Rodney Baker-Bates

From: Rodney Baker-Bates <
Sent: 13 September 2011 08:47
To: Peter Marks)
Cc: Len Wardle Paul Flowers
Subject: Project Mars

Dear Peter,

You asked for comments/thoughts etc between Project Board meetings re Mars.

At the meeting last week, I was concerned to be told that the meeting with Vendors/Advisers re the funding "term sheet" had been disappointing. Without a firm and acceptable bridging/longterm funding plan we cannot progress.

I am surprised that at least a draft of possible terms & structure does not appear to be available to discuss with purchasers. This has been an essential from the start & I would have expected the vendors to have already had a draft in place before the start of the formal process.

We are undertaking very considerable effort and expense to progress DD etc. My recommendation would be that unless we have at least a draft "term sheet" for funding from the vendors and their advisers which we can discuss and consider by the end of this month at the latest, we significantly reduce our effort/expenditure until it is available.

I accept markets are very fragile at the moment, but this only makes the need to know what is possible/available in terms of funding all the more important. It is a central plank to any consideration of this opportunity.

Regards Rodney

Rodney Baker-Bates
[redacted]
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Rodney Baker-Bates

From: Rodney Baker-Bates <[redacted]>
Sent: 14 September 2011 17:09
To: 'David Davies'
Subject: RE: Management Stretch

Dear David,

Thank you for "keeping me in the loop". In reciprocation, I spoke to Paul before the Board & am seeing Len tonight re Mars. I am agnostic, moving towards aetheistic.

I have three key strategic reasons:

(1) I am very pessimistic about the returns that banks will earn over the next decade. They will be under constant pressure to hold more capital; liquidity etc, and with ringfencing the market could become a lot more competitive given the relatively small size of the UK market;
(2) I am unsure how the retail market will change over the next five years with changes in technology (eg Ipads etc) and this leads we to question the benefit of buying branches (whatever the current research says. Also this is an enormous transaction for CCBG & any movement adversely in the asset values purchased could wipe the bank & Group out. I suffered under the impact of Crocker, so this is a very real fear for me.
(3) I feel strongly we do not have the capability to run the enlarged CBG. I certainly could not support acquisition without have secured an individual I felt had the skill and commitment to carry this through.

Two more immediate points:
(1) There is considerable concern/worry with the executive team of the risks being taken etc
(2) At the last project meeting we seemed to be no nearer having an outline bridge/logterm funding "term sheet". An acceptable one may never materialise given the markets are so difficult. Without this the transaction will never get off the ground.

I am negative enough going forward to say I am not sure I could support Mars even if we received the branches etc at no cost.

Regards Rodney

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From: David Davies [mailt[redacted]
Sent: 14 September 2011 16:08
To: Rodney Baker Bates
Subject: Fw: Management Stretch

Rodney - You ought to see this (to keep you in the loop)
david
----- Original Message -----
From: Paul Flowers

Rodney Baker-Bates

From:	Rodney Baker-Bates <[redacted]>
Sent:	17 September 2011 17:38
To:	Peter Marks ([redacted])
Cc:	Len Wardle ([redacted]); Paul Flowers ([redacted])
Subject:	Project Mars

Dear Peter,

I continue to ponder on Project Mars.

I am sceptical of the future value (against the cost of running them) of traditional bank branches, despite the current consumer research. On that my view is, if you a customer would they like a "local presence" for their bank then they will say of course, but that does not mean that they will use it. The evidence on footfalls etc is that whatever they say the practice is different.

My view is that branches are largely irrelevant from the point of view of creating personal assets (personal loans; mortgages etc), although important for small businesses & charities for cash banking etc These products are readily available to personal customers (if the terms/security can be afforded) through call centres; the internet; press and intermediaries. Also they are no longer customer relationship products.

However, I believe they can still be important for longer term savings particularly with older customers. There was some strong attachment to the old pass book at Britannia. However, in recent years this has also changed:

(1) Low interest rates has strongly prompted the search for higher rates/best buys via the internet; press; & TV advertising etc;
(2) Savers understand the bank guarantee scheme & many limit their deposits to the current maximum of £85K;
(3) Banks have responded by increasing the balances required to maintain a current account which remains a very sticky relationship with a bank given the current difficulty & hassle of making transfers.

