for the job. I cannot recall precisely when. I think it was in early July, pretty much around the time the press announcement was made. I am afraid I cannot recall the precise date, but it was in July.

Q183 Chair: Were you intending not to stay on?
Hector Sants: The original arrangement with John Tiner was that I would do three years as one of the three managing directors. He told me when I joined that he would be doing a longer period than in the event it turned out he did, and I had made it very clear that I had no interest in staying for that longer period to put myself forward for the chief executive post. I did not join the FSA with the intention of being the chief executive. I did not expect John Tiner to leave. I was not originally intending to apply for the job, I was persuaded so to do.

Q184 John Thurso: Can I just ask you one point of clarification? RBS was in the retail section, so you were not covering it; were all the British universal banks in retail?
Hector Sants: Yes, I had no responsibility for any of the UK banks. It is not a sensible structure, and I just remind you that I changed that structure as soon as I possibly could, to a unified supervisory unit. If you are an integrated regulator it makes no sense not to have a unified supervisory unit.
Lord Turner: If I may just throw one light on—

Q185 John Thurso: Can I make one further point? I will come back to you on that. On several occasions and in several answers, you prayed in aid what you did on the rights issue with RBS in pushing it through with Fred Goodwin. Can I just tell you that for quite a number of small investors—the Dowager Lady Thurso being one of them—the rights issue was not unalloyed joy. What do you say to all the small shareholders who lost out as a result of that?
Hector Sants: I am truly sorry that the bank failed. We genuinely believed at the time, if we could raise capital of that type of magnitude, unless there was a further dramatic deterioration in market conditions, that that would be sufficient. Unfortunately, that proved not to be the case. I am truly sorry for all the small shareholders who have been caught up in this financial crisis.

Q186 John Thurso: Can I come to you, Lord Turner? There are two parts to this report. There is RBS and what they did, and frankly it is not often that one reads reports of this nature and finds them as gripping as that one was. It sets out very clearly what went wrong, and I don't want to rehearse that bit. But the other strand in it is obviously how the then FSA reacted, and that is largely what we have been rehearsing today. Obviously we are looking at this with the benefit of 20/20 hindsight, but there are many places in the report where the approaches and decisions of the FSA have been criticised, were even wrong with that hindsight. Do you think this was because of the culture in the FSA or the structure of the FSA or a combination of both?
Lord Turner: I think it was a combination of the structure of the FSA and the entire intellectual

philosophy of the time. As I have said, the structure of the FSA, the fact that it had been given responsibility for this enormous span, from the capital and liquidity of major banking groups through to all wholesale conduct issues in markets, but then also retail conduct, I think was too wide a span. There is an intellectual affinity between thinking about the capital and liquidity of banks and central banking that makes that logically better to reside within the central bank, and there is a different set of disciplines to do with retail conduct, and that is why I believe that the future structure is better. I think the structure was problematic.

Even more importantly, the FSA had fallen but it was not alone in this. Indeed, a lot of the cleverest economists and authorities in the world had ended up believing that the global financial system had become safer because of innovation, liquidity and ability to distribute risk. We have to put ourselves back in a mindset where people had simply come to the belief that we were in some great moderation of low and stable inflation and that a lot of these problems of the past had disappeared. After all, that was the completely overt Greenspan document that there was a more efficient way to distribute risk. As I quoted in my own Turner Review, if you look at the April 2006 Global Financial Stability Report of the IMF you will find an extraordinary statement, which says that, because of the development of CDS, of structured credit and distribution and securitisation, the world financial system had become safer, and—I cannot remember the exact quote—the likelihood of commercial bank failure had declined. It is an extraordinary quote in retrospect.

Can I just say one final thing, which is reflected in paragraph 691, about why these banks were given to the retail side of the FSA? It was assumed that what we had to worry about them was whether they were treating customers fairly, and of 229 items reported in the 18 months before July 2007 by the managing director of retail markets, only five related in any way to “bank prudential issues.” That was just the mindset of the time. It is extraordinary in retrospect, but that is the way it was.

Q187 John Thurso: As you rightly say, it is quite extraordinary that we could have had such a collective failure of commonsense across all the regulators. This report says a lot about the FSA. It says very little about the other two wings of the tripartite system. To what extent should this report have also covered what the bank did or did not do and what the Treasury did or did not do?

Lord Turner: It is quite interesting in the US to look at a thing like the Financial Crisis Inquiry Commission—I forget the precise word—the FCIC, which is a very large analysis looking at the totality of what has occurred. We have not had that in the UK. You could argue that if we could all roll it back to 2009, we ought to have launched a Royal Commission, which would have looked at absolutely everything, including each of the banks that failed, all together rather than one by one, and at the role of all three authorities. I think there could be merit in that at some stage.

Q188 John Thurso: I will take that as you saying, “Yes, somebody ought to have a look at them at some point”. Hector, can I end with a question to you? This is to ask a fairly direct question that follows on from the comments that Andy Love was making, and only you can answer it. Do you think it is appropriate that account should be taken of your particular actions, as set out in this report previously, in making a proper assessment of your future in regulation?

Hector Sants: Yes, entirely, but I come back to the comment I made earlier. What I have undertaken to do is to deliver the regulatory reform agenda. I believe I am doing that very effectively. I am happy to debate that with you and answer questions on it, and when I have completed that I will have completed the job I committed to do.

John Thurso: Better the repentant sinner than the untried evangelist. Thank you.

Q189 Chair: Lord Turner, has the production of this report improved the quality of the work that the FSA does, or prejudiced it?

Lord Turner: The process of the report itself or, going forward, the lessons learned from it?

Chair: I am talking about whether people working in the FSA are likely to be more alert to the dangers than they were before you produced this report, and to perform better than they would otherwise have done, or has it prejudiced their performance? I am asking the question in a neutral way.

Lord Turner: I think it is favourable. If we go back to what the lessons learned from this report are, many of them we knew already. The basic fact that the capital and liquidity regimes were, to be blunt, rubbish, we knew already, and we were putting them right. The supervisory approach was wrong and we were putting that right.

When we produced this, I strongly urged all staff members to read it, particularly those going to the PRA. We have something here that all prudential supervisors, at least for the next 10 years, ought to read as part of their training programme. Indeed, all non-executive directors of banks ought to read it, because I think, when you have a lengthy and, I believe, high-quality report of what went wrong, there are a lot of lessons that you can get out of it, and they just tell you the story of a bank that made a collection of mistakes that reached a failure. That is very important for people to read.

Hector Sants: Could I just add, because we have obviously had a robust exchange of views, I also strongly believe—and this report and this process is part of it—that the regulators should be accountable for what they have done and the actions they have taken. They should be transparent and explain the basis and the thoughts behind what they did.

Chair: That is what we have been trying to do this afternoon—

Hector Sants: The whole process is one we ought to embed going forward, and I hope the PRA—going back to some of the earlier points will be at the forefront of being willing to go down that road.

Chair: Again, as you know, we are trying to improve the transparency and the accountability of these bodies in a couple of reports we produced recently.

Q190 Michael Fallon: Are we going to get an equivalent report on the failure of HBOS?

Lord Turner: As I wrote to the Chairman, sometime in early July, it is our opinion that we should produce a report, or somebody should produce a report on HBOS. In timing terms, we have the complication, as we did with RBS, as is publicly known, that we have an enforcement process in place—which of course can take some time, and if it was to conclude that there was a case, and if somebody then appealed, it could get delayed—and until that is produced we cannot produce the report.

However, what we have done is put in place a small data gathering team. They will not write down anything that is a judgment, because we cannot do that without potentially prejudicing the enforcement process, but we are going through the process of gathering together the files, doing some of the straightforward calculation analysis that we did with RBS on capital and liquidity, having done it before, so that as and when we get beyond the enforcement case—but I do stress we have no control over the overall timescale of that—we will be in a position to launch it.

At that stage there are a set of pros and cons, and they were touched on by David Walker in front of you, as to whether one does that with an external or internal review process. One of the problems on the whole—although I think this process has been incredibly successful, the combination of an internal process with external reviewers has produced a high-quality report—it is very time consuming for a lot of our best people. It is time consuming at a senior level. It has been very time consuming for myself. So a bit of me thinks that the best thing would be simply to pay somebody else to do it at that stage. But there are very strong pros and cons on that, which relate to the wider issue going forward for the PRA as to whether reviews should be done externally.

In summary, I believe that we should produce something on HBOS which is equivalent to this. The good news is it should be shorter, because it is a simpler business—it was not in lots of different businesses in the way that RBS was.

Q191 Michael Fallon: It is over three years since HBOS failed. If we are going to get a report like this, should we not have it fairly soon?

Lord Turner: We are in a legal position where we cannot, without prejudicing the enforcement case, launch a separate public accountability. Within the Bill there are, quite appropriately, and again this is something that I flagged in various letters to the Chairman—

Chair: Which I have raised with you as well privately.

Lord Turner:—yes, issues as to who should be the arbiter, and I think it can only be the Treasury, and of whether one thinks that with the strong publication interest we should be willing to prejudice an enforcement approach. I think it would be unreasonable for us to do that, because if that resulted in prejudicing an enforcement case we would then be criticised, and that is why we welcome the idea that, going forward, there is somebody who is responsible for making that balance in the timetable.

Chair: Thank you very much, all three of you, for coming this afternoon. It has been quite an interesting hearing, quite important for transparency, and very much along the lines of the sentiments that were being expressed a moment ago by Mr Sants. We are very grateful to you. We have a lot to digest now, and that is what we will do. Thank you very much indeed.

Oral evidence

Taken before the Treasury Committee

on Tuesday 24 January 2012

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Andrea Leadsom
Mr Andy Love
Pat McFadden
John Mann
Jesse Norman
Teresa Pearce
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Sir David Walker**, then Specialist Advisor to the Treasury Committee, and **Mr Bill Knight**, Specialist Advisor to the Treasury Committee, gave evidence.

Q1 Chair: You have not brought a large audience with you today. Thank you very much for coming to see us this morning, but more particularly, thank you both very much indeed for the work you have put in on behalf of Parliament to help us get to the bottom of what really happened on the RBS failure. We are extremely grateful to you for doing it. It is something that Parliament has not tried to do before, which is to send specialist advisors into a quango to find out what really happened, and it may set a precedent for the way we may need to keep an eye on a number of the quangos that answer to us, including the ever so mighty Bank of England, in the future. Can I begin by asking first Sir David and then Mr Knight whether you now have a clear grasp of why the FSA published only a one-page summary about the failure of RBS and whether you think that was reasonable?
Sir David Walker: Yes, I think we do have a clear grasp. It was a mistake. It was unreasonable. It was based—and this is my partner's territory—on a view that bodies like this may say as little as possible when there is no enforcement charge to be brought. But in the circumstances, as Adair Turner makes clear in his letter to you thereafter, there is a huge public interest in this that deserved a proper analysis and account of what happened, so it was a mistake. I am sure there was no agenda other than the desire not to say more than they had to.
The only other thing I would add was that I think you know from a conversation that we had at the time, between the publication of that document—the one-pager, or less than one page—and then the commitment to undertake this exercise, I thought it was unfortunate that they said that they had found no failures of corporate governance.

Q2 Chair: That sounds as if it was an understatement on the basis of what you have subsequently said in your written report. Mr Knight, do you want to add anything?
Bill Knight: I do not think I have anything to add to that, Chairman. I think that sums it up.

Q3 Chair: Just to clarify one point in your initial remarks there, Sir David, do you think that there should be acceptance that there is a public interest override to non-disclosure on enforcement issues?
Sir David Walker: Can I pass that to my partner because he is much more expert on process than I am?
Chair: Was that too hot a question? It has gone straight to the lawyers and we have not even passed the first set of questions.
Bill Knight: I think there is a balance, actually, to be struck. I think that individuals who give evidence in circumstances where they are protected by the law of confidentiality are normally entitled to rely on that.

Q4 Chair: I am sure everybody would agree with that, but I asked you whether there should be an override in exceptional circumstances.
Bill Knight: I think in practice that has been achieved in this case.
Chair: I am asking you whether that should be a precedent.
Bill Knight: I do not know the answer. I think that individuals do have a right to privacy.
Chair: We are agreed on that. I am asking you whether you think that there should be an exceptional case override.
Bill Knight: I would have thought not. I think each case has to be considered on its merits. I would not put in a principle of exceptional case override.
Sir David Walker: We would not disagree on many things and I do not think we have, but on this I disagree with my colleague. In exceptional cases where the public interest is so massive in having an account of why the taxpayer—and the taxpayer part of this is the least of it, given the damage to the wider economy. I think that justifies an override notwithstanding the importance of the principle.

Q5 Chair: You were nodding your head in agreement with Sir David having just said the opposite. Have you changed your mind?
Bill Knight: No, I would not wish to enunciate a general principle. I think each case should be decided on its merits.
Chair: Always good to get clear advice early on in the morning.