One of the factors troubling me re Mars has been the funding gap both absolute and relative, and within the deposits the distribution and type which are included. At Britannia, we took on the UK branches of bank of Ireland in 2006 primarily because in that transaction BoI kept the mortgages and transferred the deposits. This was a huge strength when the crisis came in 2007.

It may already be included within the analysis that we are undertaking, but the following deposit analysis by branch (which should certainly be available given the information requirements for completing the ILA);

(1) Aggregate balances on current account & number of customers;
(2) Total of deposits of less than £85K;
(3) Total of deposits greater than £85K, which I would regard as completely "mobile".

This should indicate the "value" of each branch in total from a deposit point of view and also the likely vulnerability/attrition. Demography also plays a key role in deposits at branches and the 80:20 rule is usually evident.

On the asset side, I worry about the quality of the book not the volume, at £30bn a very small deterioration in the "modelled" loss expectancy will destroy our capital base. On the liability side, particularly with the large gap I worry about the volatility. The cost of raising retail deposits remains the biggest cost in personal banking & the most competitive. It used to be an 8.5:1 customer ratio on deposits to fund assets.

For me £1 of stable longterm deposits is worth around £5 of assets, on a not wholly scientific basis.

Rodney Baker-Bates

From: Rodney Baker-Bates <[redacted]>
Sent: 22 October 2011 11:50
To: Peter Marks [redacted]
Cc: Len Wardle [redacted]; Paul Flowers [redacted]; David Davies [redacted]; 'Moira Lees'
Subject: Project Mars

Dear Colleagues,

I thought we had a very open, informed and energised debate on Project Mars last week, particularly the final contribution from our advisers. As an aside, I am not sure Peter whether everyone present understood that whilst you opened by saying they had been working "pro bono" so far, if this transaction is completed by the Group they will earn fees of many millions.

However, I felt their contribution was wide of the mark on the key issue that greatly concerns me which is affordability at both the CBG and now I am better informed at the Group level. Although,I still have substantial concerns about the risks around the Mars integration and management capability and stretch, following the joint meeting affordability is now the central and pressing issue for me.

The advisers core approach to the valuation of this opportunity is built around a multiple of book value at acquisition and forecast forward against purchase price, which is standard for banking acquisitions or mergers. This is critical to a Plc which is issuing shares/debt & understanding the market's likely valuation of the acquisition against future earnings and the current share price and future growth. However, as a mutual, our priorities are very different.

I would fully agree with the advisers and our executive colleagues that within the range of offer prices being suggested this is financially a compelling transaction, on the key assumption that the buyer has the capability to deliver the forecast growth and synergies, and the capital strength to withstand market and regulatory adversity. However, this approach does not answer the fundamental question whether the Group can afford the price and if it should make an offer what price the Group can afford & with what protections.

The new and very important information for me in the Board pack was the forecast of Group earnings and debt trends over the next seven years, which showed very clear pressure on cashflow and borrowing covenants even without Project Mars. I think that these forecast now need to be updated to include both the expected 2011 outturn for all Group businesses particularly food and the draft budget and forecasts for 2012 -2015. Project Mars will succeed or fail in the next five years.

The other piece of information which startled me, although it was not in the pack, but I had seen earlier in the CBG board papers and David raised at the meeting was the current estimate of £750 million for the pension fund deficit. I accept this is an estimate of a future liability and an "accident of timing" on the triennial valuation, in several situations where I have been involved recently the partial resolution has involved the immediate transfer of substantial cash or assets to the fund.

My assessment of future regulatory & capital requirements; the likely "commoditisation" of many banking services undermining the ability to build long term customer relationships; and the pressure on interest margins from competition leads me to question strongly the ability of the Banking Group alone to create the retained earnings to build towards the requirements of Basel 2; service through dividends to Group substantial levels of new debt; and cover Group cost & the "member dividend" for product purchases.

The Chairman kindly suggested that the IPNEDs brief the advisers on their questions in preparation for the meeting on November 4th & this happened in a quick "huddle" with them before lunch. The advisers offered and its was welcomed by the IPNEDs that they would meet with us and share their draft presentation to ensure that they covered all the various points raised by colleagues.

My points to the advisers were;

(1) Affordability both at the CBG and Group level is and remains a central and very worrying issue for me;
(2) The executive and advisers needed to agree and then put forward a single, well argued, recommendation for the price to be offered & the protections required;
(3) Any recommendation on price must then be reverse stress tested, using the updated forecasts both at the CBG level and Group level, to the point where CBG is unable to upstream any dividend and at the Group level (including the Group on a consolidated basis) where covenants are breached and no member dividend is payable;
(4) For this reverse stress test to be credible, we need to have some guidance from the FSA on their expected annual growth path for Core Tier I capital within CBG over the next five/seven years both with and without Project Mars. Regulatory capital as mandated by the FSA has a prior claim over all other distributions. As a further aside there was a discussion at the subsequent CBG board re the sale of CISGIL as a source of funds for Project Mars. As our Tier 1 ratio is currently below 10%, there must be a strong possibility that the FSA would want this capital to be immediately available to strengthen the pre Project Mars ratio, and thus not counted in the financing of any up front payment.

Following the board meeting, my position has hardened and remains one of deep concern at the risks this transaction could pose both to CBG and now the Group as a whole.

Regards Rodney

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Rodney Baker-Bates

From: Rodney Baker-Bates [redacted]
Sent: 22 October 2011 16:56
To: Ursula Lidbetter [redacted])
Subject: FW: Project Mars

Dear Ursula,

Always good to talk to you. It is comforting that I have a colleague on the Group board who from an early stage, shares my concerns on this project.

As promised I attach a silent copy of my note to Peter Marks and Barry Tootell, which I copied to Len, Paul & David Davies. I also called Paul Flowers this morning before I sent the e-mail to alert him. I also made the following private points to him:

(1) My concern that Peter appeared to have a vision (which is easy to share), but limited grasp of the detail. His enthusiasm and organizational power &personality seems to be driving the process. I have had several CBG executives privately express very valid reservations. As an aside, it is a pity they do not have the "guts" to express them in public forum:

(2) My alarm at the lack of understanding of business and specifically banking around the Group board table. This is a complex decisions, but the risks are clear enough. If completed the bank would completely dominate the Group through the sheer size of the balance sheet;

(3) Steve Huhne did not look at all relaxed & I thought was trying to put a more balanced case. He certainly more than caught my attention with his forecasts, but I was surprised (apart from Ben, Paul & yourself) no other Board member picked this up. I gather from Ben & yourself that these forecasts were "new news"

(4) Martyn Wates who should have a better grasp than most of the Group financial position was vague & indecisive in his comments;

(5) My concern that, if the CBG board recommend this decision (and the Group supported it), the FSA could aggressively reject. This would create doubts in their mind about the rigour of the challenge at the CBG board & the quality of the corporate governance. They could become very intrusive.

Paul fully shares & understands my concerns. His view this morning was that an offer will not be supported at the CBG board on November 4th & the Group board was highly unlikely to overrule that. If it did the governance consequence could be challenging!

I will be at home on Monday afternoon if a call would be useful.
Regards & hope that you had a good weekend

Rodney

Rodney Baker-Bates
[redacted]
Tel[redacted]Fax[redacted]
Mobile:[redacted]
e-mail:[redacted]

From: Rodney Baker-Bates [redacted]
Sent: 22 October 2011 11:50
To: Peter Marks [redacted]; David Davies
Cc: Len Wardle [redacted] Paul Flowers [redacted]

[redacted]'Moira Lees'
Subject: Project Mars

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However, I felt their contribution was wide of the mark on the key issue that greatly concerns me which is affordability at both the CBG and now I am better informed at the Group level. Although,I still have substantial concerns about the risks around the Mars integration and management capability and stretch, following the joint meeting affordability is now the central and pressing issue for me.

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Regards Rodney

Rodney Baker-Bates
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e-mail:[redacted]

Rodney Baker-Bates

From: Rodney Baker-Bates [redacted]
Sent: 13 November 2011 16:08
To: Len Wardle [redacted]; Paul Flowers [redacted]
Subject: Three Questions for the Chairmen

Dear Len & Paul,

Project Mars has, over the last months, forced me to think long and hard not only about the opportunities, challenges and capabilities of the bank but also the wider Group both now and into the future.

Clearly my knowledge of the Group is very incomplete, however what information and analysis I have been able to acquire has been helpful. I have also had the opportunity of two joint meetings with the Group board as well as a series of offline conversations with yourself; Paul; CBG IPNEDs and other Group board members.