Q6 Jesse Norman: I apologise, it is not actually clear to me, Mr Knight. Either something is decided on a general principle or it is decided on a case by case basis. If it is decided on a case by case basis, then presumably there could be an exceptional case in which the decision went the other way. If that is true, you are agreeing with Sir David.
Bill Knight: Sorry, but I do not want to be tied down on it. I think that individuals have rights. If they are told that their evidence is confidential, then on the whole I think that should be respected. That is my starting point.

Q7 Jesse Norman: Thank you very much. Sir David, how would you briefly describe the FSA's performance in regulating the Royal Bank?
Sir David Walker: I pause because it is necessary to begin with the predicate that the policy environment globally was massively inadequate, so we have to start with that very substantial disengagement, if you like. On the whole, they operated well within that very unsatisfactory environment. There were exceptions and in the interests of economy, time and prioritising I would think that the most significant was failing to see that the proposed ABN AMRO acquisition, despite the fact that they had no formal power to stop it, was wholly special and posed questions for capital, liquidity, leverage and risk assessment of a dimension that justified putting a taskforce on to it, which they palpably failed to do.

Q8 Jesse Norman: It was, as I recall, a contested takeover where they were making a cash offer. Is that right?
Sir David Walker: Substantially. It was certainly contested. It was largely a cash offer. Whether it had to be exclusively a cash offer was a matter that might have been a subject for discussion with the regulator.

Q9 Jesse Norman: But both of those features ought perhaps in your view to have alerted the regulators that something serious was up, in addition to the size?
Sir David Walker: Yes.

Q10 Jesse Norman: Mr Knight, do you want to add something?
Bill Knight: Yes, I agree. Indeed, the FSA frankly admit that it was a mistake.

Q11 Jesse Norman: In the statement of purposes, I think it is, we ask that as much written evidence accounting for the failure as is reasonably possible should be put into the public domain. Are you both satisfied that as much information as possible has, in fact, now been put into the public domain or would it be possible to add substantial chunks of these PWC reports and other information as requested?
Bill Knight: Yes, I think that when we appeared before you in private session we said nothing would be hidden from you and I think we have achieved that. I do not think there is anything that has been hidden from this Committee.
Jesse Norman: Of course, that is quite a separate question as to whether more information could be put in the public domain.
Bill Knight: Yes, of course more information could be put into the public domain. These reports, Pricewaterhouse's reports, are over 700 pages long. This is summarised in a very short space, but our view is that summary is fair and, in the context of trying to decide what happened here, our view is that is a fair summary. Yes, of course, there could be more information, but we think we have a fair summary.
Sir David Walker: If I may add, there is nothing, Mr Norman, that has not been published that in our view has any materiality or which if you had it would lead you or us to reach a different view of the story, the narrative, the account.

Q12 Jesse Norman: That is a very strong and very helpful conclusion. Thank you. In the FSA's document it says that in autumn 2007, in light of market conditions, the FSA CEO and chairman did consider whether the FSA should intervene in the ABN AMRO acquisition but determined it should not. Now, amazingly, as far as I can see, there is no explanation as to why they determined that they should not intervene in some way. The report agrees that that decision was reasonable. Do you agree with that view? You have hinted that you do not think it was reasonable, that they should have intervened in some way, albeit they did not have formal powers to do so.
Sir David Walker: There is a problem in the whole report and in the process in which we have been engaged, which is the judgment of history—hence my answer to your first question—this was a major error of omission that they did not stop it. The answer at the time is a bit more nuanced and difficult. I do not qualify the historical verdict. At the time, for one, they were not aware of the acuity of the liquidity exposure of RBS because they did not focus on it. That was a wider failure of regulation.

Q13 Jesse Norman: This was a culpable negligence to pay attention to liquidity issues of very highly wholesale financed banks?
Sir David Walker: No regulator did. It was part of the policy environment. But there were more specific things that—exonerate may not be the right verb. I will identify two. One was that on 10 August more than 95% of the owners of RBS voted in favour of the proposed merger. There is a very interesting question that we do not spend time on here. Where were the shareholders in responsibility for all this? But leave that aside, I think that if there had been an intervention in August or early September, which would have been a time when technically it would have been possible, this would have destabilised RBS. There is no question that the time for intervention of the kind that we now all see would have been highly desirable, appropriate, necessary, would have been much earlier, which is why we say in our document the regulator should have control, clear control in black letter primary legislation, and the way that control should be operated is right at the front of the process before all this gets into the public domain.

Q14 Jesse Norman: Very final question, thank you very much for that. Do you think that this process has been one that ought to be replicated for all of the

public institutions that were in any kind of supervisory or regulatory responsibility with regard to the crash; that is to say a thorough self-examination with external review as necessary in order to ensure proper transparency and, as it were, accountability to the public?
Sir David Walker: My view I think would be there is a good case to be made. This is the most dramatic. There is one other that is perhaps nearly as dramatic. Probably, would be my view.

Q15 Chair: HBOS is the other case you were referring to before? You are basically saying yes on HBOS? It is a valuable procedure.
Sir David Walker: Yes.

Q16 Mr McFadden: Isn't there a problem in asking the FSA to review the collapse and their own actions in this way, in that they have an interest in passing blame in two directions? Firstly, to RBS itself, of course, for the decisions it took, and you mentioned ABN AMRO and the way they ran the bank. Secondly, to kick blame upstairs to the politicians knowing that the heat of the political debate will mean that if they mention a letter from Tony Blair or they mention Ed Balls or they mention other politicians, that will take a huge amount of attention away from their role as the regulator and their job to actually supervise the system. Is that not what they have done in this report?
Bill Knight: I think that where an institution reports into itself they do have the advantage of being able to put their own point of view, certainly. What I would say was the advantage of it, though, is that it gets the facts out. Here is a document now that does state the facts. The judgments and conclusions the FSA themselves say can be a matter of public debate. With these facts as stated in here the debate can commence. While admitting that there is truth in what you say, I do believe the great merit of this is that there is a correct statement of fact that has come out.
Sir David Walker: Could I add to this, Mr McFadden, that there is also a question of the efficiency of the process as well as the outcome. In relation to the efficiency of the process, my expectation would be that if as an alternative route this Committee or whoever engaged lawyers and accountants to do a full investigation of the kind that the Governor proposed in this room a week ago—or at least indicated he might have preferred—it would have taken a much longer time, perhaps two or three years, not 12 months, and would have been hugely more expensive. It is quite interesting that the FSA review team was a bit more than 10 man-year full-time equivalent and the total cost of that was between £2 million and £3 million. The PWC investigation cost very significantly more than that, and that was focused exclusively on the enforcement part of the exercise, not on the history, which probably is of larger interest certainly in bringing the facts to light. So, the cost consideration is also relevant.
Bill Knight: If I may, it is also worth pointing out that part 3 of this report is a summary of an independent investigation.

Q17 Mr McFadden: Costs are a factor, but the cost of the collapse was of a vastly different order and, of course, the whole country is still paying for that. The point I am trying to drive at is that I accept your point about costs but in asking the regulators themselves to review their own role in this, don't they have a vested interest in saying, "Well, mistakes may have been made", but trying to pass the blame in the two directions that I spoke about?
Sir David Walker: My sharp answer to that, Mr McFadden, would be that if the Committee cannot in a situation like this trust the regulator to do an objective appraisal—maybe with the scrutiny of people like Knight and Walker, but leave aside our role—then the Committee has a problem with the regulator and his or her integrity, and that is much more serious.

Q18 Mr McFadden: Can I ask you about a specific point in the report on enforcement action? This is of huge concern to our constituents who are paying the price of this bank collapse and they see no one as really having carried the can. We have had one person who has been banned from working in banking. A lot of people walked away with an awful lot of money. We have had the political controversy over Fred Goodwin's knighthood and so on. First of all, can you confirm it was the same part of the FSA that initially recommended no enforcement action that then reviewed that decision in this report?
Bill Knight: I do not think that decision was reviewed. It was made on the basis set out in the report, and it was made, as I think Lord Turner says, by a team who were very keen on ensuring that all proper enforcement was taken.

Q19 Mr McFadden: But it does seem extraordinary to the general public that no one has had any charge brought against them for this collapse. Isn't there a case for at least an independent review of the FSA's decision on that specific point?
Bill Knight: There is no allegation here of dishonesty, and I think that is a massive first point. I think Lord Turner makes the point in his foreword that it is surprising to the general public, as you say, that no enforcement action was taken, but that so far as they can see is the law. There is no question here of dishonesty or even lack of integrity.

Q20 Mr McFadden: Apart from the FSA, RBS and PWC, who else did you speak to or take advice from in your role as reviewers of the review process, if you like?
Bill Knight: On that, our terms of reference specifically tell us that we are not to take a view on the desirability of enforcement proceedings. That is the first point. Those are the terms of reference that you set us, so we did not take that view as instructed. We interviewed directors of RBS, we spoke to the partners of PWC, and we took our own legal advice and we instructed accountants to check the figures in the report. That is what we did.

Q21 Mr McFadden: Finally, just on the process point going forward and following on from Jesse Norman's questions and looking to other situations where other organisations may be asked to review their own role in what happened a few years ago, is the better model what happened in this case, where the organisation or regulator themselves reviewed, with someone like yourselves appointed to make sure that process is honest, or a separate approach, where it is not the organisation itself that carries out a review of their actions, but actually someone else—a fully independent team or a judge or somebody standing outside the process who is sent in to do it? Having been through this experience, which of those two, looking forward, do you think is probably the better process?

Bill Knight: I think that each has its advantage and disadvantage. Can I say one thing about this model? I think it is absolutely vital if you go for this model that the board or the governance of the organisation concerned accepts, individually and collectively, responsibility for ensuring that the report is fair. I think that is absolutely vital. That is what they have done here. The board of the FSA have given us an assurance that in their view this is a fair and balanced account. I think that is terribly important because that means that examiners such as ourselves and the board are working together and they take this very seriously, believe you me. They do.

Q22 Mr McFadden: But the problem is, to use the famous adage, they would say that, wouldn't they?

Bill Knight: I agree so, as I say, each has its advantages and disadvantages. The advantage of this is speed and cost and getting the facts out. The facts are right, we are confident about that. The disadvantage is perceived lack of independence by an independent examiner, but experience shows, certainly in the case of Companies Act inspections, that such inquiries take a very long time, cost a great deal of money and often are quite non-committal, actually.

Sir David Walker: Could I make two observations, Chairman, just in enlargement of responses to Mr McFadden? One is that notwithstanding that—and we discussed this with the Chairman right at the beginning—I am not competent to judge enforcement matters. Whether enforcement might succeed if charges were pressed is a matter for legal or judicial judgment. However, in one area we did suggest to the FSA and to the enforcement team we were surprised that a particular matter had not been examined. I think we say it here, but I will say it now, which was to do with competence, not integrity and not dishonesty—the criteria for enforcement are incompetence of a negligent kind, failure of integrity or dishonesty. The particular competence question that we were very concerned to raise was whether Sir Fred Goodwin had discharged his responsibilities as a delegate competently. We thought that was an important question, which is dealt with now in the enforcement report, which I think had not been addressed in the degree we felt necessary in the earlier work that led to the December 2010 statement. The conclusion was a negative conclusion, though nonetheless we think it is hugely significant, which is why we think it is an area for future policy we might discuss later if you wish, to give much greater attention to that.

The other matter, which is quite different, which relates to Mr Knight's response, and it is a point he has emphasised and impressed me greatly with, is the importance of having the board of the body committed to the description of what happened. Of course, there is a prior question—one this Committee is addressing—which is that there is not much point in having the board committed to the view that is being expressed if the Committee does not have confidence in the board itself. It leaves aside the very important question of the population of the board itself and whether it is appropriate, which is why in this document we say that vis-à-vis the PRA—which in a way is the principal, though not the only successor to the FSA—it is very important that there be on that board people with particular skill sets, impliedly to a greater extent than are present in the FSA board.

Chair: Let us get into exactly that subject.

Q23 John Thurso: Sir David, that is a question I want to ask about, but just to put it in context, can I ask you very briefly some questions about your impact on the actual report? Bearing in mind the start point for all of this was that prior to the intervention of this Committee the FSA position was that no report was necessary or desirable, and this, which is probably one of the most important reports anybody has read about what happened in our financial services industry, is a direct result of this Committee requiring it and you being our eyes and ears on it, so I am very interested to know, first of all, how much of an impact you had. Perhaps just briefly, how many drafts of the reports were there? How much interaction did you have? You have the five areas that you sought more information on. Can you give us some idea of that process and at what point the FSA became willing partners?

Sir David Walker: Do you mind if—

John Thurso: Yes, whichever.

Sir David Walker: This is the division we have sorted.

Bill Knight: I think it is fair to say they were willing partners from the outset. We saw lots of drafts. I recall four main iterations to the report, but also we consistently saw the more difficult bits in isolation as well. It was a continuous process that went on right through the summer. We both read the long and the short bits. We made continuous comments. We were satisfied on our comments. The FSA were meticulous in dealing with every comment that we made, coming back to us on it. I think the process worked well. It was a difficult process because it is a very difficult subject matter, but as a process I think it worked well.

Sir David Walker: I crave the Committee's indulgence because we bring different skill sets to this. To give an example of the easy, we spent very little time on liquidity. You could say, "That is very strange because it is actually the liquidity that brought them down"—brought them to the exceptional assistance they needed on 8 October 2008. But the liquidity story, the dependence on the wholesale markets for funding, is just a hugely unsatisfactory story of a generic policy that was defective and a lack of attention, which the FSA acknowledge. We satisfied ourselves that the facts are correct in that account of what happened. That was the easy area.

The hard area, which is protean in its complexity and really difficult to wrestle with, was the functioning of the RBS board, where decisions ultimately were taken to proceed with ABN AMRO, and not even to think about liquidity. That is the error of omission, if you like. The difficulties there are I think best described as being a concern with accuracy but also with fairness. The two adjectives that are relevant are forensic and historical. This is the forensic; this is what actually happened. The judgment that is really difficult is: were the decisions that were taken—though bad decisions plainly with hindsight—bad decisions when taken at the time or were they in the circumstances reasonable decisions? That is really hard to gauge. How much challenge was there in the boardroom of the kind that, as you know, is immensely important in a well-functioning corporate governance? That is really hard and I have to say, with my colleague, we found the dialogue with the FSA around those questions wholly—well, we were in the same place and we were trying to find the truth.

Q24 John Thurso: I think you have put your finger on one of the things that the predecessor of this Committee found when interviewing the chairmen and chief executives of particularly HBOS and RBS but also other organisations, was a very big flaw in the corporate governance structure of particularly those two banks and the lack of challenge, so I am not surprised that that is a big area. But it leads me on quite neatly to the question I wanted to ask you. One of the five points that you brought forward was a fuller description of the nature and degree of involvement of the FSA board in setting or endorsing relevant policies and, for me, also the non-executives of the FSA board. How guilty were the FSA board as being a bit like the RBS board and leaving it to the execs to get on and rubberstamping?

Bill Knight: Well, this is a subject that is dealt with at length in the report. There is no doubt that the FSA board did not spend a great deal of time in the review period on basic banking prudential supervision. They make that quite clear. I think, quoting from memory, out of 61 major matters brought to the board in 2006–2007 only one related to banking supervision. They spent a great deal of time on other matters, treating customers fairly, Equitable Life, split capital trusts, mis-selling of pensions, all the other problems that the FSA were dealing with. That was one aspect that came out very clearly.

Q25 John Thurso: Can I just ask you on that because I think it goes to the heart of what we expect non-execs in any of these bodies to actually do, which is do we expect them to challenge what the executive put forward as the work to be done, or do they accept the work that the executive give and challenge the competence and way in which the work is done? The two are quite different and I think, Sir David, from that nod you see where I am driving. It is a huge problem or culture difference that we need to look at.

Sir David Walker: May I give two observations, Mr Thurso? One is—and this is policy-relevant in a positive way now here in this country, partly as a result of the work of this Committee—that the FSA board were, like just about everybody else, victims of the intellectual environment. They thought that markets were inherently stabilising and efficient. Many of us certainly were part of that belief, which proved to be wholly erroneous, massively, dangerously wrong. I think that criticism of any board does need to aim off for the fact that the policy environment was one in which the areas of concern that were appropriate for a regulator were to do with conduct, mis-selling, all that stuff, and that the dispersal of risk into the wider markets made the system more whole and stable, which was, as I say, a massive misjudgment.

As far as your specific question is concerned, I acknowledge that my view is—perhaps the word is "hawkish". I would be in the camp of saying that the responsibility of non-executive directors—not only in financial services, which is our focus here obviously—in a board environment, which is after all the most important policy decision-taking entity in the free world after elected bodies like parliaments and councils and so on, is to be much more challenging of the executive proposition in the normal course than has ever been the practice hitherto.

Q26 John Thurso: Across the board, if you look at most FTSE boards, there is a very considerable degree of groupthink and an unwillingness to challenge the core philosophy of management. I am sure there are notable exceptions but my firsthand observation is that most boards are very collegiate, which is quite a good thing, but that means there is no opposition. Are we at the point where that has to be severely challenged and perhaps the gene pool for non-execs should be widened out and be more than just other previous advisors and chief executives of other companies? Do we particularly have to have regard to that when it comes to public institution non-execs such as the FSA and the PRA?

Sir David Walker: Basically, I agree with the thrust of your thinking, although I do not think it is as binary as that. It is not quite black and white. I do think we are going through a phase of improvement. Non-executive directors now—and, of course, I generalise; it is easy to find exceptions—do recognise that they have this responsibility to challenge. It is very important to be clear about the chronology of what happens in the boardroom. It is the role of the executive to propose a strategic initiative—we acquire ABN AMRO or develop a new product or trading area or whatever it is—in any business. It is then for the chairman to organise a proper discussion. You have to define what is strategically significant with this; but if whatever it is is strategically significant it is for the chairman to organise a serious discussion around that, expecting and encouraging challenge from his non-executive colleagues. It is then for the chairman to sum up, "We agree with the proposition" or, "We disagree" or, perhaps most likely, "We agree but think it ought to be modified or delayed or possibly accelerated". Then the executive has to be fully empowered to implement. There is a real balancing act in this and I would not want in my broad acceptance of your analysis to be misconstrued as

undermining the authority of the chief executive. The executive is there to propose, to be challenged—
John Thurso: I completely agree with that.
Sir David Walker:—then to implement.

Q27 John Thurso: But let me then just come back to the FSA board and your assessment or an assessment of their actions in relation to the RBS affair. Could they have done anything better and is the board of the FSA culpable in any way for what actually happened? What are the lessons we need to learn for the future?
Sir David Walker: My answer to that question is no, not culpable. I think we have to change the policy expectation of what the board, like in FSA, does and, therefore, the Committee's views and the legislation in relation to the PRA and so on are hugely significant. In the circumstances of the time, given the pressures that were on the board in other matters to prioritise conduct issues, I think it is quite hard to fault the board.

Q28 Chair: Can I just pick up that last point you made, Sir David, where you say that we need to change the policy expectation for what the board does with respect to the PRA and to the FCA? What you are saying there, I think, is that these institutions need a strong non-executive cadre of people capable of challenging—not at the time that policy is being formed but at least retrospectively capable of getting into the merits of decisions that have been taken and ensuring that scrutiny takes place.
Sir David Walker: Yes.

Q29 John Thurso: Is that what you mean? Therefore, you support what the Committee has said, presumably, on Bank of England reform, which encounters so many similar problems? You take the fifth?
Sir David Walker: It is a curate's egg, Chairman. The question posed initially and the answer that I was giving related to the PRA and the FPC—

Q30 Chair: The PRA is going to be in the Bank.
Sir David Walker: But it will have a board and we have expressed here strong views about how the board should be composed.
Chair: You are taking the fifth, aren't you? It must be like what we hear about the secret services: once in the Bank of England, always in the Bank of England.
Sir David Walker: I do not agree—

Q31 Chair: Could I just ask you one other very factual question, unless you have something else you want to add on that point or subject?
Sir David Walker: Well, the only observation I make in our discussion, and of course I respect there is a wider one elsewhere, is that I would see the matter of competence and industry knowledge—financial service markets knowledge—as of much greater importance in the composition of that top body than has been the practice, recently at any rate.

Q32 Chair: Do we have the wrong people?
Sir David Walker: Something like that.

Q33 Chair: Something like that. We are getting there. I just want to clear up one factual point. Did you see all the RBS board minutes and all the FSA board minutes for the whole period relating to this report? I just want to check whether you did.
Sir David Walker: We had access to them. We saw a lot but not all of them. We could have seen all of them.
Bill Knight: I think I read all the FSA board minutes, yes.

Q34 Chair: Just to clarify one other point on the non-executives, you said that only one of the 61 matters they looked at were of a prudential nature. I think that was the evidence you gave a moment ago. They were asleep on the job, weren't they? Doesn't that score as asleep on the job, bearing in mind that we had already had Northern Rock for part of that period?
Bill Knight: No, no, the period—
Chair: For none of that period?
Bill Knight: For none of that period. The period referred to is 2006–2007 up to—
Chair: I see, not 2008?
Bill Knight: No, it is in the report. They became much more engaged after Northern Rock.

Q35 Teresa Pearce: First, thank you for the work you have done. Poring over those minutes must have been extremely tedious, I can imagine.
Bill Knight: No, actually, it was very interesting.
Teresa Pearce: Really? Well, maybe we will get to see them one day. Is it fair to say that in the review you have done of this report you believe that the report is fair and comes to accurate conclusions?
Bill Knight: Yes.

Q36 Teresa Pearce: In part 2 of the report, they talk about poor decision making and mistaken decisions, which is another word for wrong decisions. I think a couple of the words used earlier about the views that were taken, during the period this report refers to, by the banking industry and the FSA sometimes were erroneous or dangerously wrong, that sort of language. Why do you think that we can now be sure that the views that they have arrived at are right when they have been so wrong in the past? Is there something specific that has changed in their—
Sir David Walker: Is your question about the FSA?
Teresa Pearce: My question is about the FSA's report into RBS—given that the FSA has been so wrong in the past, why do you believe that they are right now?
Sir David Walker: We may do this together. I think there are three areas of material improvement that make me answer that question with a fair degree of confidence but not total confidence. If the question is—which is not the question you asked, Ms Pearce—could this happen again? It is very unlikely, but you never say never.
The three things that have changed, which give us a lot of confidence, are first what I call the black letter regulation. The regulations about capital—the amount of capital, the quality of capital, liquidity, the nature of liquidity, leverage limits and all that—are now enshrined or are in the process of being enshrined on the basis of a major international initiative. I do not

want to disparage it. It is hugely significant and necessary, but at the end of the day either a bank has the right capital and the right liquidity and so on or not—it is a box-ticking thing and the FSA must ensure that they have that. There are reporting and IT questions and all the rest, but ultimately it is not intellectually difficult. Once you set the numbers, complying with them is a matter of rote.

The second area is the scale of resource committed by the regulator to looking at RBS or other major institutions like it. I was frankly amazed to find that five people in supervision were doing RBS and Barclays for critical parts of this time, and palpably unsatisfactorily, as the FSA acknowledge. They are now putting much more significant resource into supervision.

The third leg—it is a kind of three-leg stool in my book—which I think is the most difficult part, relates to quality of resource. I think it is better now, but the jury is out on whether it is yet good enough, and we shan't know for some time. It is not enough in these supervisory roles just to throw more accountants or lawyers or former investment bankers and whatever it is into teams. They may have an important role to play, but I think that there is a need for experience and quality of judgment, which in part comes from experience in this area. I think the FSA still have some way to go, as do most regulators on the planet, in getting enough high quality experience into the supervisory process, which is why in our observations to you we say that for the future getting the relationships of trust, the right relationship between the supervisor and the board, is of absolutely critical importance and conformity with the black letter requirements alone is not sufficient.

Q37 Teresa Pearce: Do you think in what you said there about the box ticking and that sort of thing, the attitude and the culture of the organisation is also very important? You have looked at the board and the CEO and delegation and where the responsibility lies, but the culture must come from the top. Do you think there has been any change in that or do you think there needs to be further change?

Sir David Walker: No, I think my read—I do not know whether Mr Knight agrees with this—would be that the culture at the top has changed. I would be very surprised if the answer, if you were to ask them about the importance of this supervisory relationship and the culture that is necessary, were very different from the views that I take. I think the problem is just getting the people in. To have a culture of the kind that I believe to be necessary requires very high quality people, and whether they have enough of them—I think the people they have are high quality. I think they may need more. There is cost in that. I think it is a journey not yet complete. I bring to mind, if I may, the distinguished former Governor of the Bank of England—and I stand reproached as a Bank of England chap of long time ago—who said, and I thought it was very telling, that good judgment in banking comes from experience. The trouble in banking is that most experience comes from earlier bad judgment, which is why experience is so—

Teresa Pearce: They should be very experienced now.

Sir David Walker: It is relevant to the quality of the supervisory team that probably there is a need still for greater experience toward not the top level but the second level down in the FSA or the PRA to come.

Q38 Teresa Pearce: Just a further question. One of the criticisms obviously is that the industry is investigating itself and the view is that the industry did not regulate itself well so why should it investigate itself well. One of the remarks, I cannot remember which one of you actually said this, was that nothing has been hidden. Although nothing has been hidden, not everything has actually been seen. Would you support the idea of all the minutes of the board being published? If not necessary, do you think it is desirable?