On Project Mars. the price now proposed, the absence of a "funding gap" & the protections and term to be built into the hybrid debt have overcome some strong initial and still remaining concerns judging the transaction at the CBG level. These concerns are both broad and specific from the current bleak and likely future economic slow growth globally, in Europe and within the UK; the increasing impact of regulation; the product and service homogenisation with the UK retail banking driven by the IBC report; the likely impact of rapid technological change on customer relationship development; finally to the ability of the current CBG management to deliver the returns expected in a difficult and increasingly competitive environment.

At the Group level, until the first joint meeting, I was not aware of the full and increasing level of gearing within the Group balance sheet nor the current performance challenges within both food and pharmacy. This perspective clearly led me in the final discussions on November 4th to focus my comments on the overall affordability of the transaction to the Group and the increasingly challenging UK market in both the food and retail banking sectors.

On Thursday evening last week before the board, I looked back over the various papers and my own notes and realised that whilst I had been focussing on the transaction both at the bank and Group level and expressing my concerns in that context, I had much broader concerns for the Group beyond the specifics of Project Mars.

I expressed these deeper concerns at the Group board by asking it's members to form their view on Project Mars in the context of whether over the longer term the Group had (or could obtain) the leadership structure, resources and capability to prosper as a distant fifth in two of the most competitive retail markets in the UK.

I realised that my own views on Project Mars were set within the context of this strategic question on which I had developed my thinking by posing three questions:

(1) Does the concept of a "compelling co-operative alternative" offer an economically sustainable alternative in two key markets (banking & food) where price and quality are key drivers: and what does that alternative mean to the customer on the shelf, at the counter, through the internet and on the telephone?
(2) Does the Group and the individual businesses have the executive leadership capability to learn, adapt and innovate in the much more economically and socially challenging decades that are likely to be the future?
(3) Does the Group board have the breadth and depth of experience to lead through challenging and holding executive management accountable as well as the strength and will to make difficult decisions in the face of adversity ?

I thought it might be helpful to share my conclusions with you. If nothing else, it will enable you to have a better understanding of my continuing concerns for the future competiveness both of the Bank and the Group.

On the first question, whilst I can articulate the co-operative alternative (member ownership and direction; ethical & fair trade with suppliers; community involvement and investment), I would be hard pressed to express these persuasively in terms that would be substantially different from where our larger competitors aim to position themselves at the individual supplier, shop, branch or telephone conversation level. If the Group, particularly in banking and food, is to prosper as a clear alternative then the customer needs to understand, agree and invest in that difference with every transaction not only as clear principles of Group & bank behaviour but as a practical and visible benefits at the transaction level. I give two recent market examples, although you may not regard them as direct competitors, where that difference has been understood and successfully implemented.

First, Waitrose although even smaller that than the Group in the food market have been highly successful in defining a unique & sustainable alternative in food retailing. Their impact on Saxmundham, (a shop bought out of the Sommerfield estate), our historically rather run down local market town has been nothing short of astonishing. A decrepit Sommerfield has become their busiest and most profitable smaller shop in less than three years, with an increasingly positive impact on the town as a whole. They appear to have retained all the local Sommerfield customers as well as reached out to a much larger new customer base. Tesco are now building an express directly opposite. I will be interested in gauging the impact of this, if any.

Second Hoare's Bank, where over the last decade, the service proposition has been modernised and relationship management reinvigorated so that they now face the challenge of turning away politely many of the customers who wish to switch to the bank. Both these businesses have a clearly stated alternative and attractive strategies that are understood by their current and prospective customers and are visibly experienced at the point of delivery. Also, like the Group neither has the shareholder dividend structure of their mainstream and hugely larger competitors.

On the second question, I have been involved over the last decade with six businesses that have either supplied or competed against various businesses within the Group. I also have had the experience of being on the board on CBG & participation at the Group. This has allowed me to form a personal view of the quality of executive management. I have also had the benefit of comments from management within the other businesses I am & have been involved in.

There are always exceptions, but the overall view I have formed is that the executive management is below average for the aspirations you both have for the Group. Specifically, it does not look critically at business & market performance against the competitors; much of the thinking is internally focussed; a belief that the "co-operative way" is economically as well as emotionally better; is a slow follower in many areas; is unreceptive to new ideas and with a strong "not invented here" bias.

I am encouraged that opportunities are now arising to attract new talent to both food and the bank, and elsewhere in the Group. The appointment of new leadership will be an acid test at the Group and individual business level of the ability to attract, retain & motivate talent. I have heard concerns that top talent cannot be rewarded adequately within the Group. I believe this challenge can and must be solved if we are aiming for the "premier league". The Group must attract and retain leaders and managers of that quality. Sadly, I think we have been and are still paying too much for at best average performance.

On the third question, my two meetings with the Group board have not been encouraging. Although all claim leadership and espouse the interests of the Group as a whole, I perceive a number of serious challenges:

(1) The lack of broad business expertise relevant to the aspirations and complexity of a major UK retail conglomerate. This is most clearly evident in the lack of financial & accounting expertise;
(2) A clearly visible and but often privately expressed distrust of the executive management, which is reciprocate by a strong sense of disdain on their part. I do not know exactly what happened at the July strategy meeting, but I heard words like "sham"; "pre-ordained outcome"; "hoodwinked". There are also very deep divisions about the success, or otherwise, of the Sommerfield acquisition and the likely outcome of the Thomas Cook travel joint venture;
(3) Decisions & views are driven more by an individual political agenda than by objective analysis; understanding and open discussion of the economic alternatives, and a common and shared sense of the long term strategic direction for the Group. Politicians are proven, beyond reasonable doubt, to be poor (or worse) decision makers where matters of business are concerned!

I was encouraged that a number of members of the Group board appreciated the value of having IPNED's in their deliberations of Project Mars. My strong recommendation is that business understanding; informed discussion, debate & decision making at the Group board would be markedly improved by the inclusion of strong and experienced IPNEDs. I suspect executive management would find the Group board experience much more testing assuming high quality independent IPNEDs were present. I fully understand that such a change may take time, but improving the quality of understanding and debate seems both urgent and vital to future success.

Immediately however you need to tackle both the clear differences of opinion about the future direction of the Group as well as the visceral distrust between management and the board. I have had experience of a divided board on three separate occasions. All led to substantial underperformance and loss of "owner" value, great stress for all those involved and in one case the takeover and disappearance of the whole business.

You may feel that this note is strongly negative in tone & does not acknowledge the rejuvenation of the Group in recent years. I fully acknowledge and applaud this improvement. My deep concern is that it was achieved against a benign economic background both globally and within the UK. Over the last two years, the long term economic outlook in the UK & Europe has become much tougher. Political leadership is woeful (of every brand), and this is combined with a seismic shift in economic leadership and power from Europe (and increasingly the USA) to the developing nations. I see in retrospect the 90/00's decades as being almost a "golden age". In the UK our competitors (even the banks) will fight hard to recover their market position and profile in the market & new competitors will emerge to challenge incumbents who are slow to respond to rapid technological & social change.

As Warren Buffet put it so prosaically "When the tide goes out, it exposes those who are swimming naked". This has manifestly been true across a wide spectrum of the UK & Europe. My belief is the tide will "stay out" despite the best (or worst) efforts of the political & technocratic leadership. In this situation both the strategic and operational leadership has to be the very best.

I would hope that our mutual respect will allow you to see this e-mail for what it is, and honest assessment of the strategic challenges facing both the Group and the bank from a committed and concerned IPNED. I believe strongly, and encourage it elsewhere, that it is the role of an NED to articulate concerns and suggest solutions both within the board and outside as appropriate.

This e-mail has taken me some time to write & has been through several revisions. I have summarised with care a considerable amount of thought, analysis, experience and personal expertise. I would be more than willing to discuss my thoughts and ideas in greater detail but that is your call. My aim has been to give you both an honest assessment of some deep concerns arising from my experience both within & without the Group over the last three years.

Regards Rodney

Rodney Baker-Bates

From: Rodney Baker-Bates [redacted]
Sent: 18 February 2012 18:44
To: Len Wardle [redacted]; Paul Flowers [redacted]
Subject: Strategy Day Afterthoughts

Dear Len & Paul,

I appreciated the opportunity to join the Group Board strategy discussion as an observer. I fully support the conclusions reached. Strategically, if the Group aims "to excel at all it does" in the highly competitive commercial world the emphasis needs to be scale; exploiting competitive advantage; customer & market segmentation; leadership commitment; clarity of offering; and skill and experience. It seems very clear to me that the Group needs to simplify and concentrate on the markets in which it has scale & capability.