Bill Knight: I do not think it will add very much, I have to tell you. I have read them. I have read the FSA board minutes. You will find there is an awful lot about treating customers fairly and matters of that sort in there. I do not know, are FSA board minutes published now in the normal way?

Chair: No.

Bill Knight: No. I see no reason why summary minutes should not be published.

Q39 Teresa Pearce: Although you do not think it is necessary, you do not think it would be desirable or it would at least alleviate the fear among people that there was something—

Bill Knight: Yes, it would certainly do that.

Teresa Pearce: Be more open.

Bill Knight: There would have to be safeguards presumably for individual confidential cases.

Sir David Walker: My view is that it would be a wholly bad initiative. I would be against it. The reason I would be against it is when I did my report on corporate governance in banking a couple of years ago, I think I said in my covering note or something or other that one of the most interesting—and for me most interesting because most unexpected—sources of input was from a group called the Tavistock Institute here in London, who are behavioural psychologists. One of the things—the Chairman mentioned it—would be how boards behave, how groups behave, how, for example, the efficiency of a big group disintegrates quite rapidly. If you get above a board of more than eight or 10, the efficiency starts to go away quite quickly. I mention this because the behaviour of people in any group—you are talking about a board—being recorded will be different. What is said will be different if they know that what they are saying is going to be published. What we actually want, which goes back to Mr Thurso's questions, is boards behaving in a tough, rigorous, challenging way. If everything I say in the boardroom that is challenging, "Oh, Chief Executive, you have this wrong, you have failed to understand", I cannot say that if it is going to be published. I think that is a great loss. It arises in a very specific way now—and some of us have wrestled with it—I would be sceptical about the publication or the availability to the regulator of board performance evaluations. I think that boards should have their performance evaluated on a regular basis, often done by themselves with external facilitation. If that report is to be made available to the regulators or published to the shareholders—and you can make a perfectly good transparency case for that—then the value of the whole process will be, in my view, significantly undermined.

Q40 Teresa Pearce: One final question. The FSA report relies heavily on the evidence gathered by PWC and that evidence, as you mentioned before, is very lengthy and very in-depth. In your report you say that if the Committee were to read the PWC report they would learn much about the detail. I have to declare an interest; I used to work for PWC. Do you think it is advisable for us to read those reports? Do you think it is necessary?
Bill Knight: No.

Q41 Teresa Pearce: You would not support them releasing those reports to us? I know they belong—
Bill Knight: Well, that is a different question. If you ask me would you gain a lot if you want to know about the reasons for the failure of the Royal Bank of Scotland and why no enforcement proceedings were brought through reading those reports, I would say no because I think that the summary that you have deals with those issues.

Q42 Teresa Pearce: The summary is sufficient. You did, I think, say you had conversations with the partners who prepared those reports?
Bill Knight: Yes, we did.

Q43 Teresa Pearce: Do you know which department of PWC they came from? Was it audit, tax, forensic?
Bill Knight: I fear I have forgotten. I should know. We could let you know.
Sir David Walker: I think it was quite a team of audit people—
Bill Knight: There were three reports. They were done by different people.

Q44 Teresa Pearce: Because although I have the utmost respect for PWC as my previous employer, could you not see that maybe a company that sells their services to banks and has quite a large department that sells their services to banks, maybe it would not be in their commercial interest to support rigorous enforcement and people might see that as a conflict of interest?
Bill Knight: No, I could not accept that. I think they did a thorough job.

Q45 Teresa Pearce: You think it was completely ring-fenced and—
Bill Knight: I do. I think it was a thorough job. I have read the report. I would not support that.
Teresa Pearce: I would be interested to know which section of PWC it came from though.

Q46 John Mann: I am interested in this point you made, Sir David, just now about behavioural psychology because there has been a lot of bandying around of the word “culture” in terms of behaviour, but that has rather been sidelined in terms of everything since. Here we have a report by the FSA on the failings of the FSA, one could say. How do you think the organisational psychologists would analyse that?
Sir David Walker: Well, in my respectful submission, you could perhaps ask the behavioural psychologists. When I referred to Tavistock—there are obviously others—I was very struck by the importance of behaviours in ways that are not a function of ticking boxes, making sure the capital is right or the liquidity is right. Those behaviours are influenced by all sorts of factors like the style of the chief executive or the style of the chairman or the size of the board, the vulnerability to groupthink.
Your question I think, Mr Mann, is specifically about the FSA. I think more important than behavioural psychology there in explaining what happened, and I think this does emerge pretty clearly from the FSA report, was that the FSA was, let us say, a cog with a lot of other cogs in the international regulatory environment, which—as the report acknowledges and we sought to emphasise—was a huge blight, if you like, on the whole process from start to finish. The fact that there was no attention paid—almost literally no attention paid—to liquidity was not a matter of culture. It was just policy thinking. People did not think liquidity mattered because the markets had abundant liquidity and you could always go to the market and do a conduit or commercial paper transaction or whatever. I do not think that is a cultural thing. It was an intellectual mindset, a belief in a functioning of these vast markets that was wrong.

Q47 John Mann: It was also convenient, and one of the interesting questions when it comes to externals on any organisation, it seems to me, is that if they are more of the same and in the same mindset, then their contribution may be specialist but it is going to be almost by definition very limited. But the question, particularly thinking of an organisation like the FSA, is who is asking the difficult question or does the comfort zone become overarching. Let me ask a follow-on to that because I think it is an interesting area that someone has to get to grips with. Who would be the appropriate body in the future to decide whether a public report is justified?
Sir David Walker: Well, I am not sure it is for me to advise on whether the Treasury Select Committee would—a financial service entity would obviously be expected to or might be expected to have a view.
But if I could come back, Mr Mann, to the predicate of your question of who should be challenging, the problem for the FSA—and whether it is the board or the executive for this purpose is substantially immaterial—before late 2007, early 2008, I cannot emphasise enough the global policy environment was one of not blind faith but acceptance that the markets were inherently stabilising, that the system was sound, that the areas of product development, like the development of a credit default swap market, had shifted risk out of the banking system into insurance companies or elsewhere. That proved to be wrong as a matter of fact, but people did not know. When one is asking for challenge of what had become the conventional wisdom, one is really looking for

individuals in the organisation and the board who say, "Well, hang on a minute, is this international intellectual concordat right or is it seriously flawed?" Some people in some entities were saying, "Well, hang on a minute, can this go on forever?" Of course, if I may say so, for governments and I think oppositions, for banks, for employees, they were good times from which everyone seemed to benefit. I know that some chief executives have said to me subsequently they felt that this could not go on forever, but they thought actually the other guy had inferior systems and if someone got into difficulty the other guy would run into trouble first.

Now, you could say that leads to a sharp question about the FSA, why weren't they on to that? Well, I think the arguments here set it up rather well: there was not much concern about capital in the way that is now considered appropriate. If I give one statistic, which I think is truly dramatic—it shocked me and I know about these things—the FSA's calculation now of the Basel III Tier 1 capital of RBS at the end of 2007 was 1.97%. What would be required now is not less than 9.5%. They did not do that calculation at the end of 2007, but on the calculations that they did, they thought RBS's capital was kind of okay. They needed a bit more so they raised as much as they could in April 2008.

Q48 John Mann: Is there any need for a similar type of exercise to be carried out looking at HBOS, in your view?

Sir David Walker: I think we have given a view on that—probably.

Q49 John Mann: Lord Turner in 2010 said, "A report into the failure of RBS would add little, if anything, to our understanding of what went wrong". Why do you think he said that?

Sir David Walker: As we said, right at the outset, I think that was a misjudgment and if I might suggest his view, I would imagine—I think I know his view now is that—having done this exercise, there emerged matters of understanding that have been hugely beneficial for the regulator. Of course, information is laid out to the Committee and we have transparency in the way that Ms Pearce was talking about, but I would think the regulator has learned a huge amount from this process.

Q50 John Mann: My final question. A change, be it of attitude, approach, mindset, systems, and so on, within the regulator. Am I hearing you right, you are saying that you think that has changed significantly as a consequence of the process and the production of this report, or is it something that had already happened and, therefore, this report merely sat alongside what was already happening?

Sir David Walker: I think it was happening. I would think the doing of this report has sharpened up some aspects of that, but the shock of Northern Rock and the matters with which this Committee was concerned, and on which you have commented, really shook the FSA in a way that caused them to do some fundamental re–thinking of the way they operated. I think a lot of that was in train, certainly by the time we arrived.

Q51 Mr Love: Sir David, I am happy to put this question to you because it will be put to me and other Members of the Committee after this session, and that is how do you respond to the accusation or the criticism that you have gone native on this report?

Sir David Walker: I am not sure how many times I have appeared before this Committee, but each time I have appeared on private equity or corporate governance, and now on this, I have been accused of not being independent, but that is for the Committee to judge. It is independence of mind not where one works. I do feel quite strongly about two things: people who are privileged, if you like, or fortunate enough to be in senior positions in the City—in the past in my case—have to be able to manage conflicts of interest. I would submit that if you are a senior person in the City and you can't manage conflicts of interest you should not be there at all.

In the past, there has been abuse, I do not doubt—certainly in the distant past—and one of the things that the SIF process of the FSA needs to be satisfied about is that people who are being put on boards are capable of managing conflicts of interest. That is more important the greater the weight you place on having people in positions like this or on boards, who know about the business. My submission would be that—although I am reluctant to concede even this—there is always a danger of going native or losing one's independence, but I take the point of principle, and you will have to judge whether I have lost my independence on this point, that the cost of that is very small, as against the benefit having people who know what they are looking at doing these things.

Q52 Mr Love: I do agree with you that there is a benefit to that. Let me come to Mr Knight. It has been said in this session this morning, certainly in your response you said there would not be any point in producing the PWC report. Sir David was thoroughly against—hostile—to reproducing the minutes, and I can go into that in a minute. We ought to remember, and this Committee is acutely aware, that £45 billion worth of taxpayers' money is shoring up RBS at the present time and that is not to mention all the liquidity support that has been given from the Bank of England. Don't you think that there was a necessity for more transparency in the way that this has been handled?

Bill Knight: It was handled under the Financial Services and Markets Act, which sets out conditions of secrecy, and you can't really avoid that, that is the law. I think what has come out of it, in our view, is a good, fair and balanced summary that hides nothing, but the way in which it was handled, the enforcement, is set out by statute. These things are confidential according to law. Nobody is making this up. So I am not quite sure what the alternative is unless you want to change the law.

Q53 Mr Love: Sir David, you mentioned in your report five different areas where you challenged what was being suggested should be included in the report. Do you think that was a sufficient challenge? Do you think the report is critical enough—I am not suggesting enforcement action or anything of that nature—of what actually happened in RBS at the time you are reporting on?

Sir David Walker: It is a hard question, Mr Love, and as you can imagine we spent a lot of time together talking about it and discussing it with the FSA. My answer is ultimately affirmative; yes, I think it is adequately critical.

If I could come back to your question about transparency on which I certainly have strong views. If transparency means publishing minutes for the great public, or including for this Committee or for shareholders, my position is the one I described before. But if transparency means information flow, then there were huge deficiencies in what is described here in the RBS story. The two deficiencies I described as being really serious were, first, inadequate information flow to the board itself. At no point did the board have any serious discussion about the dependence of the balance sheet on this overnight money. That was a huge lacuna. Another lacuna—so this is transmission of information, it may or may not be defined as transparency, depending on your semantics now really—is the flow of information to the FSA. As the FSA now acknowledge, the fact that they did not know what the capital position of RBS was on 31 March 2008, and had an impression that was, in the event, mistaken, is very serious. What is even more serious is that I don't think RBS knew either.

That management information stuff, in my submission, is much more important than public transparency. If you don't get that right, public transparency is a totally different discussion.

Q54 Mr Love: The question then is, if they never discussed liquidity, which was absolutely critical, if they did not know their capital position at any time, regardless of Basel III and what was expected of them at the time, isn't that damning evidence and shouldn't it be pronounced on a front page of a report that goes before the public? But I want to move on just briefly. You said that, of course, that under your terms of reference we were not expecting you to pontificate about enforcement, but do you believe, Sir David, that we should be changing the rules to make it easier in circumstances like this to be able to take enforcement action against individuals?

Sir David Walker: The specific question, which I think the Chairman of the FSA mentions in his letter, and which we have thought about quite a bit—well, not very long I have to say, Mr Love—is the proposition, which would be very serious if implemented, to introduce the concept of strict liability. That is to say that directors would be personally liable where things go wrong. It is a large question for debate. I would have a lot of reservations about that, not just in this case but if you said why not any director of a board of any company. The starting point, which is in a way perhaps the easiest point to make, is that I think there would be a question whether you would get directors ready to serve in those circumstances if their personal vulnerability was so great. That is not a reason for saying this isn't a problem, but I think there are better ways of dealing with the problem. I am much in favour of beefing up the SIF process. Maybe the FSA should have even more rigorous interviews of proposed significant influence functions people. That is a new departure and I think it could be beefed up.

I am also much in favour of a thing that is currently being discussed in another context, which is in relation to remuneration. We will leave aside all the debate about say on pay and all that, but I do think there is a strong case for more substantial deferment of pay. I would include in that non-executive directors, so that related to some performance measure their fee for 2012 is not available to them, or in some part not available to them, for three or four years, by which time the company will have demonstrated success or not failure. So I think there are things that could be done that would materially help, which are not strict liability.

Q55 Mr Love: Mr Knight, Lord Turner put forward an alternative for this automatic incentive–based approach, where there would be an automatic ban on directors who had taken part in the events that we are describing in this report. Does that have any merit or do you prefer the other mechanisms that Sir David has talked about?

Bill Knight: There is already an approved person mechanism. You can't become a director of a bank without FSA approval. I think that that is the mechanism to use, and if people are involved with failed institutions then the next time that they, as it were, apply for a job I think that has to be taken thoroughly into account and I think the circumstances have to be gone into. After all, they might have fought tooth and nail to do the right thing at that previous institution. I do not think you can just legislate across the board. You have to look at what the individual actually did. But I am very much in favour of that happening, yes.

Q56 Mr Love: Just one final question. During the course of your review, did you come across any information that might support the case for a review of the FSA's enforcement decisions, Sir David?

Sir David Walker: No. No, we did not.

Bill Knight: When we did question it, as we did at the beginning, we carefully looked at the chief executive in the context of his delegation. Then when we went into that we found it had been looked at thoroughly at the time. So we found that they had done a good job.

Q57 Chair: Just back on these minutes again, the FSA and RBS minutes, you said that if we saw them you do not think it would add very much, and as a general remark, Sir David, you said that if minutes were published it would influence behaviour adversely. You also said, in this specific case, exceptional case, perhaps other approaches, higher levels of transparency are needed. Do you think that in order to allay the concern of some who argue that you have not got to the bottom of this, that it might be helpful if we have those minutes made available in this exceptional case?

Sir David Walker: The minutes of either the FSA or the RBS? Well, the question could be taken in two parts. As to the substance, would people's understanding of what had happened, and what failed, errors of omission, errors of commission, inappropriate focus, deficient—

Chair: No, I am asking a question about public confidence.

Sir David Walker: I am sorry I was answering, first, the substantive question. My answer is, no. As for public confidence, frankly, I doubt it. I am not necessarily the best judge—

Q58 Chair: Given what you have said, is there a material harm for those being published?

Sir David Walker: Yes. The material harm that I would see—we go back to a question that was posed right at the beginning: are there very exceptional circumstances? My answer to that is, yes, there might be. There is, however, danger. I think if boards of regulators or of major banks feel that there is some risk—a sword of Damocles hanging over their proceedings—that their minutes will reach the public eye, then their behaviour will change. That follows as the night the day. You asked whether it would have adverse consequences. Well, I think that probably would be an adverse consequence. I would just confine myself to saying the behaviour would change. For example, one of the things that I know is—

Chair: I think we are accepting that point as a general principle.

Sir David Walker: One of the things that has been looked at is should the secretary be obliged to record everything that every board member says with a view to the sort of challenge proposition that Mr Thurso was asking about earlier. You can see what would happen. It is entirely predictable. Every non-executive director would think it was his or her responsibility to make sure that in the minutes there was some challenge attributed to his or her name. That does not advance matters at all.

Q59 Andrea Leadsom: Following on from Mr Love's comments, I find it rather astonishing that you think that there should be no strict liability for directors. After all, if you look in the SME world, if you want to start a business and borrow money from a bank you normally put your house, your car, your children's school fees and everything else you have, up against that as collateral; indeed, your reputation, your standing in the community and so on. So, why is it different for somebody with a small business over somebody who is a board executive in a FTSE 100 company, for example?

Sir David Walker: Small businesses can raise money in the way you describe. I don't think big businesses can. The reason we started with—

Q60 Andrea Leadsom: No, but talking about the individual liability for that individual director, why should they have no skin in the game? It seems astonishing to me that we should accept a scenario that takes us forward where, in the event that this happens again, which it will, that again there will be nobody who can be held strictly accountable.

Sir David Walker: Even under the present system, which you may feel, Ms Leadsom, is unsatisfactory—in some ways I would concur in that—directors have accountability to the shareholders. The directors, unlike the owner of the start-up and SME, are not necessarily people who have skin in the game in the sense that they have ownership. The only ownership they have might be some deferment of their board fee. But to be a director of a FTSE 100 company one is not required as a non–executive director to have any ownership of the company, although it has become normal for executive directors to be required to have some ownership. I think that is the normal pattern, most FTSE companies do that. But for non-execs it is not normal, and I think if non-executive directors were required to have skin in the game, in the sense of stockholding in any material way, that might be an interesting departure, but if it were the departure I think they would require higher fees.

Q61 Andrea Leadsom: Surely that would be a reasonable trade. But going back to it again, it does seem to me that it is in the human nature of things—I am sure that Tavistock would agree—that if you have a personal liability, if you stand to lose something if it goes wrong, then it concentrates the mind wonderfully.

Sir David Walker: You would be concentrating the mind of directors in this country in the way that no other democracy does. This does not exist in the States, in Europe, in Australia, New Zealand or Canada. So it would be a bold departure, which is not a reason for not doing it but it would be very novel.

Andrea Leadsom: Yes, rather like the retail ring-fence we are the only people doing it, but it is not a reason not to do it.

Sir David Walker: No.

Q62 Andrea Leadsom: Moving on, the FSA chose not to seek sanctions against RBS as the bank, on the grounds that it had already failed and was in public ownership. In hindsight, bearing in mind they failed to achieve enforcement against any one individual, do you think they should have looked at enforcement against the bank as a whole?

Sir David Walker: I don't, no.

Andrea Leadsom: You don't.

Sir David Walker: I have not given this a lot of thought, I have to say, Ms Leadsom. The bank is "bust" and it is now substantively in public ownership. It is not clear to me what incentive structure would be created by litigation against the bank.

Q63 Andrea Leadsom: I absolutely agree with you on that point, what purpose would be served in the sense of enforcement against the bank. But there is this absolutely enormous issue, which is the genuine public outrage and concern that this happened and that people are still paying for it. Not only that, but we are now significantly under water in terms of the taxpayers' shareholding in RBS. So there is still that desire for somebody to pay for it somewhere, even if that ended up being at firm level. But just to give you a very specific example, I wonder the extent to which, on the competence issue, matters of RBS and what the

board agreed to, and what subsequently took place in the bank, have been looked at in any detail. Specifically, I was told in a private conversation that, in fact, the board of RBS declined to follow a policy of investing in asset-securitised loans, but after that board decision the bank at a lower level went ahead and took part in that anyway and, of course, as we know, that was one of the major losses in RBS. So is this type of investigation been gone into in any detail?
Sir David Walker: On that specific matter that you did mention to us in a different session, we did look into it. We raised it with the FSA who in turn raised it with the lawyers of RBS. They did an investigation on our behalf and we were satisfied that, although there was a discussion about the matter to which you refer, which was widening the scope of their mortgage lending business into—I have forgotten what it is called—a looser categorisation, lower standards, in the event there was a decision against. It was not totally clear. It was not a black and white decision and there continued to be some examination of whether they might do it just a little bit. In the event, they did not do it.
Andrea Leadsom: They did not?
Sir David Walker: They did not embark on that strategy that had been the subject of quite a bit of toing and froing.
Andrea Leadsom: Right.
Sir David Walker: We did look into that.

Q64 Andrea Leadsom: Thank you. I am delighted that you did, thank you. I would like to push back on something else, which is you say that at the time it was reasonable to believe that the markets were kind of self-righting, that capital was endless and liquidity was endless, and so on. I was actually working for a big funds management company at the time and I distinctly remember, in 2007, a US fund manager coming in to talk to the chief executive saying that property prices in the States were collapsing and this would have a massive impact on asset-securitised loans. At the same time, for two years before Northern Rock went bust, the UK equity fund managers had not touched bank assets, and they were talking all over the place about the massive bank leverage and the fact that this was an asset bubble, that it was completely unsustainable. So why is it then that the FSA, and the board of RBS, seem to be the only people in the markets who had absolutely no idea that this might be an asset bubble and that it might all burst? You talk as if absolutely everybody was in agreement, and clearly, from my own personal experience, that simply was not the case.
Sir David Walker: I hope, if I may say so, Ms Leadsom, you were on the shorting side. Not many people—
Andrea Leadsom: No, long only.
Sir David Walker: Not many people shorted and if the view was as widely held as you suggest then there would have been very much more shorting, starting in late 2006, and it did not happen.
Andrea Leadsom: I agree with you on that point, but that is not to say that the discussion was not taking place that there was very big bank leverage, it was inappropriate, this was an asset bubble. It is simply not true to say that there was none of that conversation and there was this mass hysteria that everything was fine and would be fine forever.
Sir David Walker: It is a view of history, if I may say so. I can't reconcile what you say with the fact that 95.5% of the shareholders of RBS—in my view, extraordinarily—voted in favour of the ABN AMRO transaction, and that most fund managers did not, on either side of the Atlantic, short financial stocks. Now, specifically within RBS there was a recognition, although it was a bit late, in the credit business—the American business—which became very exposed to the American mortgage market, that this market was falling away. They were slow to move to hedge those positions. When they did hedge them they hedged them with monolines who eventually went bust.
Andrea Leadsom: Yes.
Sir David Walker: They didn't know that was going to happen. They didn't have a very good distribution capability so they retained it on balance sheet. But in particular, the biggest misjudgment they made was to think, "Oh, the super-senior credit default swaps are AAA+ rated, they'll be absolutely fine." That was a major misjudgment, but it was a major misjudgment that others made, although they started to change their judgment a bit earlier than RBS. I do not think the story, respectfully, is anything like as dramatic as you suggest it is.
I go back to the rather disagreeable thing I said in answer to one of Mr Mann's questions. If you try to reconstruct the atmosphere in 2006–2007, quite a lot of people were saying, "This can't go on forever". Not many people acted on it and one or two chief executives have said to me—of course, this is being wise after the event, which is easy—"Oh we knew it couldn't go on forever, but we thought the other guy would go down first and we would have time to protect ourselves". There was quite a lot of that about.

Q65 Andrea Leadsom: Perhaps with hindsight, but that surely is a definition of incompetence. But just one very last question and that is did you in your investigations look at the issue of what would have happened if Barclays had won the bid for ABN instead of RBS? Did you ever consider would Barclays then have been the one that was in taxpayer ownership, and so on?
Sir David Walker: We did have a conversation with Barclays about the circumstances that had led them initially to think this was attractive, and the factors that led them to conclude they did not want to proceed.
Chair: Weren't they lucky? Yes, they were, look at your face. Look at your face, Sir David. You have answered the question without saying anything.
Sir David Walker: Yes, they were certainly lucky. The only hesitation I have is that sometimes good luck is what you position yourself for, and I think they had done the arithmetic and they had done their homework and they had judged it—
Chair: They judged their luck well.

Q66 Michael Fallon: I want to ask you about the FSA's role in controlling acquisitions. But first, could we just establish your own view of Sir Fred

Goodwin's responsibility. Taking this report as a whole, do you think it amounts to censure of Sir Fred?
Sir David Walker: If the criterion for censure is whether charges could successfully be brought against him under the present regime, then no. So, to the extent I am able to judge the enforcement criteria, I—
Michael Fallon: I am not asking you about his legal responsibility, I am asking you whether this report, in total, amounts to censure.
Sir David Walker: In the non-legal sense?
Michael Fallon: Indeed.
Sir David Walker: Yes.

Q67 Michael Fallon: So it would then satisfy the criteria for removing his knighthood, as it is censure by the professional and regulatory body that operates in his area?
Sir David Walker: I don't know what the criteria are.
Michael Fallon: No, but you think the report amounts to censure?
Sir David Walker: Yes.
Michael Fallon: Right. Mr Knight, do you agree with that?
Bill Knight: I find it quite difficult. It amounts to censure on the board because it makes it clear that in their view, and the view of the FSA, the decisions of the board were mistaken, and not only with the benefit of hindsight. So that is clear, and Sir Fred was clearly a major player on that board. But in terms of individual censure I am hesitant actually. It raises questions about his conduct, but I would hesitate to find a passage in that report that I would say amounted to specific censure of Sir Fred as opposed to his role as part of the board.
Michael Fallon: So just Sir David agrees that the report does censure Sir Fred, is that right?
Sir David Walker: There is an accumulation of poor decisions, which were—as the report says—poor by the standards of the time. It is very hard to see how this cannot, in your sense, be a censure of the chief executive who was pivotal in virtually every decision that was taken.