In the two core markets of food & banking (even after Project Mars) our scale will be insufficient to achieve the economies of scale available to our larger competitors. Our strategy should be to achieve scale, dominance (or both) in chosen market and customer segments. In this regard, the Jill Barr work is critical, but so far does not seem to have reached a conclusion. The Group has customer share in each of the six segments she identified, but the Group does not have the capability to be successful across each segment. The difficult challenge is to narrow the target customer segment, and achieve dominance by meeting their needs, whilst bigger competitors are trying to serve all segments and thereby dispersing their resources.

For the Bank, I see the natural customer segment as middle and lower income families who look for simple & "value priced" priced products that meet their core needs. This is the way the FSA wants to drive the whole industry, but this will result in lower margins and profits. Over the last decades, banking profits have been driven by complex, high margin investment and insurance products. I hope the new Finnacle system will give us the capability to distribute simple, value products on a scale comparable with our much larger competitors. I have the same view on CIS which has a good name & competes in the core are of house, contents & motor insurance. The emphasis for every product must be simplicity (meeting the core need well). Complexity adds cost in marketing; distribution and processing, as well as leaving us open to possible "mis selling" claims. Project Mars will give us the add and necessary advantage of convenience from a branch view. On food, it seems to me that we have broadly the same criteria & values. We may have customers from other segments who also find our offering whether in banking or food attractive, but that is an added bonus rather than a market objective. The difficulty will then be on deciding what we are not going to do, broadly the subject of the strategy day. However, we need to be determined as are resources are too constrained to be anything other than highly focused.

On farming & farm land ownership the two key questions are now on the table. On farming, long personal experience shows this is an industry dominated by successful individuals rather than institutions. It is highly volatile in terms of returns, requires ownership (as opposed to managerial) commitment, and depends critically on the growers ability which is often crop specific. Security of supply for the buyer/consumer comes from long term mutually beneficial relationships with financially strong growers.

On farm land, prices have risen very substantially over the last decade fuelled by the arbitrage between UK & Europe prices as a result of the strengthening Euro. At Shropshire's we are currently looking at buying a substantial block of land from the Mormons (who bought heavily in the UK in the 1980's). The buyers challenge is that at current price levels even with a 15 year AMC mortgage, productions yields are not sufficient to repay the capital. For me this indicates currently a seller's market, with a "bubble" that may run for another one/two years. In the medium term the growing margin must rise or land prices start to fall (or both).

On pharmacies, I am less sure. It is a strongly needed (by our core customer segments) and used "community service" which I see as a fundamental strength of the Group. I am not close to the business but suspect that it could be better run, particularly on the sourcing side and improving OTC sales. There is always going to be sustained downward pressure on drug margins which puts a premium on quality management, however this is offset by the restrictive licensing regime which limits competition. My current bottom line is we need to try harder.

Finally, we did not discuss Legal Services but I think our strategy here needs to be carefully thought through & gradualist. My sense is we need to "white label" simple core services which "our" customer segments need, and which can be distributed particularly through the bank . The history of large institutions piling in, and that seems inevitable with 96 known applications for ABS licences, to previously closed shop markets is that too much capital chases to little demand. Also there was absolutely no chemistry or understanding between the existing market participants and the "new" investors. Although different the opening up of stockbroking & estates agents in the 1970/80's to outside capital both resulted in very substantial losses for most of the early entrants.

As always happy to discuss further if that would be useful.

Regards Rodney

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Mobile:[redacted]
e-mail:[redacted]

Rodney Baker-Bates

From: Rodney Baker-Bates [redacted]
Sent: 28 May 2012 18:24
To: Paul Flowers [redacted]
Cc: David Davies [redacted]
Subject: Project Mars

Dear Paul,

My apologies for intruding on what I expect will be a very difficult week for you. I hope by using email you can make the active choice to read this when you wish.

I fully accept Len's challenge that the current situation re the bank is " very taxing", but I remain to be convinced that Project Mars is the solution. As my Chairman I wanted you to be fully aware of my views as I have a strong sense that Len & Peter have already come to a positive conclusion. I have copied this email to David with whom over the last months I have discussed my concerns.

On the way back from Manchester I reviewed my previous notes & the discussion on Friday. Before the meeting I had three key concerns, protection against conduct risk in the existing portfolio; "living with Lloyds"; and board and management capability to achieve the forecast outcomes.