Q68 Michael Fallon: So this is evidence that should obviously be laid before the Honours Forfeiture Committee?
Sir David Walker: The evidence is now delivered to you. How it is dealt with is a matter for the Committee.

Q69 Michael Fallon: Thank you. On control of acquisitions, your report says the current process for controlling acquisitions "is at best partial and indirect". The AMRO acquisition was, I think, the 24th, 25th or 26th acquisition that RBS had made by that particular point.
Sir David Walker: Yes.
Michael Fallon: What do you think the FSA should have done earlier to get involved in the number of acquisitions that RBS was making?
Sir David Walker: Apart from Citizens in the United States, I do not have in my head all the acquisitions they made. Obviously, much the most significant was NatWest. In the case of acquisitions in the UK, where there is a change in control, the FSA had and have full control over the acquisition process because they have to authorise the change of control. In the case of ABN AMRO, the only assets within the UK whose control was changed were the—you know, they had a broker and a relatively small banking presence in London, which was not really material to the whole transaction. So the point of leverage of the FSA then and now still is on the change in control of a UK entity, and to repeat the UK entity of ABN AMRO was very small in relation to the whole. NatWest was mainly a UK entity, so they had full control of that.

Q70 Michael Fallon: Let's just stick with AMRO. Why shouldn't the FSA have taken more responsibility, given the consequences of the deal?
Sir David Walker: As I think the report indicates, they should have. They should have and in my view could have. For example—and I think there is here in the report an indication that—this is what we meant by the word "indirect"; they do not have the clear statutory power of control—one of the indirect things they could have done would have been to set capital buffers, to have set an individual capital guidance level for the combined entity that would have made the transaction commercially unattractive. That was an option that they could have followed.

Q71 Michael Fallon: I think Lord Turner acknowledges that, but there is no evidence that they even considered that, is there?
Sir David Walker: No. I think we are clear that not to have stood in the way of this, with hindsight, was a mistake, but at the time much more difficult.

Q72 Michael Fallon: The mistake, surely, was not even to have considered it. They might well have waved it through after considering it, but this simply never got to board level, did it?
Sir David Walker: It got to the chairman in early September. It is important to recall that this was relatively late in the process, after 95% plus of the shareholders had voted in favour of the transaction. So for a regulator without direct power to stop it, in the face of such strong shareholder support, would have required a very strong view that liquidity, capital and whatever were a problem. Of course they should have had that sense, but they didn't have it at the time.
Michael Fallon: But they could have.
Sir David Walker: They could have if they had been more attentive to liquidity and capital, which was not then the environment.
Bill Knight: Yes, it was very difficult by September. They were advised in memoranda, which I have seen, that the capital and liquidity requirements—the legal requirements—would be met following the takeover. So they didn't actually have anything to go on at that point. They say they should have intervened much earlier in April when the thing was being planned. That is their position and I think it is correct.

Q73 Mr Ruffley: Sir David, you have answered in response to Michael Fallon that you think the report does amount to a censure of the chief executive, Sir Fred Goodwin, and Mr Knight has referred to bad decisions that he said were bad or wrong, even with the benefit of hindsight, that the board as a whole made. Could you just refresh our memory to the actions that you believe Sir Fred Goodwin took that are outlined in this report that amount to something that warrants a censure. So, in short, what are the things that Sir Fred Goodwin did that lead you to the conclusion he is being censured in this report? ABN AMRO, the decision to force that through, what else?

Sir David Walker: The thing that I would go back to was the matter we did raise with enforcement, as I mentioned earlier, which was delegation by the chief executive. The chief executive of an entity like RBS—this is relevant to the ring-fencing question that has been mentioned by others—can't possibly have a detailed knowledge of all the silos of specialism that the entity is engaged in. What the chief executive is required to do, if he is performing effectively, is to choose people to whom he can delegate with total dependability and, in my view, it was a very important question whether the discharge of that responsibility was fully adequate. The conclusion reached by the enforcement team was that there was not a sufficient failure of competence there to justify an enforcement action, but I think there is still a question about the performance there. It is relevant that—and this is mentioned in the report—the view taken by an outside professional subsequently, I think a head hunter, was that Johnny Cameron would not be someone who would be regarded by head hunters as suitable for the role that he was asked to discharge if the question came up now.

So I would think that going back well before ABN AMRO there were questions about the trust, the confidence, the judgment the chief executive was making about individuals in the team that were reporting to him. That is quintessentially a responsibility of the chief executive. As we say in our document, of course, it is for the chief executive on matters like that to consult appropriately with the board and seek the chairman's view: is this guy the right person to have in this role? But ultimately, the board needs to support the chief executive in those judgments, and if it is not ready to support him, the board has a problem with the chief executive. So the sense in which there is censure here is that those judgments were made clearly by the chief executive, but in many of them that confidence was proved to be misplaced. That relates to failures of a flow of adequate management information; for example, failures of adequate risk assessment. To give a specific example, when the decision was taken in 2006 by the board to embark on a significant P&L revenue strategy in the credit trading space, not thinking about leverage, not thinking about balance sheet or asset quality, the board were not presented with adequate risk information, the kind that would now—

Q74 Mr Ruffley: You see that as a shortcoming of Sir Fred, one example?

Sir David Walker: Well, he was responsible for the whole structure that presented this to the board, yes. So there are a number of things of that kind that, cumulatively, in my opinion, amount to poor judgment even by the standards of the time, which were lower than standards are now.

Q75 Mr Ruffley: Just before I move finally onto another subject, Sir David, wearing your hat as a very distinguished practitioner in the City of London, can you cite any examples of individuals being stripped of their knighthoods—not for malpractice, let me put it another way—for being censured?

Sir David Walker: No, I don't but I do not know that I would know, Mr Ruffley.

Mr Ruffley: No, but you are a City practitioner. We aren't around this table. It is not something that you have come across before?

Sir David Walker: There are cases historically.

Mr Ruffley: That is what I am asking.

Sir David Walker: The answer is I don't know.

Mr Ruffley: Does Mr Knight know?

Bill Knight: No, I don't. I can't think of any.

Q76 Mr Ruffley: Can I just turn to the report. It does indeed criticise certain FSA methodologies and policies, but what it lacks is any specific reference to mistakes that individuals in the FSA made at the senior management level. Why is this?

Bill Knight: It does not specifically identify people below very senior individuals in the FSA, that is true.

Mr Ruffley: Those who were making some of the decisions on a delegated basis; any particular reason for that?

Bill Knight: The truth is that the major mistake, which is that the conclusions drawn by the FSA, which the evidence that we have seen supports, is that, by and large, officials were doing what was expected of them. It was what was expected of them that was wrong and, therefore, the responsibility has to lie at the top of the FSA. There are one or two exceptions to that, but they are not dramatic. The real problem is with the rulebook itself and with a decision, taken in April 2007, not to intervene in the ABN AMRO acquisition, which in such a massive transaction has to be a matter I think—

Chair: Can you speak up, I am sorry—

Bill Knight: It has to be a matter for the top of the FSA. So my understanding of this is that there are no terrible crimes committed by people in the FSA.

Q77 Mr Ruffley: A final question for you, Sir David. Is there anything you have seen, in the course of your review, which would suggest not only that the FSA was perhaps under-performing but also that Her Majesty's Treasury senior officials were asleep at the wheel or under-performing, as well as individuals at the Bank of England? In short, do you think there should be a review of some description as to what the senior officials at the Bank and at the Treasury were doing during this time period?

Sir David Walker: I have nothing to say about the Treasury, and the Chairman will be able to reproach my lack of independence because I was there for 16 years.

Mr Ruffley: Although not, thankfully, during this time.

Sir David Walker: Not during this period. Vis-à-vis the Bank of England, the only thing I would say, which is I would like to think a constructive criticism and it is certainly intended as such, is that if you look at the reviews on what we would now call financial stability produced by the Bank of England in the period before the crisis, they were very perceptive. The criticism I would make is not that they were not perceptive but that they were not hammered home hard enough. This goes back to the questions that Ms Leadsom was asking earlier. Serious people were saying, "This can't go on and there are risks", and they were people that were huge in their professional integrity, competence, and all the rest, who should have banged the drum louder. So, if I have criticism, perhaps the Bank did not make enough noise about its concerns. Of course, the architecture then is not what it is about to become with an Financial Policy Committee and all that.

Q78 Chair: Before I ask the next question, I just want to clarify that you are acting under the protection of full parliamentary privilege in answering it. You will have seen the earlier drafts of this report, prior to this report having been sent to Sir Fred Goodwin's lawyers and, therefore, you will have seen the "Maxwellisation" process in action on this report. Is the fact that there is no censure of Sir Fred in this report in any way related to what you saw of the Maxwellisation process?
Bill Knight: It is true that the references to Sir Fred were changed following Maxwellisation, but in my judgment actually that was a fair change.

Q79 Chair: What was the change?
Bill Knight: The change was that there was a suggestion that he lacked the experience to run an international bank. The point being made against that was that was, in truth, an attack on his competence and that there was no evidence of incompetence. I felt that that was a fair point, actually, and was subsumed into the point about delegation, which Sir David has mentioned. So yes, there was a change but I felt that the point was fair because there was no evidence of lack of competence, in terms of the experience of running an international bank.
Chair: Is there anything you want to add, Sir David? There is another area I want to explore.
Sir David Walker: No, I don't think so.

Q80 Chair: No. We are all agreed that bad decisions were made at RBS and that they were bad decisions even in the context of the time. Can I take you to what I think is a key passage in this very full report, which is paragraphs 427 to 429. I will give you a moment to look that up, but I suspect you have looked at this carefully.
Sir David Walker: Yes.
Chair: This says, basically, that the FSA could have stopped the ABN AMRO deal but decided not to, and the question I want to ask you is whether, even by the standards of the time, that was a poor judgment?
Sir David Walker: I think it was. I hesitate and pause, but I think it was.
Chair: If I may say so, I am slightly surprised you are hesitating because this must have been right at the heart of what you were thinking about.
Sir David Walker: It is not an equivocation, I hesitate because the deep tradition of supervision and regulation of financial institutions—not just here in the UK but widely—was for the regulator not to become shadow directors on matters of strategy, but to leave these matters to the judgment of the board. So this would have been a first. An intervention to stop this, where there wasn't a doubt about the integrity, and at the time not much doubt about the liquidity or capital capability of the entity to make this acquisition, would have been very exceptional and they did not have the formal power. Nonetheless, on balance, I would think that they should have intervened before all of this. I think after the shareholder vote it became very difficult to intervene without destabilising RBS in a way that would have had its own consequences. They could have done it earlier in a way that would not have been, they could have been saying to the chairman, "We are not sure about this, but if you want to do it we are going to raise the capital requirements very substantially".
Chair: It is something we will go into in more detail but it is very helpful to have your advice on that key point.
***Bill Knight*:** Paragraph 420 puts the point very frankly, I think. They say the FSA's supervisory approach to the acquisition of ABN AMRO did not entail adequate assessment of the risks that RBS were taking—three bullets—clearly this was a significant mistake.
Chair: Yes, but what I was asking was whether I should put this on a par with, and sitting alongside, the kind of judgments that were being made at the time, and your assessment of those bad judgments being made at the time, in RBS. Paragraph 420 does not make it clear whether that is a judgment with the benefit of hindsight or a judgment at the time.
Bill Knight: They are not praying hindsight in aid. They are not saying "in hindsight"—
Chair: It is unclear, which is why I decided I wanted to clarify your view—
Bill Knight: I think they are quite clear about it.
Chair:—and we are now getting your view. Jesse Norman wanted to come in with one final rejoinder.

Q81 Jesse Norman: Yes. It is just to recap the situation very quickly. The ABN AMRO was a transaction whose total value was €71 billion. The following year, RBS, having raised its dividend, had a loss of £40 billion, and I just want to briefly focus on an area that hasn't been touched at all, which is the role of the advisors. Obviously the board did not review liquidity issues. We have just discussed this. First of all, could you remind me who the advisors were?
Sir David Walker: Principally Merrill Lynch.

Q82 Jesse Norman: Merrill Lynch, who have something of a reputation for getting these things wrong and I believe did the same thing in HBOS one might notice. How much were they paid, do you think, on a €71 billion transaction?
Sir David Walker: I don't know the precise amount but it was a very substantial sum.
Jesse Norman: North of €100 million or €200 million?
Sir David Walker: North of €100 million, certainly.

Q83 Jesse Norman: Yes, thank you. Did you see the report from the advisors that they would have given to the directors?
Sir David Walker: There was certainly one major report. At the time when the board were first considering the ABN AMRO acquisition possibility, which was probably about February/March—I don't know the precise date and my recollection is not clear—there was a report, the thrust of which was supportive of this being an attractive opportunity, something like that.

Q84 Jesse Norman: That report would have modelled the financial effects of the takeover?
Sir David Walker: No, I don't think it did. I don't think that question had been posed. I think the question that was posed was, "Here is an opportunity. Is it interesting for us?" It was at a fairly high level I recollect.
Jesse Norman: But there must have been some projection of the financial benefits. The board must have had some advice as to what the financial implications of buying an institution worth €71 billion were, for its own balance sheet, for its own liquidity, for the status of its own operations.
Bill Knight: I am sure they did. You should bear in mind, of course, that €71 billion was the total price. RBS's share of that was 38%.
Jesse Norman: Yes, it was about €27 billion.
Bill Knight: Yes, that is right, so it was actually much smaller.
Jesse Norman: But the board was, nevertheless, buying into a transaction of the larger size and one would have expected that the portions it was buying would have been in substance modelled pro forma into its own P&L, into its own financial statements, into its own capital requirements.
Sir David Walker: My belief is that although they had that advice at the beginning, which was generic, rather high level advice—saying, "This is an interesting opportunity to pursue"—most of the arithmetic, the pro forma stuff of the kind you refer to, was done within RBS in the ensuing period, and the focus of the advisor was in the execution of the transaction, not advice on the way it could be done.

Q85 Jesse Norman: Does that mean that the advisor never actually gave the advice that what you might call a traditional financial advisor would give, "Is this a good transaction for you"?
Sir David Walker: It depends what you mean by "traditional financial advisor". I think the error of omission there, and it is what leads us to make a specific policy proposition, is that in situations of this kind if it were to happen again it should be the norm that independent advice is taken, which is not remunerated on the basis of success with the transaction.
Jesse Norman: That is what I am trying to get at.
Sir David Walker: Yes.

Q86 Jesse Norman: A final question: how would you assess the quality of—
Chair: A very quick question and a very brief answer.
Jesse Norman: Very quickly, but it is rather germane. Did you have a chance to assess of the quality of due diligence that would have been given on the purchase by the advisors?
Sir David Walker: No.
Jesse Norman: Or indirectly come to a judgment on it?
Bill Knight: The due diligence done by RBS was inadequate.
Chair: Was?
Bill Knight: Inadequate. There is no doubt about that.
Jesse Norman: Could you just describe it a little bit more so we can get a sense, don't forget we haven't seen any of it and we would like to know just how inadequate it is, the kinds of things it covered or did not cover.
Bill Knight: It was famously, in April at least, two lever-arch files and a CD. That is what is referred to in the—a very minimal amount of information was given, so it was largely based on published information, the reports to the board. The PWC report, summarised in part 3, clearly concludes that this was inadequate.

Q87 Jesse Norman: So the punch line is that the transaction of €27 billion was made by the board without independent financial advice on the back of thoroughly inadequate due diligence by Merrill Lynch for which they, and other advisors, would have been paid well north of €100 million or €200 million. That is the punch line of what you are saying?
Bill Knight: To give the complete picture, though, this was a contested takeover bid in which due diligence, in the sense of information volunteered by the target, was not available. That is the situation.
Sir David Walker: The conclusion to which it leads me is not only the importance of independent advice—this is a kind of rhetorical question and the Chairman may want to end here—but whether in large financial services entities a contested takeover is ever acceptable. Because it is not possible in the framework of contested takeovers to do the sort of due diligence that is necessary, and whether the advisors failed or the board failed or the regulator failed is of second order importance. They all failed because it was not available, and I think the inference is irresistible for me that contested takeovers in financial services are doubtfully permissible in future.
Jesse Norman: Thank you very much.
Chair: That is an extremely interesting final remark, and of course we have the HBOS deal where virtually no due diligence was done at all, and we have that on public record already.
Sir David Walker: But things can go wrong without it being contested.
Chair: That is the point that I was making. Thank you very much indeed for coming this morning to give evidence. Thank you, much more particularly, for the huge amount of work you have done on this and for exercising your judgment. The Committee very much appreciates it. Thank you again.

Written evidence

Written evidence submitted by Bill Knight, then Specialist Adviser and Sir David Walker, Specialist Adviser to the Committee, in relation to the report by the Financial Services Authority into the failure of The Royal Bank of Scotland

On 23 May 2011 you appointed us as specialist advisers to the Committee to assist with the Committee's work on the failure of RBS and the FSA's conduct with respect to it. Our terms of reference required us to report to you on the extent to which the FSA Report into that failure is a fair and balanced summary of the relevant evidence gathered by the FSA and PricewaterhouseCoopers and whether it fairly reflects the findings of the FSA's investigation. We were also asked to report on whether the FSA Report is a fair and balanced summary of the Authority's own analysis of its regulatory and supervisory activities in the run up to the failure of RBS.

The FSA Report has been published today, 12 December 2011, and we are pleased to be able to report that, in our view, it meets the criteria that you specified. We set out later in this evidence the work that we commissioned and undertook which enables us to reach this conclusion and forms the basis for our opinion.

Part 2 of the FSA Report contains a number of judgments made by the FSA which they acknowledge could reasonably be subject to public debate. In all the circumstances, and bearing in mind that it is clearly stated that the fact that some decisions are described as poor or mistaken carries no implication that either RBS or any individual was guilty of any regulatory breach, we believe that it was appropriate and reasonable for the FSA to complement the more forensic parts of the report with a historical perspective on the failure of RBS and to draw from it key lessons for the future.

Changes in the FSA Report made at our Request

Our terms of reference call upon us to report to the Committee on any instances where our work has led to "significant and substantive alterations in the published report" and on any instances where we suggested alterations to the draft report which we were unable to agree with the FSA. The terms of reference also indicate that we are able to raise with the Committee any matters related to the work of the FSA that we think appropriate.

As the process of drafting evolved there were five material areas where we suggested alterations, comprising:

(a) a fuller explanation of the reasons for selecting the three areas for enforcement investigation;

(b) greater emphasis on the delegation responsibilities of the RBS CEO and the adequacy of their discharge, in particular in respect of the credit, sales and trading business;

(c) a fuller description of the nature and degree of involvement of the FSA Board in setting or endorsing the relevant policy approaches of the FSA executive during the review period;

(d) more detailed review and conclusions on the FSA's response, even within the policy approach and framework at the time, to the exceptional complexity, method of execution and risks inherent in the ABN AMRO acquisition, given the seriously constrained due diligence process that was undertaken; and

(e) a clearer assessment of the substantive functioning as distinct from the formal process of the RBS Board, in particular in relation to oversight of the very rapid balance sheet expansion in the review period and the ABN AMRO acquisition.

We believe that the final Report adequately addresses the questions that we identified in these five areas. While the structure, content, editing and conclusions of the FSA Report are the responsibility of the FSA, we were able to comment freely on all aspects of the FSA's review and there are no material points on which our work has led us to disagree with the FSA.

Matters to which we wish to draw Attention

There are four matters relevant to future policy that we wish to draw additionally to the attention of the Committee. We do not believe that our views on these differ to any degree from those of the FSA, but we wish to give them special emphasis alongside and in reinforcement of the substantial array of policy developments already in train or in contemplation as set out in the FSA Report.

CEO's responsibility for delegation

The first relates to the particular responsibility of the CEO to ensure that those to whom he or she delegates responsibility are fully capable of discharging their roles. As a major recent policy development, the FSA has boosted its focus on significant influence functions (SIFs) both through rigorous interview screening of individuals, in particular those proposed as chairman, chief executive or non-executive director of major financial institutions and in the ongoing supervision process in dialogue with existing holders of major SIF positions at both board and senior executive level. Within the approved persons framework, and as indicated in the FSA report, the FSA requires a CEO to ensure that senior management teams have the appropriate mix of skills and experience to run the businesses for which they are responsible. It is noteworthy that while, in the context of RBS, the FSA's enforcement investigation concluded that Sir Fred Goodwin's delegation to the particular leadership of the senior team responsible for global banking and markets was not unreasonable, the report also gives the FSA's view that, in terms of competence for the role to which he was appointed as chairman of the global banking and markets business of RBS, Johnny Cameron would not meet the FSA's current standards for a new approval.

It is difficult to overstate the key relevance and potential implications of a CEO's judgement in delegation to his or her immediate executive team. In the case of a major international or global bank, a CEO might not be expected to have detailed technical knowledge and experience of all of the complex array of products and services that make up the bank's business. But this underscores the pivotal importance of the CEO's judgement on the specific capabilities of those to whom key responsibilities are delegated. While the CEO might seek advice from the chairman or board on such appointments, a board will reasonably place substantial reliance on the judgement of the CEO in relation to the assembling and functioning of the senior executive team and, indeed, a board that does not feel ready or able to do so presumptively has a substantive issue with its CEO.

Against this perspective, in our view the FSA (and in future PRA) SIF screening process ahead of initial appointment should be complemented by the placing of an explicit obligation on the CEO to attest that he or she is satisfied, on the basis of appropriate and regular performance assessments, that those to whom key responsibilities have been delegated continue to be fully able to discharge them appropriately. Knowledge that discharge of the CEO's responsibility in this respect is being given much greater weight than hitherto in the ongoing supervisory process should yield correspondingly greater attentiveness to this critical aspect of their role on the part of CEOs. The executive heads of all major businesses bear heavy responsibilities, but these are amplified in the case of major financial institutions by the potential social externalities associated with failure. In our view, misjudgements in respect of delegation to the senior team in a major bank that are not promptly identified and corrected are matters not only for the confidence of the board in its CEO but also for the supervisory assessment whether the CEO should be allowed to continue in so critical a SIF role.

Regulation of banking acquisitions

Second, we think it unsatisfactory that existing statutory provision does not require a UK bank of which the FSA is the lead regulator to obtain the specific agreement of the FSA for a proposed acquisition. Present policy arrangements call for FSA authorisation of a change of control of the UK business of an offeree and, separately but related, the provisions of the Takeover Code protect the interests of shareholders in an offeree company listed in the UK. In the case of the RBS acquisition of ABN AMRO this required, in formal terms, FSA focus on and authorisation for only the transfer of control of ABN AMRO's UK entities, a small part of the whole ABN AMRO group. In substantive terms, control of a significant acquisition initiative by a UK offeror of which the FSA is the lead regulator is currently at best partial and indirect. This seems to us to be a material deficiency in statutory provision in the context of the value destruction that may be (and not infrequently has been) the result of significant strategic acquisition and was specifically the result, not only for RBS shareholders, of the acquisition of ABN AMRO.

We understand the potential difficulty for the regulator in considering whether and how best to assess the business and strategic judgement of the board in respect of an intended acquisition. But given that the balance sheet and other direct and indirect consequences for a major bank of a misjudged acquisition may extend well beyond losses sustained by the bank's shareholders, we believe that, as a public policy priority, a specific requirement for regulatory authorisation should be introduced. We accordingly urge that such a provision be incorporated in the new legislation that is currently in preparation.

We recognise that there may be a significant problem in relation to timing. Regulatory reservation or resistance to an acquisition proposition may become increasingly difficult to sustain without risk of destabilising the bank's board or its CEO if the proposition is in the public domain and is known to have substantial shareholder support. This points to the importance of engagement of the supervisor at an early stage in the process, well before knowledge of the board's strategic interest or intention reaches the market. This points in turn to the need for a board to be in early communication with the supervisor before crystallisation of its own strategic planning and any consequential announcement.

Despite such timing and other issues, we believe that the existence of a specific statutory power would not only give the lead supervisor a clear locus in the process, facilitating probing and questioning to an extent that may not hitherto have been practicable, but should also promote greater discipline and challenge in the board's own assessment of the proposed initiative and, specifically, to an extent much greater than that achieved in the RBS Board's consideration of the ABN AMRO transaction. We also suggest, in the fourth matter that we discuss below, that, in a case involving a proposed significant acquisition or other strategic initiative by a major UK bank of which the UK supervisor is the lead supervisor, appropriate ways and means should be found to enable the independent board members of the supervisor to give advice to the executive before a final regulatory decision is taken.

We would recommend additionally that, as an aid to its own appraisal process of any major acquisition proposition, the supervisor should encourage a board to seek independent external advice. Such advice would be independent in the sense that its remuneration does not depend on completion of the proposed transaction and would be wholly separate from the banking advice and capital markets capability that is applied to and remunerated largely or wholly on completion of the proposed transaction. Independent advice of this kind was not sought by the RBS board in the context of the ABN AMRO transaction. We acknowledge that, even if it had been sought, it would not necessarily have led to any change in the strategic judgement reached by the board or the outcome. But in that situation, and for such situations in future, it should be expected to boost constructively the thoroughness and discipline of the board process, whose critical relevance in respect of strategic decision-taking by a major bank can hardly be overestimated.