I now accept that we can provide reasonable legal mitigation against conduct risk through the Sale & Purchase Agreement (SPA); "living with Lloyds" can also be covered contractually. I also believe that over the next decade the need for all UK retail banks to develop Recovery & Resolution (R&R) plans could create an independent provider market for the outsourcing of core banking systems. It is not impossible that a common independent utility may be developed for all banks as the sensible solution to the regulatory challenges posed by R&R plans.

On management capability, I remain deeply concerned. In any major acquisition, the assessment of the management being "acquired" is the critical criteria to any proper evaluation of likely future success. However, this is the one area on which the papers we have received so far at the Board are totally silent. I gather from a post Group board conversation with Anne that we do not yet know what management structure or capability is being proposed by Lloyds. I also assume that at the more senior levels this will be a matter of individual choice. Yet the CBG board are soon to be asked for approval to enter into an SPA to acquire a "carved out bank" with no independent management or leadership track record which can be independently evaluated, which is five times the size of the bank currently being managed by the existing CBG leadership team. As I said at the board, this is a complete "blank page" to me but fundamental to making any considered judgement as an NED.

Our current management is clearly stretched managing the existing business, and in parallel completing the Project Mars transaction. My confidence in this management team and the Board's ability to exercise oversight on this investment was badly shaken by the revelation in March of both the cost "blow out" for integration under Plan A, and the capability shortfalls and cost increases of the "vanilla" Plan B.

In addition, underlying operating performance at CBG is weak and being bolstered by one off "events" (liquidating profitable treasury positions etc), which will only exacerbate the challenge to improve future profitability. There have been a number of high level departures & Rod the architect of Plan C still expects to move to head the new Legal Services business. The FSA has also highlighted this key challenge.

At the meeting PM said "we will also be taking on the Lloyds management team", this suggests to me that he has made a judgement on their ability. Has the negotiating team additional information not seen by the board to make such a judgement? At this moment I have no basis for making any judgement.

Finally, I continue to have an overarching concern whether the Group has the capital resources and management leadership and depth in the long term to succeed as the fifth ranked and smallest competitor in two of the most capital hungry and competitive retail markets in the UK, food and banking.

In banking the combination of Vickers and the FCA will , over the next decade, force banks to carry higher levels of capital but for the services and products offered to be standardised, clear and simple. Their aim is to tip the balance decisively in favour of the consumer through regulation down to the product level. My own view is that in the mass retail market this will reduce choice but also price since the range for competition (other than on price) will be very narrow. Differentiated customer service is hard to deliver cost effectively in such a market. In such a market scale becomes even more critical, so I forecast further consolidation.

If I had confidence in the management capability this would be a clear mitigant to this longer term risk. I covered my concerns on this across the Group in an earlier email.

I hope the coming weeks are not too stressful and my thoughts are with you at this difficult time

Regards Rodney

Rodney Baker-Bates
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Tel[redacted]Fax:[redacted]
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e-mail:[redacted]

Rodney Baker-Bates

From: Rodney Baker-Bates [redacted]
Sent: 12 June 2012 22:51
To: Paul Flowers [redacted])
Cc: David Davies [redacted]
Subject: Project Mars

Dear Paul,

My apologies for not being with you & the board this evening. David, very helpfully, summarised his concerns re Project Mars & I know you will be discussing this and the current "state of play" with him.

I thought it would be helpful to summarise my position, which only differs from David's more in emphasis than substance. I know that you (and I hope the Board more generally) are aware of my concerns but I share some of David's reluctance re a full discussion with management present, who seem less and less objective about the risks & occasionally trite (at a minimum) in their replies, particularly Peter.

My major concerns are the UK economy & likely future regulatory environment; branch delivery and profitability; scale & stretch both for the Bank and Group; the Lloyds "partnership"; leadership, management culture and depth:

(1) In the short term (and that maybe for some time) the UK & European economies are likely to be very weak and if the Euro disintegrates thrown into turmoil. Low interest rates which are a "killer" for profitability will remain low or go even lower. In the medium term the combination of Vickers and the FCA will fundamentally change the framework of retail and smaller corporate banking. Regulation will both drive up equity capital requirements and simplify product and service design to increase transparency and to simplify and standardised delivery.
(2) Against this background, like David I am increasingly questioning the relevance of branch delivery. The ability of banks to differentiate through product or service design will be limited through product simplification. Non branch delivery is likely to be the standard within a decade Price is likely to become the key competitive weapon and scale even more important;
(3) On scale, although Mars will increase our market share to approx. 5%, it still leaves the Bank as fifth/sixth behind the "big four" and Nationwide. I have very real concerns whether the Group has the capital and other resources available to sustain a successful presence in two highly competitive markets in fifth position behind four much larger and capital strong competitors;
(4) Lloyds are only considering the transaction, and a longterm partnership because they are required to do so by Brussels. We are requiring very tight warranties for pre-acquisition "behaviour", and post acquisition infrastructure and systems service provision. However, this partnership is critical to our success and we are exercising our strength at this stage. I believe that once completed these arrangements could well lead to resentment, tension and sub optimal performance where the final resort is to the courts;
(5) Finally leadership and management, I like David have been very disappointed in the way the strategic direction has shifted over the last six months through Plan A; B and now C. We are still a long way from completing the successful integration of Britannia, a substantially smaller task. They have lost credibility, and deeply undermined my belief in their ability to deliver Mars or truly understand the challenges that face them. We have the Lloyds management who will come with the transaction but they are an unknown quantity and have no objective performance track record (since this is a carve out). Finally, as David points out, if the Britannia merger is any indication the Bank has difficulty in absorbing "external" senior management.

I hope none of this is new to you but it is important that as my Chairman you know the direction of my thinking as we approach the deadline for a final decision.

Regards & see you tomorrow.

Rodney Baker-Bates

From: Rodney Baker-Bates [redacted]
Sent: 13 July 2012 13:39
To: Ursula Lidbetter [redacted]
Subject: Project Mars

Dear Ursula,

Thanks for the call. Sent as written. I will call around 14.00

You will probably be aware by now that the CBG board is recommending the HoT for Project Mars to the Group board next Monday. It was passed on a majority (12:2) with two dissents David Davies & myself.

Everyone had an opportunity to speak and a number of the other IPNEDs I would say are certainly cautious though voting in favour.

What is particularly difficult (at least for me), in terms of management credibility, is that the financial & risk analysis now shows Plan B as both riskier and worse than Plan C. However until November last year this plan with Finnacle implimentation etc. was being strongly supported by both CBG and Group (PM's "Ferrari"!). Plan C has emerged only once it became clear that the revised costs of Plan B destroyed the Project Mars business case.

However, management credibility is only one part of my argument. The is both a very challenging economic and an extremely intrusive and aggressive regulatory environment for banks. Can the general environment get any worse for banks? There are a range of transaction risks which are positively daunting conduct; "living with Lloyds"; maintaining two parallel bank organizations with management, functional and operational overlaps (which will result in substantial redundancies in due course) for eighteen months; and the cultural risks once the banks are merged. The Britannia/CBG merger has not been a success story on that front.

Finally, although the price is very attractive the CBG capital ratio is very stretched and will need accounting engineering by KPMG. It is almost certain that GI will need to be sold & we need the Jupiter transaction capital as well. Given that the FSA is also reviewing the ICAP etc, I think the bank will need £500 + mill. additional capital over the next three years.

This of course brings the argument full circle to where does the Group want to put it's scarce capital. I wonder how many of your colleagues thought about this when they agreed to remain a participant I food (5th) and banking (6th), two of the most capital hungry and competitive (and in banking, regulated) markets in the UK at the time of last year's strategy review. A point that Len keeps reminding everyone.

Interestingly, after the meeting several colleagues said they understood my arguments but still voted in favour, Group think? What is abundantly clear is that Len, Paul & Peter want to do this deal and seem to be "deaf" to objective risk analysis. I know there is great "political" support but so there was for the original HBOS/Lloyds deal which brought Lloyds to its knees and is why this is all happening.

Neither David nor I will be at the Group board so I thought I would at least share my concerns with you. David's comments were broadly similar. What is certain is that if/when Project Mars completes, banking will dominate the Group financially (if not in the eyes of the ordinary member). It will change the nature and direction of the Group irreversibly and I believe will force the exit from food over the next decade. I do not believe the Group will be able to generate the returns to stay in both markets.

At the end of the meeting (my last board) Paul made some nice remarks which I appreciated. I believe my contribution has been valued even if I have stood against the tide. In my thanks I said I hoped I was wrong and wished the board every success for the future of the Group but sadly I believe I am right.

I am at home over the weekend (below) and Monday Am. I will also be at the Group strategy meeting joining the dinner on Tuesday night.

Regards Rodney

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