The supervisory relationship

A matter to which we draw attention from our experience and observation is the critical importance of the degree of trust in the relationship between the supervisor and the board and senior executive of a major financial entity. We emphasise this because acknowledgement of the role of the qualitative process of supervision is currently often upstaged by the focus on quantitative black-letter regulatory requirements. On the basis of global initiative within the frameworks set by the Financial Stability Board, Basel III and associated EU initiative, substantial headway is being made toward strengthening minimum capital, liquidity and other related standards. These are essential regulatory ingredients toward boosting the soundness of banks and of the whole financial system. But while they understandably attract intense political, market, regulatory and media attention, they need to be complemented by enhanced qualitative oversight of the performance and decision-taking process of major banks through better supervision. In this context we welcome and attach great importance to the substantial strengthening that has already been put in place in the FSA's approach to and resourcing of supervision, to be developed further under the new PRA regime.

Achievement of an appropriate supervisory relationship inevitably calls for a delicate balance among an array of elements. There is an essential tension in the functioning supervisor-bank relationship which should not be designed or seen as collegial. In the past the FSA's supervisory approach appears to have been essentially reactive, placing heavy reliance on the judgment of the board and management of a major bank even in respect of significant strategic initiative. It is now acknowledged that, under the new supervisory model, prospectively that of the PRA, the supervisors will need to be ready to form their own view on any proposed strategic initiative and, where this differs from the judgement of a bank's board or executive, the supervisor will need to be ready to act. This may have particular relevance in the context of an acquisition as discussed above but may arise in respect of any other material issue that the supervisor may have with a bank.

But while, on the side of the supervisor, the focus may ultimately need to be demanding and intense, it should not become so intrusive as to displace the necessary commercial prerogative of the board and to risk making the supervisor a shadow director. On the side of the board, the chairman, chief executive and, as appropriate, the whole board of a major bank should be committed to regular and open communication with the supervisor without compromising the clear fiduciary responsibility of the board to take commercial decisions on the direction and strategy of the bank within established regulatory parameters.

Without trust in its supervisor, the tendency will be for a bank to communicate with the supervisor only to the extent formally necessary, holding back from any degree of openness going beyond what is strictly required; and in such a situation the parallel tendency will be for the supervisor to be in degree suspicious and correspondingly more intrusive.

The supervisor is entitled to see board minutes, on occasion to attend board meetings and to be closely informed on the outcome of a board evaluation process. But the risk is that the fact of such formal exposure to the supervisor will change behaviour in the boardroom and, in any event, written records cannot be expected reliably to identify inadequacies in a board and in the quality of its judgement.

With trust, a relationship that involves the sharing of information, experience and views should be mutually beneficial and potentially value-additive for both parties. This will require on the side of the bank a build-up of confidence in and respect for the capability, professionalism and style of the supervisor; and similarly, on the side of the supervisor, the development of a sense of assurance that the chairman, board, CEO and senior executive of the bank are committed to engagement in an open, frank and appropriately consultative regular dialogue. The prize of such a relationship will not be achievable through approaches based on box-ticking conformity but will require sustained effort over time on the part of both supervisors and bank boards.

All of this is fundamentally attitudinal and cultural and we emphasise it here because of the widespread current tendency to see repair of the financial system in terms of much more demanding ratios for capital, liquidity and leverage. These are critically important. But they will not alone deliver the enhancement in the robustness of major banks and of the whole financial system that will be achievable through higher quality supervision based on a solid foundation of mutual respect and trust between supervisor and supervised.

Industry expertise on the board of the regulator

The fourth matter on which we comment relates to the functioning and composition of the board of the regulator, in future the PRA. We are aware that decisions on these matters will need to be taken shortly by the Treasury and we suggest that this opportunity be taken to give greater weight than in the past to constituting the regulatory board at least in part with independent members who can draw on current or immediately recent relevant institutional and market experience. We recognise that composition of the PRA Board on these lines would increase the risk that conflict issues arise. In the case of the FSA Board, we understand that the established view has been that the Board should not be directly involved in executive decisions in respect of individual authorised entities and that its role should rather be wider and generic in scope, overseeing broad policy issues with, as prominent recent examples, treating customers fairly, remuneration policies in major financial Institutions, value for money in the regulatory process and the functioning and staffing of the FSA itself. This approach to the responsibilities of the Board was, understandably and properly, much influenced by concerns at conflict situations that could arise that would preclude board members with current involvement in a financial institution from assuming any responsibility for regulatory decisions relating to that institution, or to one of its competitors or to a market situation directly relevant to its business.

The responsibilities of the PRA Board will of course similarly cover such broad policy issues within its prudential regulatory remit. But, looking ahead, we believe that the Board should also be in a position to contribute constructively to regulatory decision-taking on strategic issues such as an acquisition or significant wholly new business initiative on the part of a major bank of which the PRA is the lead regulator. We believe that directors equipped with current or immediately recent institutional and market experience could in such situations be a valuable advisory resource on which the PRA executive could draw. While some of the elements in the financial crisis that overtook RBS and other banks grew out of wholly new types of product and associated exposures, others were, or should have been seen as, fundamentally familiar, above all those in respect of credit and the dependability of market liquidity. The new Basel III rules will mitigate or remove major regulatory inadequacies, in particular in relation to capital and liquidity, but they will not displace the critical need for judgement by bank boards and chief executives who should wisely be displaying much greater readiness to draw on experience than was commonly the case before the crisis.

It would be in our view an advantage for such experience to be similarly available to the regulator as part of its governance structure. A regulatory Board with such experience would be in a good position to hold the executive to account, to assist with the identification of priorities and to command the respect of the market. The benefit for the PRA Board and for the whole regulatory process of having better access to such topical relevant experience should in our view be regarded as outweighing the negative associated with the increased conflict problem on the occasions when specific regulatory decisions were the subject of Board discussion. Such cases would probably not be commonplace, but they would, by definition, be important, requiring the best intelligence and input. The conflict problem could be substantially mitigated if, where the regulatory Board considers a proposed significant executive decision in respect of a major bank or market issue, the established process should be for independent Board members to make their input to the regulatory process exclusively in an advisory capacity.

The way we went about our Task

The FSA Report falls into three main parts—dealing with the reasons for the failure of RBS, the lessons for the regulatory framework and enforcement. The enforcement section relies extensively on three PwC Reports. We read the PwC Reports, which deal respectively with Johnny Cameron—the Chairman of Global Banking and Markets, the due diligence undertaken in advance of the acquisition of ABN AMRO and the investment circulars issued by RBS. Helpfully, the PwC Reports contain summaries so we were able to arrange for a concordance between those summaries and the FSA Report to be prepared. The PwC Reports are very long (858 pages) and thorough and contain a great deal of information about the conduct of RBS and its executives.

If the Committee were to read the PwC Reports they would learn much detail about the conduct of the investment banking side of RBS through a chaotic and difficult period, and much detail about the due diligence concerning the ABN AMRO acquisition and the investment circulars issued by RBS. But, given that the purpose of the FSA Report is to shed light on the failure of RBS and the FSA's consequent enforcement action we believe, on the basis of our work, that the FSA Report contains, in part 3, a fair and balanced summary of the PwC Reports and contains the essential material. FSA themselves give a similar assurance at paragraph 6 of part 3 of the FSA Report. We talked to the partners of PwC who prepared PwC's Reports and who have seen the FSA Report in draft. They told us that they saw no reason to disagree with our view.

For the remainder of the FSA Report, dealing with the reasons for the failure of RBS and the FSA's supervisory role, there was nothing like the PwC report to form the foundation of our work. We therefore read the material which the FSA supplied to us and then asked for other documents which seemed to us to be relevant. For example we read transcripts of key interviews which formed part of the FSA's investigation and enforcement. We read the FSA Board minutes for the relevant period and the CEO's reports to the FSA Board throughout 2007 and 2008. We read two FSA Board evaluations (one externally facilitated), the RBS ARROW reports for 2006 and 2007 and the Group Internal Audit Report, July 2008, prepared at the initiative of their chairman for the board of RBS.

We offered the principals from RBS and FSA the opportunity to meet us to say anything they wished. On this basis we spoke to Johnny Cameron, Sir Steve Robson, Sir Fred Goodwin, Sir Tom McKillop and Guy Whittaker (formerly RBS) and John Tiner and Matthew Elderfield (formerly FSA).

With the assistance of our legal adviser, Alan Karter of Simmons & Simmons, we arranged for key facts in the FSA Report to be tested. We did this by asking approximately 150 questions about the FSA Report (in its draft stage) to which we required a written answer. We did not seek to cover every statement in the FSA Report or every implication arising from the FSA Report (for example we left the regulatory capital calculations to the FSA) but the questions operated as a form of test process in the determination of the fairness and balance of the FSA Report having regard to the evidence, the findings of the FSA's investigation and the FSA's own analysis of its regulatory and supervisory activities in the run-up to the failure of RBS. We took the view that testing was particularly appropriate where the FSA claimed that its actions satisfied regulatory standards at the time; where the FSA Report used general phrases in a manner critical of individuals; and where the FSA was relying on information from third parties to support its judgments or conclusions. In each case we asked the FSA to consider whether the statement questioned was misleading in the form and context in which it is included; whether there were any material facts omitted which would make the statement misleading and what implications might reasonably be drawn from the relevant statement. This testing process was treated seriously by the FSA who gave full and careful answers.

In addition, and again with assistance from Alan Karter, we reviewed the FSA Report to identify numbers which in our view, ought to be carefully checked. At our request this was done by a numbers verification team seconded from Grant Thornton UK LLP. Their work did not extend to an audit, but the team checked that numbers and other financial information identified by us had been correctly sourced, that estimates were made in the manner described and that calculations were correct.

The draft FSA Report was subject to "Maxwellisation" and was read by a large number of institutions and individuals, including the firms of solicitors acting for RBS and for past executive and non-executive directors of RBS. We saw their comments on the draft.

In addition to our own scrutiny a process of quality control was adopted by the FSA for the production of the FSA Report. Parts 1 and 2 were produced by a separate review team, independent of executive management, led by Rosemary Hilary, the FSA's Director of Internal Audit. Part 3 was prepared by the case team within the Enforcement and Financial Crime Division led by William Amos (a head of department in that division) which took forward the original investigation. Both teams reported directly to Lord Turner, the FSA's Chairman, for their work on the review and Lord Turner was personally involved in challenging both the content and findings of the FSA Report.

The FSA Report was reviewed in detail by a sub-group of the Board's nonexecutive directors chaired by Brian Pomeroy. The sub-group had been set up by the FSA Board for the purpose of providing direct board-level scrutiny of the FSA Report and of the objectivity and independence of the process by which it was produced. The FSA Board saw our evidence in draft. The FSA Report as a whole, and the judgements made within it, were reviewed by the full FSA Board. On the basis of these quality assurance procedures and its own discussions of key conclusions and judgements the FSA Board has confirmed to us that, in its opinion, the FSA Report represents a fair and balanced summary of the evidence gathered by the FSA and by PwC during their review of the failure of RBS, that it fairly reflects the findings of the FSA's investigation and that it is a fair and balanced summary of the FSA's analysis of its regulatory and supervisory activities in the run up to the failure of RBS.

We wish to thank the FSA staff involved with us in this work, particularly Rosemary Hilary, for their patience, forbearance and efficiency during this process.

Prudence in Banking

There are many lessons to be learned from the failure of RBS. These are set out in the FSA Report in detail. We wish to emphasise one critical generic point—the overriding importance of prudence in banking.

It is in the nature of banking that a bank, however large and apparently impregnable, is vulnerable to a loss of confidence which may quickly become severe and dramatic, whether through a drying up of access to funding in the wholesale markets or a run on deposits by retail customers, or both. While large non-financial companies may survive a serious loss of confidence, a bank is much less likely to be able to do so.

This critical lesson has been learned before and is so simple and obvious that it may seem surprising that it is necessary to reiterate it here. But it struck us with renewed force during our work on the failure of RBS. We accordingly emphasise it in the knowledge that we may be accused of over-simplification and of attaching inadequate weight to the importance of ambition on the part of visionary bank executive directors and supportive boards. The time dimension is key here. The boards of banks need to decide on a prudent risk appetite, focussing on long-term and over the cycle value rather than short-term returns, and they need to be rigorous in sticking to their risk appetite decisions once taken.

The enhanced regulation and supervision now put in place will greatly mitigate the risk of bank failures in future. But it cannot remove the danger of the unexpected in a financial system that is highly interconnected in terms of functions, counterparties and geography. The directors of a bank should be continually aware of this unavoidable vulnerability in setting their risk appetite and the bank boardroom should never be the place for initiation or endorsement of a daring strategy. The risks in banking are simply too great. It follows that bank shareholders will have to become accustomed to returns which, though probably less volatile, will be lower than they have sought and achieved in the past.

Anyone who doubts the need for prudence in circumstances of such vulnerability should read the story of the failure of one of the largest banks in the world—The Royal Bank of Scotland.

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